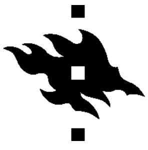



# Equity Decoupling

University of Helsinki

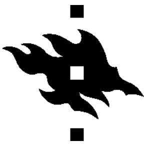
Faculty of Law

Securities Markets and Company Law

Master's Thesis

Antti Luhtala

November 2014





| Tiedekunta/Osasto Fakultet/Sektion – Faculty<br>Faculty of Law | | Laitos/Institution– Department<br>- |
|---|---|---|
| Tekijä/Författare – Author<br>Antti Luhtala | | |
| Työn nimi / Arbetets titel – Title<br>Equity Decoupling | | |
| Oppiaine /Läroämne – Subject<br>Securities Markets and Company Law | | |
| Työn laji/Arbetets art – Level<br>Master's Thesis | Aika/Datum – Month and year<br>November 2014 | Sivumäärä/ Sidoantal – Number of pages<br>XXV + 100 |



Tiivistelmä/Referat – Abstract

This thesis employs the law and economics method and explores the topic of equity decoupling, which refers to the separation of the control and economic rights of shares. It is the aim of the thesis to answer the questions of what has driven the equity decoupling phenomenon and how has equity decoupling changed the key fundamental paradigm that control rights and cash-flow rights of shares are inseparable. Furthermore, answers are also provided to the questions of what kind of implications do the new developments have, how have regulators responded and how should they respond to the new developments.

The research questions are answered by first discussing the basics of corporate theory: what is a corporation, why does it exist, what are shares and what are the properties of shares. It is argued that the two main components of shares, control and economic rights, have in traditional corporate theory been considered inseparable. Since then, a shift in this fundamental paradigm of corporate law theory has occurred. This paradigm change has led to circumstances under which investors are able to separate control and economic rights and trade these components in the financial markets.

Two main drivers have driven the paradigm change. Firstly, marketization and complete market developments have resulted in an economic environment in which everything is tradable and liquid. This driver has provided the supply of equity decoupling. Secondly, changes in the theory of investment and ownership structures have resulted in the dominance of financial intermediaries. The concentration of ownership under well-diversified financial intermediaries has resulted in undervaluation of governance rights. This undervaluation has been targeted by activist investors, who have taken the role of gap-fillers in corporate governance. The activist investors' need for empty voting and hidden ownership, the two subcategories of equity decoupling that can be described as different sides of the same coin, have been the creative force behind the demand for equity decoupling.

Equity decoupling strategies may have both positive and negative effects in terms of economic efficiency. Thus far the academic literature has, however, mostly focused on the possible detrimental side of equity decoupling by adopting an approach that is too narrow. At the same time, some commentators have failed to understand the paradigm change behind the equity decoupling phenomenon. This thesis embraces the possibility that equity decoupling may under certain circumstances be efficient and therefore desirable. In this light, a critical analysis of the proposed and already taken regulatory actions is provided. The conclusion of this thesis is that it should be carefully considered whether equity decoupling should be regulated at all and, if so, to what extent. It is possible that the positive effects of equity decoupling outweigh the negative ones. Thus, equity decoupling may be efficient in terms of social welfare.



| Avainsanat – Nyckelord – Keywords<br>securities markets – shareholder activism – hedge fund – equity decoupling – empty voting – hidden ownership |
|---|
| Säilytyspaikka – Förvaringställe – Where deposited<br>Faculty of Law library |
| Muita tietoja – Övriga uppgifter – Additional information |

# CONTENTS

CONTENTS ..... I

BIBLIOGRAPHY ..... V

Literature ..... V

Edited publications ..... VI

Academic journals and working papers ..... VIII

Newspapers, magazines, blogs and other articles ..... XX

Official sources ..... XXII

Case law ..... XXIII

ABBREVIATIONS ..... XXIV

1 INTRODUCTION ..... 1

1.1 Background of the topic ..... 1

1.2 Research question and limitations of the study ..... 4

1.3 Methodology ..... 6

1.3.1 Law and economics ..... 6

1.3.2 Legal dogmatics ..... 8

1.3.3 Comparative law ..... 9

1.4 Structure ..... 10

2 CORPORATION AND SHARES .......... 11
2.1 Foundations of a corporation .......... 11
2.1.1 Core characteristics of a corporation .......... 11
2.1.2 Theories of corporation in law and economics .......... 13
2.2 Nature of shares .......... 16
2.3 Basis for shareholder voting rights .......... 18
2.3.1 Uniformity of interests .......... 18
2.3.2 Need for protection .......... 19
2.3.3 Residual interest .......... 19
2.4 Share indivisibility and distribution of economic and control rights .......... 21
2.4.1 Share indivisibility and general assumption of rights distribution .......... 21
2.4.2 Analysis of rights distribution among shareholders .......... 23
2.4.2.1 Economic risk and control rights .......... 23
2.4.2.2 Private benefit extraction .......... 25
2.4.2.3 Control rights and management monitoring .......... 26
2.4.2.4 Transaction costs .......... 27

3 CHANGING LANDSCAPE OF SHARE OWNERSHIP .......... 30
3.1 Changes brought by new financial innovation .......... 30
3.2 Drivers of change .......... 32
3.2.1 Marketization and complete markets – supply of equity decoupling .......... 32
3.2.2 New agency capitalism – demand for equity decoupling .......... 37
3.2.2.1 Traditional agency problem .......... 37
3.2.2.2 Investment intermediaries .......... 38
3.2.2.3 Shareholder activism .......... 40

4 EFFECTS OF EQUITY DECOUPLING .......... 45
4.1 Mechanics of empty voting .......... 45
4.2 Mechanics of hidden ownership .......... 47
4.3 Understanding the problematic nature of equity decoupling .......... 49
4.3.1 Empty voting .......... 49
4.3.2 Hidden ownership .......... 52
4.3.2.1 Problem of hedging structures .......... 52
4.3.2.2 Mandatory ownership disclosure rules .......... 53
4.3.2.3 Mandatory bid rules .......... 58
4.4 Possible benefits of equity decoupling .......... 59
4.4.1 Empty voting .......... 59
4.4.2 Hidden ownership .......... 69
4.4.2.1 Issues of management and controlling shareholders .......... 69
4.4.2.2 Information acquisition, aggregation and decision-making .......... 70

5 REMEDIES FOR DEALING WITH EQUITY DECOUPLING .......... 75
5.1 Current rules and regulatory actions to date .......... 75
5.1.1 Nordic countries .......... 75
5.1.2 United Kingdom and Germany .......... 77
5.1.3 Amendment of the Transparency Directive .......... 78
5.1.4 United States .......... 80
5.2 Suggested future remedial approaches .......... 83
5.2.1 Non-regulation .......... 83
5.2.2 Self-regulation .......... 85
5.2.3 Increased disclosure and transparency .......... 87

5.2.4 Bans and alternations of voting rights ................................................................ 88

5.2.5 Expansion of fiduciary duties and liability for damages .................................... 90

5.3 Critique and new aspects ........................................................................................ 91

6 CONCLUSION ........................................................................................................... 99

# BIBLIOGRAPHY

## Literature


| | |
|---|---|
| Berle and Means 1932 | Berle, Adolf A. Jr. – Means, Gardiner C.: *The Modern Corporation and Private Property*. The MacMillan Company, 1932 New York. |
| Hart 1995 | Hart, Oliver D.: *Firms, Contracts and Financial Structure*. Clarendon Press, 1995 Oxford. |
| Ihamuotila 1994 | Ihamuotila, Mika: *Corporate Ownership, Capital Structure and Investment: A Theory and Evidence*. Helsinki School of Economics and Business Administration, 1994 Helsinki. |
| Kaisanlahti 1999 | Kaisanlahti, Timo: *Sidosryhmät ja riski pörssiyhtiössä*. Edita, 1999 Helsinki. |
| Kraakman et al. 2009 | Kraakman, Reinier H. – Armour, John – Davies, Paul – Enriques, Luca – Hansmann, Henry B. – Hertig, Gérard – Hopt, Klaus J. – Kanda, Hideki – Rock, Edward B.: *The Anatomy of Corporate Law: A Comparative and Functional Approach*. Second Edition. Oxford University Press, 2009 Oxford. |
| Mähönen and Villa 2006 | Mähönen, Jukka – Villa, Seppo: *Osakeyhtiö I: Yleiset opit*. WSOYPro, 2006 Helsinki. |
| Posner 2003 | Posner, Richard S.: *Economic Analysis of Law*. Aspen Publishers, 2003 New York. |

Schouten 2012 — Schouten, Michael C.: *The Decoupling of Voting and Economic Ownership*. Uitgaven vanwege het Instituut voor Ondernemingsrecht, Rijksuniversiteit te Groningen, deel 88, 2012 Amsterdam.

Taipalus et al. 2003 — Taipalus, Katja – Korhonen, Kari – Pylkkönen, Pertti: *Arvopaperistaminen*. Suomen Pankki, 2003 Vammala.

Timonen 1997 — Timonen, Pekka: *Määräysvalta, hinta ja markkinavoima. Julkisesti noteeratun yrityksen määräysvallan siirtymisen oikeudellinen sääntely*. Gummerus, 1997 Jyväskylä.

Vahtera 2011 — Vahtera, Veikko: *Osakeomistuksen riski ja sääntely*. Lakimiesliiton kustannus, 2011 Hämeenlinna.

## Edited publications

Aarnio 1997 — Aarnio, Aulis: *Oikeussäännön systematisointi ja tulkinta*. *Minun metodini*. (edit.) Häyhä, Juha. WSOY, 1997 Helsinki.

Bebchuk et al. 2000 — Bebchuk, Lucian A. – Kraakman, Reinier – Triantis, George G.: *Stock Pyramids, Cross-Ownership and Dual-Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*. *Concentrated Corporate Ownership*. (edit.) Morck, Randall K. University of Chicago Press, 2000 Chicago.

| | |
|---|---|
| Kaisanlahti 1998 | Kaisanlahti, Timo: *Osakkeen jakamattomuus ja osakkaan äänioikeuden perusta*. Näkökulmia oikeustaloustieteeseen 2. (edit.) Kanniainen, Vesa – Määttä, Kalle. Lakimiesliiton kustannus, 1998 Helsinki. |
| Määttä 1999 | Määttä, Kalle: *Regulaatioteorian perusteita*. *Näkökulmia oikeustaloustieteeseen 3*. (edit.) Kanniainen, Vesa – Määttä, Kalle. Lakimiesliiton kustannus, 1999 Helsinki. |
| Partnoy and Thomas 2007 | Partnoy, Frank – Thomas, Randall S.: *Gap Filling, Hedge Funds, and Financial Innovation. New Financial Instruments and Institutions: Opportunities and Policy Challenges.* (edit.) Fuchita, Yasuyuki – Litan, Robert E. Brookings Institution Press, 2007 Washington, D.C. |
| Smith 1776a | Smith, Adam: *An Inquiry into the Nature and Causes of the Wealth of Nations*. *Volume I*. (edit.) Playfair, William. Pickering and Chatto Publishers, 1995 London. |
| Smith 1776b | Smith, Adam: *An Inquiry into the Nature and Causes of the Wealth of Nations*. *Volume II*. (edit.) Playfair, William. Pickering and Chatto Publishers, 1995 London. |

Smith 1776c | Smith, Adam: *An Inquiry into the Nature and Causes of the Wealth of Nations*. *Volume III*. (edit.) Playfair, William. Pickering and Chatto Publishers, 1995 London.

Vahtera 2007 | Vahtera, Veikko: *Osake ja ääni -periaate ja siitä poikkeaminen julkisesti noteeratussa yhtiössä*. *Oikeus, talous hallinto – Oikeustieteen päivät 30.-31.8.2007*. (edit.) Kultalahti, Jukka – Nuolimaa, Risto. Gummerus, 2007 Vaajakoski.

## Academic journals and working papers

Akhigbe et al. 2007 | Akhigbe, Aigbe – Martin, Anna D. – Whyte, Ann Marie: Partial Acquisitions, the Acquisition Probability Hypothesis, and the Abnormal Returns to Partial Targets. *Journal of Banking & Finance*, 2007, Vol. 31, No. 10, pp. 3080–3101.

Akerlof 1970 | Akerlof, George A.: The Market for "Lemons": Quality Uncertainty and the Market Mechanism. *Quarterly Journal of Economics*, 1970, Vol. 84, No. 3, pp. 488–500.

Alchian and Demsetz 1972 | Alchian, Armen A. – Demsetz, Harold: Production, Information Costs, and Economic Organization. *American Economic Review*, 1972, Vol. 62, No. 5, pp. 777–795.

Anabtawi and Stout 2008 | Anabtawi, Iman – Stout, Lynn A.: Fiduciary Duties for Activist Shareholders. *Stanford Law Review*, 2008, Vol. 60, No. 5, pp. 1255–1308.

Arrow and Debreu 1954 | Arrow, Kenneth J. – Debreu, Gerard: Existence of an Equilibrium for a Competitive Economy. *Econometrica*, 1954, Vol. 22, No. 3, pp. 265–290.

Barclay and Holderness 1989 | Barclay, Michael J. – Holderness, Clifford G.: Private Benefits from Control of Public Corporations. *Journal of Financial Economics*, 1989, Vol. 25, No. 2, pp. 371–395.

Barry et al. 2013 | Barry, Jordan M. – Hatfield, John W. – Kominers, Scott D.: On Derivatives Markets and Social Welfare: A Theory of Empty Voting and Hidden Ownership. *Virginia Law Review*, 2013, Vol. 99, No. 6, pp. 1103–1167.

Bebchuk and Jackson 2012 | Bebchuk, Lucian A. – Jackson, Robert J. Jr.: The Law and Economics of Blockholder Disclosure. *Harvard Business Law Review*, 2012, Vol. 2, No. 1, pp. 39–60.

Bebchuk et al. 2013 | Bebchuk, Lucian A. – Brav, Alon P. – Jackson, Robert J. Jr. – Jiang, Wei: Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy. *Journal of Corporation Law*, 2013, Vol. 39, No. 1, pp. 1–34.

Bebchuk et al. 2014 | Bebchuk, Lucian A. – Brav, Alon P. – Jiang, Wei: The Long-Term Effects of Hedge Fund Activism. *Columbia Law Review*, 2014, Vol. 114, forthcoming December 2014.

| | |
|---|---|
| Black 2012 | Black, Bernard S.: Equity Decoupling and Empty Voting: The Telus Zero-Premium Share Swap. *M&A Lawyer*, 2012, Vol. 12, No. 9, pp. 3–8. |
| Black and Kraakman 1996 | Black, Bernard S. – Kraakman, Reinier: A Self-Enforcing Model of Corporate Law. *Harvard Law Review*, 1996, Vol. 109, No. 8, pp. 1911–1982. |
| Brav and Mathews 2011 | Brav, Alon P. – Mathews, Richmond D.: Empty Voting and the Efficiency of Corporate Governance. *Journal of Financial Economics*, 2011, Vol. 99, No. 2, pp. 289–307. |
| Brav et al. 2008 | Brav, Alon P. – Jiang, Wei – Partnoy, Frank – Thomas, Randall S.: Hedge Fund Activism, Corporate Governance, and Firm Performance. *Journal of Finance*, 2008, Vol. 63, No. 4, pp. 1729–1775. |
| Brav et al. 2009 | Brav, Alon P. – Jiang, Wei – Kim, Hyunseob: Hedge Fund Activism: A Review. *Foundations and Trends in Finance*, 2009, Vol. 4, No. 3, pp. 185–246. |
| Chance 2004 | Chance, Don M.: Equity Swaps and Equity Investing. *Journal of Alternative Investments*, 2004, Vol. 7, No. 1, pp. 75–97. |
| Chattopadhyaya 2011 | Chattopadhyaya, Soumyadri: The Effectiveness of Being Invisible: Hedge Funds, Hidden Ownership and Corporate Governance. *European Company and Financial Law Review*, 2011, Vol. 8, No. 3, pp. 305–333. |

| | |
|---|---|
| Christoffersen et al. 2007 | Christoffersen, Susan E. K. – Geczy, Christopher C. – Reed, Adam V. – Musto, David K.: Vote Trading and Information Aggregation. *Journal of Finance*, 2007, Vol. 62, No. 6, pp. 2897–2929. |
| Clifford 2008 | Clifford, Christopher P.: Value Creation or Destruction? Hedge Funds as Shareholder Activists. *Journal of Corporate Finance*, 2008, Vol. 14, No. 4, pp. 323–336. |
| Clottens 2012 | Clottens, Carl: Empty Voting: A European Perspective. *European Company and Financial Law Review*, 2012, Vol. 9, No. 4, pp. 446–483. |
| Coase 1937 | Coase, Ronald H.: The Nature of the Firm. *Economica*, 1937, Vol. 4, No. 16, pp. 386–405. |
| Cohen 2008 | Cohen, Jonathan: Negative Voting: Why it Destroys Shareholder Value and a Proposal to Prevent It. *Harvard Journal on Legislation*, 2008, Vol. 45, No. 1, pp. 237–257. |
| Cuillerier and Hall 2011 | Cuillerier, Ian – Hall, Claire: CSX Corp. v. Children's Investment Fund Management (UK) LLP: Disclosure Requirements in the Context of Total Return Swaps. *Journal on the Law of Investment & Risk Management Products*, 2011, Vol. 31, No. 11, pp. 1–6. |

| | |
|---|---|
| Deeg 2009 | Deeg, Richard: The Rise of Internal Capitalist Diversity? Changing Patterns of Finance and Corporate Governance in Europe. *Economy and Society*, 2009, Vol. 38, No. 4, pp. 552–579. |
| Dent 2010 | Dent, George W. Jr.: The Essential Unity of Shareholders and the Myth of Investor Short-Termism. *Delaware Journal of Corporate Law*, 2010, Vol. 35, No. 1, pp. 97–150. |
| Dombalagian 2009 | Dombalagian, Onnig H.: Can Borrowing Shares Vindicate Shareholder Primacy? *UC Davis Law Review*, 2009, Vol. 42, No. 4, pp. 1231–1313. |
| Easterbrook and Fischel 1983 | Easterbrook, Frank H. – Fischel, Daniel R.: Voting in Corporate Law. *Journal of Law and Economics*, 1983, Vol. 26, No. 2, pp. 395–427. |
| Esö et al. 2014 | Esö, Péter – Hansen, Stephen – White, Lucy: A Theory of Vote Trading and Information Aggregation. *University of Oxford working paper*, 2014. |
| Fama 1970 | Fama, Eugene F.: Efficient Capital Markets: A Review of Theory and Empirical Work. *Journal of Finance*, 1970, Vol. 25, No. 2, pp. 383–417. |
| Fama and Jensen 1983a | Fama, Eugene F. – Jensen, Michael C.: Separation of Ownership and Control. *Journal of Law and Economics*, 1983, Vol. 26, No. 2, pp. 301–325. |

Fama and Jensen 1983b — Fama, Eugene F. – Jensen, Michael C.: Agency Problems and Residual Claims. *Journal of Law and Economics*, 1983, Vol. 26, No. 2, pp. 327–349.

Ferrarini 2000 — Ferrarini, Guido A.: Share Ownership, Takeover Law and the Contestability of Corporate Control. Company Law Reform in OECD Countries. A Comparative Outlook of Current Trends. *OECD Conference Proceedings*, 2000.

Fischel 1978 — Fischel, Daniel R.: Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers. *Texas Law Review*, 1978, Vol. 57, No. 1, pp. 1–46.

Flood 1991 — Flood, Mark D.: An Introduction to Complete Markets. *Federal Reserve Bank of St. Louis Review*, 1991, Vol. 73, No. 2, pp. 32–57.

Gilson and Gordon 2013 — Gilson, Ronald J. – Gordon, Jeffrey N.: The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights. *Columbia Law Review*, 2013, Vol. 113, No. 4, pp. 863–928.

Gilson and Gordon 2014 — Gilson, Ronald J. – Gordon, Jeffrey N.: Agency Capitalism: Further Implications of Equity Intermediation. *European Corporate Governance Institute (ECGI), Law Working Paper,* No. 239/2014.

| | |
|---|---|
| Gilson and Whitehead 2008 | Gilson, Ronald J. – Whitehead, Charles K.: Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets. *Columbia Law Review*, 2008, Vol. 108, No. 1, pp. 231–264. |
| Gompers et al. 2003 | Gompers, Paul A. – Ishii, Joy L. – Metric, Andrew: Corporate Governance and Equity Prices. *Quarterly Journal of Economics*, 2003, Vol. 118, No. 1, pp. 107–156. |
| Gompers et al. 2010 | Gompers, Paul A. – Ishii, Joy L. – Metric, Andrew: Extreme Governance: An Analysis of Dual-Class Companies in the United States. *Review of Financial Studies*, 2010, Vol. 23, No. 3, pp. 1051–1088. |
| Goshen and Parchomovsky 2006 | Goshen, Zohar – Parchomovsky, Gideon: The Essential Role of Securities Regulation. *Duke Law Journal*, 2006, Vol. 55, No. 4, pp. 711–782. |
| Grant et al. 2009 | Grant, Jeremy – Kirchmaier, Tom – Kirshner, Jodie A.: Financial Tunneling and the Mandatory Bid Rule. *European Business Organization Law Review*, 2009, Vol. 10, No. 2, pp. 233–253. |
| Grossman and Hart 1988 | Grossman, Sanford J. – Hart, Oliver D.: One Share – One Vote and Market for Corporate Control. *Journal of Financial Economics*, 1988, Vol. 20, No. 1, pp. 175–202. |

| | |
|---|---|
| Grossman and Stiglitz 1980 | Grossman, Sanford J. – Stiglitz, Joseph E.: On the Impossibility of Informationally Efficient Markets. *American Economic Review*, 1980, Vol. 70, No. 3, pp. 393–408. |
| Holmström and Tirole 1993 | Holmström, Bengt – Tirole, Jean: Market Liquidity and Performance Monitoring. *Journal of Political Economy*, 1993, Vol. 101, No. 4, pp. 678–709. |
| Hong and Stein 1999 | Hong, Harrison – Stein, Jeremy C.: A Unified Theory of Underreaction, Momentum Trading and Overreaction in Asset Markets. *Journal of Finance*, 1999, Vol. 54, No. 6, pp. 2143–2184. |
| Hu and Black 2006 | Hu, Henry T. C. – Black, Bernard S.: The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership. *Southern California Law Review*, 2006, Vol. 76, No. 4, pp. 811–907. |
| Hu and Black 2008 | Hu, Henry T. C. – Black, Bernard S.: Equity and Debt Decoupling and Empty Voting II: Importance and Extensions. *University of Pennsylvania Law Review*, 2008, Vol. 156, No. 3, pp. 625–739. |
| Husa 2007 | Husa, Jaakko: About the Methodology of Comparative Law – Some Comments Concerning the Wonderland. *Maastricht Faculty of Law Working Paper*, 2007/5. |

| | |
|---|---|
| Jensen 2001 | Jensen, Michael C.: Value Maximization, Stakeholder Theory, and the Corporate Objective Function. *Journal of Applied Corporate Finance*, 2001, Vol. 14, No. 3, pp. 8–21. |
| Jensen and Meckling 1976 | Jensen, Michael C. – Meckling, William H.: Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics*, 1976, Vol. 3, No. 4, pp. 305–360. |
| Kahan and Rock 2007 | Kahan, Marcel – Rock, Edward B.: Hedge Funds in Corporate Governance. *University of Pennsylvania Law Review*, 2007, Vol. 115, No. 5, pp. 1021–1093. |
| Kalay and Pant 2009 | Kalay, Avner – Pant, Shagun: Time Varying Voting Rights and the Private Benefits of Control. *Unpublished working paper, University of Utah*, 2009. |
| Kalay et al. 2014 | Kalay, Avner – Karakas, Oguzhan – Pant, Shagun: The Market Value of Corporate Votes: Theory and Evidence from Option Prices. *Journal of Finance*, 2014, Vol. 69, No. 3, pp. 1235–1271. |
| Kettunen and Ringe 2012 | Kettunen, Maiju – Ringe, Wolf-Georg: Disclosure Regulation of Cash-Settled Equity Derivatives – An Intentions-Based Approach. *Lloyd's Maritime and Commercial Law Quarterly*, 2012, Vol. 2012, No. 2, pp. 227–260. |

Klein and Zur 2009 — Klein, April – Zur, Emanuel: Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors. *Journal of Finance*, 2009, Vol. 64, No. 1, pp. 187–229.

Kobayashi and Ribstein 2006 — Kobayashi, Bruce H. – Ribstein, Larry E.: Outsider Trading as an Incentive Device. *UC Davis Law Review*, 2006, Vol. 40, No. 1, pp. 21–86.

Lee 2007 — Lee, Michael: Empty Voting: Private Solutions to a Private Problem. *Columbia Business Law Review*, 2007, Vol. 22, No. 3, pp. 883–911.

Macey 1991 — Macey, Jonathan R.: An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties. *Stetson Law Review*, 1991, Vol. 21, No. 1, pp. 23–44.

Manne 1964 — Manne, Henry G.: Some Theoretical Aspects of Share Voting. An Essay in Honor of Adolf A. Berle. *Columbia Law Review*, 1964, Vol. 64, No. 8, pp. 1427–1445.

Markowitz 1952 — Markowitz, Harry M.: Portfolio Selection. *Journal of Finance*, Vol. 7, No. 1, pp. 77–91.

Martin and Partnoy 2005 — Martin, Shaun P. – Partnoy, Frank: Encumbered Shares. *University of Illinois Law Review*, 2005, Vol. 67, No. 3, pp. 775–814.

| | |
|---|---|
| Mikkelson and Ruback 1985 | Mikkelson, Wayne H. – Ruback, Richard S.: An Empirical Analysis of the Interfirm Equity Investment Process. *Journal of Financial Economics*, 1985, Vol. 14, No. 4, pp. 523–553. |
| Morck et al. 1988 | Morck, Randall K. – Shleifer, Andrei – Vishny, Robert W.: Management Ownership and Market Valuation: An Empirical Analysis. *Journal of Financial Economics*, 1988, Vol. 20, No. 1, pp. 293–315. |
| Nenova 2003 | Nenova, Tatiana: The Value of Corporate Voting Rights and Control: A Cross-Country Analysis. *Journal of Financial Economics*, 2003, Vol. 68, No. 3, pp. 325–351. |
| Pönkä 2008 | Pönkä, Ville: Määräysvallasta osakeyhtiössä. *Defensor Legis*, 2008, Vol. 88, No. 5, pp. 737–758. |
| Pönkä 2013 | Pönkä, Ville: Oppi osakkeen jakamattomuudesta. *Defensor Legis*, 2013, Vol. 93, No 3, pp. 326–337. |
| Ringe 2013a | Ringe, Wolf-Georg: Hedge Funds and Risk Decoupling: The Empty Voting Problem in the European Union. *Seattle University Law Review*, 2013, Vol. 36, No. 2, pp. 1027–1115. |
| Ringe 2013b | Ringe, Wolf-Georg: Empty Voting Revisited: The Telus Saga. *Oxford Legal Studies Research Paper*, No. 18/2013. |

| | |
|---|---|
| Shleifer and Vishny 1989 | Shleifer, Andrei – Vishny, Robert W.: Management Entrenchment: The Case of Manager-Specific Investments. *Journal of Financial Economics*, 1989, Vol. 25, No. 1, pp. 123–139. |
| Strine 2014 | Strine, Leo E. Jr.: Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law. *Columbia Law Review*, 2014, Vol. 114, No. 2, pp. 449–502. |
| Walkling 1985 | Walkling, Ralph A.: Predicting Tender Offer Success: A Logistic Analysis. *Journal of Financial and Quantitative Analysis*, 1985, Vol. 20, No. 4, pp. 461–478. |
| Zanoni 2009 | Zanoni, Andrea: Hedge Funds' Empty Voting in Mergers and Acquisitions: A Fiduciary Duties Perspective. *Global Jurist*, 2009, Vol. 9, No. 4, pp. 1–37. |
| Zetzsche 2009 | Zetzsche, Dirk A.: Hidden Ownership in Europe: BAFin's Decision in Schaeffler v. Continental. *European Business Organization Law Review*, 2009, Vol. 10, No. 1, pp. 115–147. |
| Zingales 1995 | Zingales, Luigi: What Determines the Value of Corporate Votes. *Quarterly Journal of Economics*, 1995, Vol. 110, No. 4, pp. 1047–1073. |

## Newspapers, magazines, blogs and other articles


| | |
|---|---|
| Activist Hedge Fund Report 2014 | Preqin Special Report: Activist Hedge Funds. June 2014. http://tinyurl.com/pj7qe8n (visited on Jul 24, 2014) |
| Helsingin Sanomat, Sep 23, 2014 | Eläkepääoma karttaa riskiä. http://tinyurl.com/qa5chrp (visited on Oct 6, 2014) |
| Marketwatch, Apr 2, 2008 | Sara Lee, Coach set rules to spot shareholder actions. http://tinyurl.com/mcccfhw (visited on Jul 24, 2014) |
| Nathan and Amdur 2009 | Nathan, Charles M. – Amdur, Stephen: Second Generation Advance Notice Bylaws and Poison Pills. The Harvard Law School Forum on Corporate Governance and Financial Regulation. http://tinyurl.com/dm2qx4 (visited on Jul 15, 2014) |
| The New York Times, Dec 13, 2004 | Icahn Accuses a Hedge Fund of Stock Manipulation. http://tinyurl.com/kft33tn (visited on Jul 15, 2014) |
| The New York Times, Jan 1, 2013 | Ackman, Herbalife and Celebrity Short-Sellers. http://tinyurl.com/lmk4ypt (visited on Jul 2, 2014) |
| The New York Times, May 4, 2014 | Greenlight Asked S.E.C. for Delay on Disclosure of Micron Stake. http://tinyurl.com/mz8ndth (visited on May 6, 2014) |
| The New York Times, May 20, 2014 | For Activist Investors a Wide Reporting Window. http://tinyurl.com/kmh5xbf (visited on May 21, 2014) |

The New York Times, May 28, 2014 — Ackman Plans Public Hedge Fund. http://tinyurl.com/k4kgwn7 (visited on May 28, 2014)

The New York Times, Jun 9, 2014 — Carl Icahn Discloses Stake in Family Dollar. http://tinyurl.com/mmodshs (visited on Jun 10, 2014)

The New York Times, Jun 10, 2014 — Family Dollar Adopts Plan to Keep Carl Icahn at Bay. http://tinyurl.com/k6u3nua (visited on Jun 10, 2014)

Sara Lee Form 8-K 2008 — Sara Lee Corporation. Form 8-K. March 27, 2008. http://tinyurl.com/n3ke57z (visited on Jun 13, 2014)

Shareholder Activism Report 2012 — Schulte, Roth & Zabel: Shareholder Activism Insight. http://tinyurl.com/d49z59r (visited on Apr 4, 2014)

The Wall Street Journal, Dec 15, 2004 — Icahn Cries Foul At Perry's No-Risk Play In Takeover Fight. http://tinyurl.com/lhxpdc2 (visited on May 28, 2014)

The Wall Street Journal, Mar 28, 2014 — Martin Lipton Names Some Activists He Respects. http://tinyurl.com/m3dud9x (visited on Apr 2, 2014)

The Wall Street Journal, Jun 12, 2014 — Activist Funds Dust Off 'Greenmail' Playbook. http://tinyurl.com/m86lyvy (visited on Jun 12, 2014)

The Wall Street Journal, Jul 7, 2014 — Returns From Activist Hedge Funds Are Causing a Stir. http://tinyurl.com/lb9t767 (visited on Jul 7, 2014)

Weingarten and Magnor 2009 — Weingarten, Marc – Magnor, Erin: Second Generation Advance Notification Bylaws. The Harvard Law School Forum on Corporate Governance and

Financial Regulation. http://tinyurl.com/mect75y (visited on Jul 30, 2014)

WLRK Petition, Mar 7, 2011 — Wachtell, Lipton, Rosen & Katz: Petition for Rulemaking under Section 13 of the Securities Exchange Act of 1934. http://tinyurl.com/lgkrm88 (visited on Jul 30, 2014)

## Official sources

Council Press Release 2013 — Council of the European Union: Council approves transparency requirements for issuers of securities. October 17, 2013. http://tinyurl.com/l2x2cun (visited on Aug 1, 2014)

ESMA 2012/415 — European Securities and Markets Authority: Feedback Statement. Call for Evidence on Empty Voting. June 29, 2012. ESMA/2012/415. http://tinyurl.com/k8hgbpp (visited on Aug 1, 2014)

FIN-FSA 8/2013 — Finnish Financial Supervisory Authority: Regulations and guidelines 8/2013. http://tinyurl.com/mzswzgk (visited on Jul 15, 2014)

HFSB 2012 — Hedge Funds Standards Board: The Hedge Fund Standards. Feb 2, 2012. http://tinyurl.com/kpq5zh9 (visited Jul 30, 2014)

## Case law

*Deephaven Risk ARB Trading Ltd. v. UnitedGlobalCom, Inc.*, 2004 WL 1945546. (Del. Ch. 2004).

*High River Limited Partnership v. Mylan Laboratories, Inc.*, 383 F. (M.D. Pennsylvania. 2005).

*CSX Corp. v. Children's Investment Fund Management (UK) LLP*, 562 F. (S.D.N.Y. 2008).

*Schreiber v. Carney*, 447 A.2d 17, 26 (Del. Ch. 1982).

## ABBREVIATIONS

| | |
|---|---|
| AG | Aktiengesellschaft |
| AIFMD | Directive on Alternative Investment Fund Managers 2011/61/EU |
| ANB | Advance Notice By-law |
| BaFin | Bundesanstalt für Finanzdienstleistungsaufsicht |
| CDS | Credit Default Swap |
| CfD | Contract for Difference |
| DAX 30 | Deutscher Aktienindex 30 (stock market index) |
| DTR5 | Disclosure and Transparency Rules, chapter 5 |
| CESR | Committee of European Securities Regulators |
| EMH | Efficient Market Hypothesis |
| ESMA | European Securities and Markets Authority |
| EU | European Union |
| EURIBOR | Euro Interbank Offered Rate |
| HFSB | Hedge Funds Standards Board |
| HFS | Hedge Fund Standards |
| LIBOR | London Interbank Offered Rate |
| MAR | Market Abuse Regulation No. 596/2014 |
| MBS | Mortgage Backed Security |
| MPT | Modern Portfolio Theory |

| | |
|---|---|
| OTC | Over-the-Counter |
| RMBS | Residential Mortgage Backed Security |
| S&P 500 | Standard & Poor's 500 (stock market index) |
| TD | Transparency Directive 2004/109/EC |
| TRS | Total Return Swap |
| FIN-FSA | Finnish Financial Supervisory Authority |
| WLRK | Wachtell, Lipton, Rosen and Katz |

# 1 INTRODUCTION

## 1.1 Background of the topic

The previous few decades have been marked by various significant changes in securities markets. Lawmakers around the globe, trying to keep up with the highly dynamic changes in the markets, are facing challenges given the rise of totally new phenomena. One phenomenon in particular has drawn an increasing amount of attention during the past 10 years and especially after the financial crisis that began in late 2007. The phenomenon in question impacts a key assumption of corporate and securities law: the economic and control rights of a share are inseparable.

Taking into account the events since the beginning of the 2000s, it should be considered whether this fundamental paradigm of corporate and securities law holds anymore. Financial innovation has developed in leaps and bounds and that is easily visible in today's securities markets.[1] Through sophisticated financial derivatives, investors are able to reduce the economic exposure of their share ownership while retaining the voting power of their shares. In some extreme cases it is even possible to gain a negative financial interest and still hold full voting power. This kind of behavior is generally referred to as *empty voting*[2] or *negative voting*. Empty voting may be problematic for companies and fellow shareholders, since an empty voter does not necessarily possess the traditional incentive to maximize the value of the firm as one might expect. On the other hand, empty voting may have some benefits that are seldom acknowledged.

As a mirror image to empty voting, investors are also able, again through financial derivatives, to amass significant economic exposure similar to holding actual shares. However, this position does not formally include any voting power. Therefore, these kinds of positions do not currently in many jurisdictions trigger mandatory ownership disclosure nor the obligation to a mandatory

---

[1] See e.g. Gilson and Whitehead 2008 pp. 243–247. See also Chance 2004, p. 75, who reports that equity swaps were only used for the first time in 1990, after which their use has become more common. Equity swaps are derivatives that are often a part of equity decoupling schemes. These instruments and their use in equity decoupling schemes are discussed in further detail later in this thesis.

[2] First defined by Hu and Black, 2006.

takeover bid, although the holder of the concealed economic position may at least in theory have access to the corresponding number of voting rights. This mirror position to empty voting is referred to as *hidden ownership*. Like empty voting, hidden ownership may also be very problematic due to its detrimental effects on several aspects of transparency in the financial markets. Alternatively, hidden ownership may for the same reasons be beneficial for the efficiency of financial markets.

Empty voting and hidden ownership, together termed 'equity decoupling', have become a more common phenomenon.[3] The strategy of equity decoupling has been favored especially by highly sophisticated activist investors, often hedge funds that have used these kinds of strategies as a part of arbitrage strategies and event driven activist investor plays. It seems that equity decoupling is very tightly linked to activist investors – and only carried out by them – for a reason. Hedge funds have played an important role in making the financial markets more efficient, but in doing so they have introduced new risks and costs.[4] Hedge funds have, thus, acted as the embodiment of some fundamental changes that have caused controversy and created pressures for legislators all over the globe.

The rise of hedge funds and activist investing is an important issue to acknowledge because activist investors are acquiring more and more assets to manage. Although hedge funds have

---

[3] See e.g. Hu and Black 2008, p. 630, who report over 80 incidents in over 20 countries all over the world. In their previous article two years earlier Hu and Black 2006, pp. 848–849 reported 21 incidents of equity decoupling.

[4] Partnoy and Thomas 2007, pp. 120–131. With respect to market efficiency, the authors recognize especially 1) information asymmetry and convergence trades, 2) capital structure motivated trades, 3) merger and risk arbitrage, and 4) governance and strategy activism. See also Bebchuk et al. 2014, who find empirical evidence that hedge fund interventionism produces positive long-term results. During the five-year period following the intervention month, the operating performance of target companies relative to peers improves consistently. On average, the companies targeted by activists close two-thirds of their gap with peers in terms of return-on-assets and two-fifths of this gap in terms of Tobin's q.

existed since the late 1940s,[5] their role in financial markets only became truly significant in the early 1990s. At the end of 2013, an estimated $93.1 billion was managed by activist hedge funds. By summer 2014, the assets under management were estimated to have surpassed $100 billion.[6] According to the Wall Street Journal, there have been 1,115 activist investor campaigns since the latest activism wave started in 2010.[7] In the first half of 2014 only, 148 new activist campaigns were reportedly launched.[8]

Furthermore, although activist hedge funds are sometimes viewed as controversial, there seems to be no end in sight for this development. In 2012 the law firm Schulte, Roth & Zabel's 2012 Shareholder Activism report observed that 84% of the survey's respondents expected a significant rise in shareholder activism in the near future.[9] Statements made by individual investors resonate with the same kind of conception. For example, in October 2013 William A. Ackman, who is considered one of the most prominent modern activist investors, told an audience at the Said Business School at the University of Oxford in England that it was only a matter of time before investor activism took hold in Europe as European pensioners demanded bigger returns after years of low returns.[10] In addition to low stock returns in certain markets,

---

[5] Partnoy and Thomas 2007, p. 113 and p. 115. "Scholars attribute the development of the first hedge fund to Alfred Winslow Jones, a sociologist and journalist who in 1949 established a private investment partnership that reduced risk by buying one stock while shorting another in the same industry."

[6] Activist Hedge Fund Report 2014, p. 2. The world's largest activist hedge fund, Elliot International, has some $15.6 billion of assets under management.

[7] The Wall Street Journal, Jun 12, 2014.

[8] The Wall Street Journal, Jul 7, 2014.

[9] Shareholder Activism Report 2012, p. 3.

[10] The New York Times, May 28, 2014. In the Finnish context this view is also reflected in the comments made by Reima Rytsölä, who currently serves as the Chief Investment Officer of Finland's largest mutual pension insurance company Varma, which has almost €40 billion assets under management. Mr. Rytsölä has emphasized the importance of hedge funds in the current market environment, where real returns in some asset classes are close to zero. See Helsingin Sanomat, Sep 23, 2014.

investor activism has been linked to the emergence of a new kind of agency capitalism.[11] Thus, the trend of investor activism appears to be on the rise and, perhaps, for a good reason.

The phenomena of equity decoupling and activist investors are novel and have only emerged quite recently.[12] This emergence raises the question: is there a larger fundamental paradigm shift occurring in the field of corporate and securities law that can explain the phenomena or indeed has the shift already occurred? With reference to equity decoupling, the view of the old corporate and securities law paradigm is perhaps best described by the 1983 view of Easterbrook and Fischel:

> "*It is not possible to separate the voting right from the equity interest. Someone who wants to buy a stock must buy the vote too.*"[13]

However, in this study the view of the old paradigm is put under scrutiny in the ways described next.

## 1.2 Research question and limitations of the study

This thesis aims to examine the basic elements of shares, the basis for shareholders' rights and how the latest developments of equity decoupling have changed the basic assumptions. The research questions of this thesis are as follows:

1) what has driven the equity decoupling phenomenon;
2) how has equity decoupling changed the key fundamental paradigm that control rights and cash-flow rights of shares are inseparable;

[11] See Gilson and Gordon 2013 and Gilson and Gordon 2014. This issue is scrutinized in further detail later in this thesis.

[12] In this respect see e.g. Bebchul et al. 2000, p. 295, who distinguish that separation of control and cash-flow rights can occur in three ways: 1) dual class share structures, 2) stock pyramids and 3) cross-ownership ties. These separation methods occur more or less in the institutional contexts of corporate law. The equity decoupling discussed in this thesis is novel in the sense that it occurs outside the context of institutional corporate law. From the above classification it can be assumed that the novel methods of equity decoupling were unknown or poorly known only some time ago.

[13] Easterbrook and Fischel 1983, p. 410.

3) what kind of implications do the new developments have; and
4) how have regulators responded and how should they respond to the new developments?

A growing body of literature on empty voting and hidden ownership has already been published. However, according to the author's view the majority of this literature is imperfect in the sense that it examines either empty voting or hidden ownership as separate phenomena. Generally the existing literature fails to grasp the fact that the two phenomena are mirror image transactions.[14] When examined separately, the interrelationship between the two phenomena is generally omitted. Furthermore, there are instances, in which equity decoupling may be efficient and beneficial. In the existing academic literature, this aspect is often disregarded.

The omission of the interrelationship of the two sides of equity decoupling leads to a failure to acknowledge the paradigm change and its drivers that are the main focus of this study. This, in conjunction with the underestimation of the possible beneficial effects of equity decoupling, has led to incomplete or inefficient suggestions for remedial approaches. The development of a comprehensive regulatory framework requires full understanding of the issue and a better idea about what extent the issue is beneficial and what extent it is detrimental. So far the development of such a framework has been elusive.

This study contributes to the existing literature by taking a step back from the practical mechanics of the phenomena themselves and scrutinizes the phenomena more as a singular phenomenon resulting from fundamental changes of the last few decades that, in turn, are driven by a marketization development affecting the whole society. Hence, the aim of this study is to take a more comprehensive and profound approach towards the literature than has been taken previously. Hopefully, this leads to a better understanding of the problem and the underlying drivers behind it.

The scope of this study is limited to the regulation of stock exchange listed companies. Although in most jurisdictions the regulatory framework for small companies is the same as for large

[14] Creation of empty voting positions always creates corresponding positions of hidden ownership and, usually although not necessarily, vice versa. See e.g. Zetzsche 2009, pp. 134–135.

listed companies, the nature of a company changes significantly when moving from listed companies towards small and private one-man companies. The relationships of shareholders differ, since the relationships are usually distant in a listed company and closer and more flexible in small companies, where the shareholders often work for the company.[15] What is more, the financing base of small companies is usually quite narrow in the sense that small companies often have a small number of investors that are of domestic origin and who hold securities that are more illiquid than in stock exchange listed securities generally. Thus, since this study focuses on the implications of financial engineering on listed shares, it is a reasonable choice to exclude other than stock exchange listed companies from the scope of this study. However, in many instances the argumentation and findings of the study may, despite the limitation, also be applied to companies outside the scope of this study.

This study does not provide in-depth analysis on practical methods of equity decoupling, since these methods are already sufficiently elaborated in existing literature.[16] Furthermore, since the methodological approach of this thesis is based on theory of regulation as discussed below, there is little or no use to provide in-depth analysis of practical aspects of financial engineering relating to equity decoupling. Practical examples and methods of equity decoupling are discussed where it is justifiable in the broader context of discussing an issue relevant for this thesis.

## 1.3 Methodology

### 1.3.1 Law and economics

The core of this study in terms of methodology is the law and economics approach. The study focuses on the theory of regulation. The theory of regulation can be described as serving the legislator, while legal dogmatics can be understood to serve the administrators of law. The objective of this study is to seek a firm basis for legislation in the economic environment in which the relevant parties, from the perspective of this study, operate. Therefore, this thesis aims to provide more elements from a *de lege ferenda* than a *de lege lata* perspective.

[15] Vahtera 2011, p. 29.

[16] See e.g. Hu and Black 2006 and Hu and Black 2008.

The regulation theory approach comprises of the normative and positive theories of regulation, the first of which deals with the question of what kind of legal regulation should exist in order to satisfy all the regulatory objectives. Regulation theory's normative approach involves the utilization of regulatory standards. Regulatory standards are a kind of indicator of how appropriate rules should be considered. Such standards include, for example, effectiveness, cost-effectiveness, administrative efficiency and flexibility.[17] Positive regulation theory, in turn, focuses on analyzing the possibilities for achieving a predetermined goal and discovering those issues, which are essential to the selection and implementation of the final legislation.[18] Thus, positive regulation theory assesses the ways in which a legal instrument is best incorporated into society.

Normative analysis of what currently is the most appropriate way to address social problems is deprived of practical significance if the legislature ignores the public interest. In this context strategies of legitimization can be discussed, which means the ways in which the approval of the legislation's target is achieved. On the other hand a positive regulation theory is also a perspective on the factors that can compromise the stability of law. Furthermore, the positive regulation theory provides an opportunity to analyze the costs of adaptation.[19]

One example of the normative theory of regulation also applied in this study is the model by Richard Posner that sets wealth maximization as its primary goal in society's decision-making. The Posner model is about the normative application of positive economic analysis. Thus, for the application of the Posner model it is necessary to employ positive economic analysis in all social decision-making, since only the positive method is able to distinguish which option promotes wealth maximization the most.[20]

---

[17] Määttä 1999, pp. 13–14 and Posner 2003 pp. 24–25.

[18] Kaisanlahti 1999, p. 18 and Posner 2003, p. 25.

[19] Määttä 1999, pp. 14–15.

[20] Kaisanlahti 1999, p. 21.

The economic approach to law has received extensive criticism.[21] For example, it has been argued that the wealth maximization model discussed above excessively favors individuals who participate in production activities in a society. Furthermore, the model has been criticized for disregarding aspects of income distribution.[22] Especially in the Scandinavian doctrine the protection of the weaker party has been one of the most central functions of law as a part of ensuring the principle of rightness.[23] However, in this respect is should be noted that consideration of economic efficiency or wealth maximization does not mean an endeavor to disintegrate values of rightness and justice. In this sense it is more of a question of keeping the aspects of economic efficiency effectively on display. Especially when there is no conflict between rightness and economic efficiency, i.e. when alternatives considered are all equally right, there are no convincing reasons why economic efficiency should be disregarded as the determining issue in social decision-making. This is even more correct when decisions concern the economic activities of individuals and organizations.[24]

### 1.3.2 Legal dogmatics

If the function of law and economics and theory of regulation is to serve the regulator, the function of legal dogmatics is to serve the administrators of law by systemizing legal rules and by providing explanations of their content by means of interpretation. Aarnio describes the first aspect as theoretical and the latter aspect as a practical aspect of legal dogmatics.[25]

Although the methodology of legal dogmatics is not in the core of this thesis, it is in any case used where relevant. A *de lege ferenda* analysis is not complete without analyzing the pros and cons of the predominant rules. This analysis requires full systemization of the relevant rules as well as their interpretation. The theoretical aspect of legal dogmatics is especially important in the field of securities and corporate law, which together – from the perspective of a stock exchange listed company – create a broad and very fragmented regulatory framework. Listed

21 Posner 2003, pp. 26–28.

22 Kaisanlahti 1999, p. 22.

23 Ibid., p. 29.

24 Ibid., pp. 46–47.

25 Aarnio 1997, pp. 36–37.

companies are impacted by laws and stock exchange rules, as well as other self-regulatory codes, like takeover and corporate governance codes for example. Therefore, perceiving all the pieces and fitting them together requires extensive systemization of the regulatory environment of a listed company. Then again, this systemization is not of use if it does not provide deeper understanding of the rights and obligations of which it is comprised. Thus, where relevant, this thesis aims to embrace the both above-mentioned aspects of legal dogmatics.

### 1.3.3 Comparative law

As is the case with legal dogmatics discussed above, the methodological focus of this study does not rest on comparative approach either. However, comparison of legal solutions cannot be disregarded due to cross-border nature of the problems addressed in this study. David J. Gerber has been able condense the core message of one of the most prominent names in comparative law, Ernst Rabel, in a single phrase:

> *"Look at how a problem is solved in two or more legal systems and explore the differences and similarities in the respective treatments of the problem."*[26]

As is later illustrated, the environment in which the subjects of this study operate is increasingly international in nature. In today's globalized world corporations as well as investors do not operate and move within the borders of a single country or even a continent for that matter. However, sovereign nations still rely mostly on enacting their own laws and keeping their own systems, although countries are increasingly stepping up their efforts to coordinate and harmonize their legislations.[27]

Thus, this study uses the aforementioned approach and analyzes different actions that different nations have taken to address the possible problems arising from equity decoupling. A comparative approach is also embraced when considering whether or not different regulators have acknowledged the possible benefits of equity decoupling. Analysis of solution models

[26] Husa 2007, p. 6.

[27] See e.g. Vahtera 2011, pp. 113–116, who discusses of the convergence pressure falling upon different corporate governance systems.

adopted in different countries may be used to provide valuable empirical observations regarding the functionality of the adopted measures.

## 1.4 Structure

The thesis is structured so that the first chapter provides an introduction to the subject and clarifies the research questions and the method used. The objective of the first chapter is to familiarize the reader with the topic and provide an illustration of how the author has approached the topic.

The second chapter looks into the foundations of a corporation and the rights of its shareholders. The chapter aims to scrutinize shares as instruments, examine their properties and their meanings to shareholders. Emphasis is placed on why shareholders have voting rights and the distribution of those rights with respect to capital invested is analyzed.

The third chapter examines the changes that have remodeled some of the issues discussed in the second chapter. The chapter embraces the question of whether or not economic and voting rights of shares are still inseparable and if not, what issues have been the key drivers in developments changing some of fundamental paradigms of corporate and securities law. The chapter provides both supply and demand explanations for equity decoupling.

The fourth chapter looks into the more practical side of equity decoupling and its mechanisms. The chapter also aims to provide critical analysis of possible beneficial and detrimental effects of equity decoupling and its two subcategories, empty voting and hidden ownership.

The fifth chapter applies the analysis from the fourth chapter. Remedies for tackling equity decoupling that have already been implemented and proposed are assessed and discussed. Based on the evidence and views presented so far in the thesis, possible alternatives for regulatory framework are also discussed.

Finally, the sixth chapter presents a summary of the subject, key findings and concludes this study.

# 2 CORPORATION AND SHARES

## 2.1 Foundations of a corporation

### 2.1.1 Core characteristics of a corporation

Kraakman et al. distinguish five different core structural characteristics of a corporation: 1) legal personality, 2) limited liability 3) transferable shares, 4) centralized management under a board structure, and 5) investor ownership. These characteristics define corporations all over the world and make it the most attractive form of organizing productive activity. At the same time the characteristics introduce tensions between different stakeholder groups, some of which are discussed later in this study.[28]

The first and perhaps most visible of the aforementioned characteristics is legal personality. Legal personality provided for in corporate law enables corporations to serve as a single contracting party that is distinct from owners, managers and employees of the corporation. In this sense Kraakman et al. discuss "separate patrimony", which means that a corporation is the owner of its assets and that the assets owned by the corporation are distinct from the assets owned by its shareholders. The core function of the separate patrimony is to shield the corporation and its assets from the claims of creditors of the corporation's owners.[29]

The flip side of the legal personality is the limited liability of shareholders. This means that creditors of a corporation are limited to making claims only against the assets owned by the corporation. Creditors have no claim based on the contract between them and the company against the assets that the shareholders hold in their own names. In other words, shareholders are not responsible for the obligations of the company they own shares in. Together with the entity shielding function of legal personality, this owner shielding limited liability sets up a regime that Kraakman et al. describe as "asset partitioning", whereby the assets of the company

---

[28] Kraakman et al. 2009, pp. 5–6. Similar view exists also in Finnish legal literature. See e.g. Mähönen and Villa 2006, p. 29.

[29] Kraakman et al. 2009, pp. 6–7.

are pledged as a security to business creditors of the company, while the personal assets of shareholders are pledged as a security to their personal creditors.[30]

Transferability of shares is the third core characteristic of a corporation. The point of transferability is to allow a company to continue on its ordinary course of business uninterrupted despite changes happening in its ownership base. Transferability is the basis for liquidity, which allows construction and maintenance of diversified equity portfolios. Transferability is also closely connected to the two previous characteristics of legal personality and limited liability. Absence of legal personality and limited liability would have an effect on the creditworthiness of a company and also on the other shareholders as the identity of shareholders changed.[31]

Fourthly, corporations are characterized by delegated management with a board structure. The board of directors is assigned all but the most fundamental decisions in business operations. The board itself has four distinctive features. Firstly, the board is at least formally separate from the operational managers of the company. Secondly, the members of the boards are selected by shareholders, which should assure that the board remains responsive to the interests of the company's shareholders.[32]

Finally, investor ownership is also a characteristic that distinguishes corporations from other organizational forms. Investor ownership denotes that owners have the right to control the company and also have the corresponding right to receive the company's net earnings. Moreover, both rights are typically proportional to the amount of invested capital.[33] The investor ownership aspect is the most crucial for this thesis and, hence, its aspects are covered more closely in latter parts of the study.

---

[30] Kraakman et al. 2009, pp. 9–10.

[31] Ibid., pp. 11–12.

[32] Ibid., pp. 13–14.

[33] Ibid., p. 14.

### 2.1.2 Theories of corporation in law and economics

As discussed above, legal personality, limited liability, transferable shares, delegated management and investor ownership can be considered the basic characteristics of a corporation. However, these characteristics make it uncertain why companies exist in the first place. Today there are a variety of theories explaining the existence of companies. The one thing common for all these theories is that none of them offers a fully comprehensible explanation and understanding of companies. All of the theories work only partially to explain a certain viewpoint.[34]

In this study the company is conceived as a vehicle for collaboration as well as a nexus of contracts of all of the stakeholder groups. Both views emphasize the nature of a company as an instrument for organizing efficient economic activity, in which risk-taking as well as the allocation of risks between various interest groups is organized in such a way that risk-bearing happens according to one's capacity to bear risks. Thus, the corporation appears to be a hybrid of society's regulatory efforts and contractual arrangements of the participating stakeholders.[35]

In institutional context the analysis of corporation is usually directed towards framework conditions of economic cooperation. The function of the company and company law according to institutional theory is to serve the needs of the society as a whole. From the markets' point of view, the company exists to serve as a vehicle for exchange for all market participants. The organizing of the enterprise into a company is based on the institutional set of rules, which can be considered to realize in efficiency benefits stemming from the organization. In addition, the economic cooperation of individuals requires a certain level of predictability and legal certainty, which promotes the existence of standardized organizational forms.[36]

Before the 1930s law and economics theory did not have a theory of the firm, but rather a theory of markets in which firms are important actors. For example in his *magnum opus*, which is also the foundation of neoclassical economic theory, Adam Smith provided a description of the

---

[34] Vahtera 2011, pp. 76–77.

[35] Ibid., p. 77.

[36] Ibid., p. 79.

division of labor in a pin factory, but said nothing about the internal organization of the factory.[37] In this sense, companies operating in the economic setting were considered black boxes in the neoclassical theory of the firm, where outputs were produced from inputs with present value maximization as the main objective.[38] The neoclassical theory adopted in this respect an external analysis approach.[39] This approach, however, reveals nothing about the internal organization inside the black box or the boundaries of the firm.[40] In most fields of economics the neoclassical theory is sufficient, but because of the above-mentioned problems this is not the case in the field of law and economics.

Ronald Coase changed this mindset by pointing out that firms exist because of transaction costs. Coase acknowledged the black box problem of the inner workings of the corporation disregarded by neoclassical theory. Coase distinguished free market coordination and entrepreneur coordination of production as alternative methods of coordinating production. What is more, Coase noted that if production is regulated by price movements, production could be carried on without any organization at all and, yet, organizations carry on the most of production. Coase noted that hiring workers, negotiating prices and enforcing contracts was time-consuming and did not contribute to the actual producing activities. Coase's main insight was that a firm is essentially a device for creating long-term contracts instead of more costly short-term contracts, which is why the theory of his is often called the transaction costs theory of organization.[41]

Coase's arguments came up again some 40 years after they were first published. Deviating from the neoclassical model, Alchian and Demsetz[42] provided an extension to Coase's work and defined the essence of a firm as a contractual organization of inputs where there is:

---

[37] Smith 1776a, pp. 8–9.

[38] Jensen and Meckling 1976, pp. 306–307.

[39] Mähönen and Villa 2006, p. 172.

[40] Hart 1995, p. 17.

[41] Coase 1937, p. 42.

[42] Alchian and Demsetz 1972, p. 794.

a) joint input production;
b) several input owners;
c) one party who is common to all the contracts of the joint inputs;
    a. who has rights to renegotiate any input's contract independently of contracts with their input owners;
    b. who holds the residual claim; and
    c. who has the right to sell his contractual residual status.

Thus, Alchian and Demsetz considered a corporation as a means to capitalize on the benefits of team production. Their work, thus, provided a team production theory of the firm, where a firm is an entity that gathers a team that operates more efficiently together than they would otherwise individually.[43]

The view of the private corporation was then extended and defined as simply one form of legal fiction that serves as a nexus for contracting relationships among participating individuals. Furthermore, the private corporation is also characterized by the existence of divisible residual claims on the assets and cash-flows of the organization, which can generally be sold without permission of the other contracting individuals.[44] Contractual relations are, thus, the essence of the firm according to this theory.[45] The nexus of contracts also means that providers of equity do not have any special position as the owners of the company. Equity investors are only in the position of mere residual risk bearers and that position is compensated with the economic return corresponding to the residual risk.[46] The nexus of contracts theory also leads to the conclusion that corporate law should be dispositive instead of non-discretionary. In this sense dispositive provisions should provide a set of terms available off-the-rack so that participants can, when

[43] Alchian and Demsetz 1972, pp. 779–780.

[44] Jensen and Meckling 1976, p. 311.

[45] Ibid., p. 310.

[46] Kaisanlahti 1999, p. 63.

necessary, choose those predetermined contracting terms and save the costs of contracting themselves.[47]

The above analysis also introduces the basis for corporate voting. It has been argued that corporate voting exists because of the fact that contracts are inherently incomplete.[48] The existence of corporate voting has been explained by arguing that there has to be a group that possesses residual power to act when the incompleteness of contracts arises.[49]

## 2.2 Nature of shares

In corporate and securities law, a share is not an unambiguously defined physical object, but rather an instrument that provides certain rights and duties. Ownership of a share provides the shareholder with shareholder rights that stem from law, company by-laws and possible other commitments made by the shareholder. Thus, a share can be delineated as an instrument of rights and duties, the contents of which are dependent on legal norms valid at that time. In this sense, a share can be conceptualized as the sum of the rights and duties it gives to its holder.[50]

According to Mähönen and Villa, ownership of a share means complete and secured exclusivity to exercise the rights that the share provides. Ownership also includes the right to freely agree on the exercising of those rights. In the context of Finnish corporate law, Mähönen and Villa have distinguished four different and distinctive elements of share ownership in general corporate law: 1) company's own material ownership of its assets; 2) shareholder's ownership of rights and duties provided by the share; 3) shareholders' ownership of the company's assets; and 4) economic ownership of shares.[51]

---

[47] Mähönen and Villa 2006, pp. 189–190.

[48] Schouten 2012, p. 3.

[49] Easterbrook and Fischel 1983, p. 403.

[50] Mähönen and Villa 2006, pp. 219–220. See also Pönkä 2013 p. 326, who expresses a similar kind of view and describes the share as an instrument of indirect ownership.

[51] Mähönen and Villa 2006, pp. 219–220.

Share ownership provides rights that can be divided into economic rights and control rights, which can be defined as rights to assets and cash-flows of the company and the rights to participate in corporate decision-making respectively. In the context of Finnish corporate law, Timonen[52] has provided the following systemization of economic and control rights:

Economic rights

- Right to dividends
- Right to pro rata investing
- Pro rata right to other distributions
- Right to register the share or ownership to book-entry system
- Right to damages due to breach of law or other provisions

Control rights

- Right to ownership registration to share register
- Right to exercise power in general meetings
- Information rights regarding general meetings and financial information
- Rights relating to minority protection

The existence of voting rights as a part of control rights has been explicated on the basis that someone must have the residual power to act or delegate when contracts are incomplete.[53] As Alchian and Demsetz note, the residual claimant (i.e. shareholder) must have power to revise the contract terms and incentives of individual members (i.e. input providers) without having to terminate or alter every other input's contract.[54] Thus, in this sense it appears to be an issue of economic efficiency.

---

[52] Timonen 1997, p. 245. See also Kaisanlahti 1998, p. 83, who distinguishes rights to dividends and residual distributions as the most important economic rights and the right to participate in general meetings as the most important control right.

[53] Easterbrook and Fischel 1983, p. 403.

[54] Alchian and Demsetz 1972, p. 782.

## 2.3 Basis for shareholder voting rights

### 2.3.1 Uniformity of interests

One reason for voting rights belonging to shareholders is the uniformity of interests of shareholders. If management was obliged to take into account also the interests of other stakeholder groups, the management would not, in practice, have the duty to act with the best interest of any of the stakeholder groups due to the differing interests.[55] Instead, Jensen argues that maximizing the total market value of the firm (i.e. the sum of the market values of the equity, debt and any other contingent claims outstanding on the firm) is the objective function that will guide managers in making the optimal tradeoffs among multiple constituencies.[56]

This view has been opposed by arguments stating that even the interests of different shareholder classes differ so much that this "too many masters" argument cannot be valid. Just as the interests of common shareholders can conflict with the interests of non-shareholder constituencies, so can the interests of one class of equity claimants conflict with the interests of other classes. For example certain preferred shareholders may have interests that more closely resemble those of fixed claimants than those of common shareholders. Such preferred shareholders may prefer that a firm refrain from engaging in certain risky projects, while the common shareholders would prefer that the firm undertake such projects.[57] The above argument that aimed to tackle the uniformity of interests' point of view may very well be correct. However, it can be questioned whether preferred shareholders can even be compared to common shareholders in this context. It is quite common that preferred shares do not carry any voting rights. This may be an implication of the differing interests of preferred shareholders.

Furthermore, in Finnish legal literature Kaisanlahti rejects the aforementioned view by arguing that in this case the question regards internal distribution of control of one stakeholder group.[58]

---

[55] Kaisanlahti 1998, p. 89 and Jensen, 2001, p. 9.

[56] Jensen 2001, p. 12.

[57] Macey 1991, p. 33.

[58] Kaisanlahti 1998, p. 89.

Easterbrook and Fischel also state that the preferences of one class of participant are likely to be similar if not identical, although empirical studies offer evidence to reject this assumption.[59] According to their analysis this is true of shareholders especially, for people buy and sell in the market so that the shareholders of a given firm at a given time are a reasonably homogeneous group with respect to their desires for the firm.[60]

### 2.3.2 Need for protection

The legitimacy for shareholder voting rights has also been promoted by the view that shareholders are in need of protection. For example, Macey notes that non-shareholder constituencies can protect themselves against virtually any kind of managerial opportunism by retaining negative control over the firm's operations. These constituencies can protect their interests by contracting for the right to veto future proposed actions by management. By contrast, the shareholders must retain positive control over the actions of the firm in order to realize the full potential value of their shares.[61] In other words, the argument is that shareholders need voting rights, since they do not have any other mean for protecting their investment.

Kaisanlahti rejects the view presented by Macey and notes that voting right is a type of guarantee that enables shareholders to change management if necessary. If shareholders would not possess voting rights, they would just simply require higher returns for their invested capital. That is to say, equity financing would be even more expensive for companies.[62]

### 2.3.3 Residual interest

Perhaps the most compelling argument in favor of shareholder voting rights is their position as residual risk holders. Residual risk means that shareholders may have their returns and/or capital only after the claims of other constituencies have been fulfilled.[63] Since shareholders are the

---

[59] Barclay and Holderness 1989, p. 394.

[60] Easterbrook and Fischel 1983, p. 405.

[61] Macey 1991, p. 36.

[62] Kaisanlahti 1998, p. 91.

[63] Ibid., p. 95.

bearers of residual risk, their position is inherently more risky than the positions of other stakeholders, whose economic returns are usually fixed and independent of whether the company makes a profit or not. On the other hand, economic returns of shareholders are dependent on the profitability of the company.[64]

Due to their position as the bearers of residual risk, it can be argued that shareholders have the strongest incentive to ensure that the company makes profits. Other stakeholders do not have a similar kind of incentive or their incentives are weaker.[65] For example, Easterbrook and Fischel have noted that shareholders, as the residual claimants, are the one group with the appropriate incentives to make discretionary decisions. This is because shareholders incur most of the marginal costs and receive most of the marginal benefits for undertaking a new investment project. At the same time all other constituencies lack these incentives.[66]

Hence, residual risk is followed by residual control. Shareholders are usually the bearers of residual risk and, therefore, they have residual control, which is embodied in the right to vote in general meetings. As noted above, the existence of voting rights is based on the economic efficiency perspective that someone must have the residual power to act or delegate when contracts are not complete.[67] As an extension to this, shareholders have voting rights, because they are in the most economically efficient position to maximize the value of the firm. The notion that shareholders are the sole residual claimants can be criticized by arguing that other constituencies, such as employees, creditors and the government, may also have residual claims.[68] However, the same kind of value maximization could not occur, if voting rights were given to these other constituencies.

---

[64] Vahtera 2011, p. 384.

[65] Ibid., pp. 384–385.

[66] Easterbrook and Fischel 1983, p. 403.

[67] Easterbrook and Fischel 1983, p. 403 and also Alchian and Demsetz 1972, p. 782.

[68] Schouten 2012, p. 3.

## 2.4 Share indivisibility and distribution of economic and control rights

### 2.4.1 Share indivisibility and general assumption of rights distribution

If the assumption of voting rights belonging to shareholders is accepted, the question of residual control distribution among shareholders remains. This control can be distributed evenly among shareholders according to the capital invested or at any other ratio deemed justifiable.[69] The common doctrine of shareholders' voting rights is the one share–one vote principle, according to which each share carries one vote. Thus, the general assumption of voting power distribution has usually been even distribution of power among shareholders with respect to the capital invested.[70] The one share–one vote principle is, therefore, a corporate voting mechanism that makes control exactly proportional to the capital invested by tying cash-flow rights to the voting rights for these shares.

The doctrine has received a significant amount of scrutiny. In many countries shareholding voting rights are based on the one share–one vote principle, but exceptions to this model contract assumption are often also allowed. The general basis for the principle is that if shareholders' proportional share of voting rights exceeds the share of invested equity capital in the company, the shareholder does not have sufficient incentive to take care of the company's affairs.[71] Therefore, the traditional justification for bundling economic and control rights together is that

---

[69] Vahtera 2011, p. 385.

[70] Ibid., p. 385.

[71] See e.g. Kaisanlahti 1998, p. 85 and Easterbrook and Fischel 1983, p. 410, who argue: "For example, if the owner of 20 percent of the residual claims acquires all of the votes, his incentive to take steps to improve the firm (or just to make discretionary decisions) is only one-fifth of the value of those decisions. The holder of the votes will invest too little. And he will also have an incentive to consume excessive leisure and perquisites and to engage in other non-profit-maximizing behavior because much of the cost would be borne by the other residual claimants. The risk of such shirking would reduce the value of investments in general, and the risk can be eliminated by tying votes to shares."

it is the best way to encourage shareholders to exercise their control rights in ways that will maximize the value of the company[72] and minimize agency costs.[73]

Whatever the decision regarding distribution of control rights and economic rights has been, control rights and economic rights have in general been deemed as indivisible. In the context of Finnish corporate law this has been referred to as the theory of share indivisibility.[74] The point of indivisibility is that when a shareholder has acquired shares, the shareholder has not, at least without amendments in institutional instruments such as company by-laws, been able to alter the distribution of economic and control rights in the institutional context of corporate law. Thus, decoupling of control and economic rights has not been regarded possible so that the decoupling would also bind the company that has issued the shares.[75] Legally the rights and duties relating to share ownership are predetermined for the shareholder whether they come in the form of one share–one vote or in some other form such as the form of multi-vote shares.

According to Pönkä the principle of share indivisibility includes two sub-principles. Firstly, a share cannot be divided into smaller pieces in the institutional corporate law context. This does not exclude joint ownership of a share, but the owners must act and exercise their powers towards the company as one unanimous entity.[76] Thus, for example fractional share rights are not possible. The second sub-principle is the prohibition to divide economic and control rights of a share, which refers to the decoupling theme of this thesis. Pönkä notes that the decoupling prohibition is valid only in the institutional context of corporate law, but does not prevent contractual shareholder arrangements *inter partes.*[77] Hence, shareholders may, in principle, agree on themselves on the exercise and transfer of share rights. This may, however, introduce

[72] Grossman and Hart 1988, pp. 175–178.

[73] Easterbrook and Fischel 1983, pp. 408–410.

[74] Pönkä 2013. See also Mähönen and Villa 2006, p. 220, who state that there is no ambiguity with reference to the existence of the indivisibility principle.

[75] See e.g. Easterbrook and Fischel 1983, p. 410, Kaisanlahti 1998, p. 85 and Pönkä 2013, pp. 327–332.

[76] Pönkä 2013, p. 328.

[77] Ibid., p. 330.

problems for the assumptions of share ownership. Mähönen and Villa discuss circumstances under which the shareholder has irrevocably transferred all the rights and duties of shares by agreement, but still reserved the formal right of ownership.[78] In such a case, it is reasonable to ask, who is the shareholder? May ownership of shares be something other than the right to share's rights and duties?

### 2.4.2 Analysis of rights distribution among shareholders

#### 2.4.2.1 Economic risk and control rights

As already touched on above, one of the key arguments in favor of matching economic rights and control rights is that it is the most efficient means to match economic risk and corresponding control rights among shareholders.[79] Deviation from the principle may lead to concentration of voting power in the hands of shareholders, who do not bear equivalent economic risk with respect to their voting rights.[80] Disproportionate structures of ownership can distort the incentives of decision-making shareholders with respect to efficient project selection and investment decisions,[81] firm size and roles of control.[82] Furthermore, impairment in the functioning of the market for corporate control may occur.[83]

As Vahtera[84] points out, the idea behind the above arguments is that shareholders are risk-neutral or that they at least share similar kinds of risk preferences.[85] In this kind of setting deviation from the one share–one vote principle does not add any value for any of the shareholders. A

---

78 Mähönen and Villa 2006, s. 221.

79 See e.g. Easterbrook and Fischel 1983, pp. 408–410 and Hart 1995, p. 64.

80 Hart 1995, p. 207.

81 Hu and Black 2006, p. 851 and Ihamuotila 1994, p. 98 and p. 138.

82 Bebchuk et al. 2000, pp. 301–305.

83 Grossman and Hart 1988 and Hart 1995, pp. 95–125. Well-functioning market for corporate control has generally been viewed as promoting economic efficiency. See e.g. Gompers et al. 2003, who find evidence that firms with strong takeover defenses have lower Tobin's q-values than firms with weak takeover defenses.

84 Vahtera 2007, p. 247.

85 See also Easterbrook and Fischel 1983, p. 405.

shareholder does not have an incentive to try to acquire the votes of other shareholders, since the shareholder is aware that other shareholders have similar preferences and therefore use their voting power similarly.

However, the arguments in favor of the one share–one vote principle as the most efficient means to match economic risk and corresponding control rights fall apart, if shareholders risk preferences differ.

> Let us assume that company A has three shareholders: X, Y and Z. X is a risk-taker, Y is risk-neutral and Z is risk-averse. Company A has two mutually exclusive investment projects, M and N, that both have the same positive net present value. The investment project M is safe and it has a certain return of 100. The investment project N on the other hand is risky. N has a return of 200, but a probability of success of only 50%.
>
> As a risk-taker X will prefer project N, Z will prefer project M and Y is indifferent with respect to which project is chosen. Hence, the shareholders X and Z have an incentive to acquire the votes of the shareholder Y. The votes are not of any value for Y, since she is indifferent to which of the two projects is chosen, but this is not the case with respect to X and Z. In theory, the value of the votes of Y equals the marginal benefit of either X or Z, whichever is higher.

Many authors have argued that the assumption of shareholders' risk preferences' similarity is not correct.[86] Indeed, this view of differing shareholder preferences can be considered more realistic, especially in today's society, where thinking is distinctive because of marketization and complete markets.[87] Following this logic, separation of control rights from cash-flow rights (i.e. allowing deviations from the one share–one vote principle) should lead to an efficient market for corporate votes. This market should provide a fair compensation for voting rights.[88]

---

[86] See e.g. Martin and Partnoy 2005, p. 778 and Vahtera 2007, p. 248.

[87] See chapter 3.2.1 below for further discussion.

[88] Kaisanlahti 1998, p. 85. Based on control block purchases Barclay and Holderness 1989, p. 394, report control premiums of 20% in the U.S. market equivalent to approximately 4% of market capitalization. Extending the model of Grossman and Hart 1988, Zingales 1995 creates a model where the voting premium is equal to the ratio between the value of the private benefits of control and the value of cash-flow rights (the present value of

### 2.4.2.2 Private benefit extraction

The key trade-off of enhanced management monitoring – discussed in further detail below – is the increased agency costs between controlling and minority shareholders.[89] Deviations from one share−one vote principle have been criticized on the basis that they enable controlling shareholders to extract private benefits, also known as tunneling. Examples of this kind of behavior include excessive executive compensation, dilutive share measures, asset sales and personal loan guarantees.[90] For example, Barclay and Holderness have provided empirical evidence that the large-block shareholders typically use their voting power to secure private corporate benefits that do not accrue to other shareholders.[91]

However, deviating for the one share−one vote principle does not – or at least should not – itself create any automatic unfounded benefits for controlling shareholders with respect to minority shareholders. If this kind of behavior is possible, the reason lies more in a weak corporate governance system than in deviation from the one share−one vote principle. An efficiently

corporate benefits distributed pro rata to shareholders) divided by the fraction of voting shares in the company's equity. Zingales 1995, p. 1059 finds the mean voting premium, i.e. the value of a vote, to be 10.5% in the U.S. market. Also Nenova 2003, applies analysis of dual class stocks in 661 firms across 18 countries and finds (p. 334 and p. 340) that the value of control block votes for example in Finland, Sweden and Denmark is 1% or less of the market value of the firm, but 48% in South Korea. The voting premium for example in Finland is –5.03% (no statistical significance) and 2.01% in the U.S. On the most recent empirical study, Kalay et al. 2014, introduce a new way of measuring the value of votes by quantifying the market value of the right to vote as the difference in the prices of the stock and the corresponding synthetic stock. The synthetic stock is constructed using option prices, particularly facilitating the put-call parity relationship. The authors find that the mean annualized voting premium 1.58% (or 0.16% in 38 days, p. 1247) of the underlying stock price in the U.S. over the years 1996-2007. The authors also find that the value increases around shareholder meetings, which are likely to be more contentious.

[89] Schouten 2012, p. 8.

[90] Barclay and Holderness 1989, p. 374 and Ihamuotila 1994, p. 33.

[91] Barclay and Holderness 1989, p. 394.

organized corporate governance system regulates shareholders' possibilities to use and extract companies' assets and provides remedies to manage this kind of behavior *ex post*.[92]

#### 2.4.2.3 Control rights and management monitoring

Separation of ownership and control is often believed to decrease the value of a firm. The objectives of management responsible for running the company are considered to be at least partially contrary to those of shareholders. Shareholder monitoring is considered to mitigate this problem, although empirical evidence may not back the idea.[93] Multi-voting shares have been argued to enhance monitoring of management. This enhanced monitoring can be seen as a trade-off to the risks of private benefit extraction.[94] The positions of shareholders and management, delegated control and consequent information asymmetry constitute an inherent conflict of interest between shareholders and management. Well-working corporate governance systems enable harmful management behavior to be put in check, but this does not mean that shareholder monitoring is totally unnecessary.[95]

In the Anglo-American corporate governance system the importance of market for corporate control as the main barrier for management's opportunistic behavior has been emphasized. In this respect voting rights have a significant role in the functioning of the market for corporate control.[96] The European perspective, however, has been somewhat different. The European view has generally been that opportunistic behavior by management is best curbed with active monitoring by a controlling shareholder. The possibility to deviate from one share–one vote principle makes it easier to create concentrated control ownership that enables effective

[92] Vahtera 2007, p. 250.

[93] Ihamuotila 1994, p. 8 and p. 21.

[94] Schouten 2012, p. 8.

[95] Vahtera 2007, p. 253.

[96] Hart 1995, p. 206 and Holmström and Tirole 1993, pp. 678–679.

monitoring.[97] Thus, the difference between Anglo-American and European approaches has been over the issue of who is responsible for disciplining the management. Discipline by a monitoring control owner can be intuitively considered more effective than discipline by the market for corporate control. This is due to the fact that monitoring and disciplining of management is effective only when a single party becomes large enough to internalize the externalities of collective action e.g. by making a takeover bid.[98] However, the European approach creates the above-discussed tension over private benefits extraction, which is not present or at least is not present so strongly in the Anglo-American approach. Hence, in terms of management monitoring, one share–one vote principle has its pros and cons.

#### 2.4.2.4 Transaction costs

As discussed above, allowing deviations from the one share–one vote principle should lead to an efficient market for corporate votes and this market should provide fair compensation for voting rights.[99] The market for voting rights can be argued to serve two functions. First, the market gives the advantage of someone else's information gathering to all the shareholders willing to sell their votes. Secondly, it also enables votes to move into the hands of shareholders for whom the vote itself is most valuable, i.e. those who know how to use it most profitably.[100]

Easterbrook and Fischel do not, however, accept the above arguments. They argue that transactions in votes would present difficult problems of valuation and create other costs without conferring any apparent benefit over transactions in votes tied to shares.[101] In other

[97] Vahtera 2007, p. 254 and Ihamuotila 1994, pp. 30–33. On the other hand, Holmström and Tirole 1993, pp. 679–680, argue that only a certain level of ownership concentration is desirable. Otherwise ownership concentration reduces asset liquidity, which consequently decreases the level of monitoring.

[98] Grossman and Hart 1988, p. 176 and Jensen and Meckling 1976, pp. 312–313.

[99] Kaisanlahti 1998, p. 85. See also Black and Kraakman 1996, p. 1946, who note that control (like other assets) tends to move to those who value it the most.

[100] Manne 1964, p. 1444. The first argument is also emphasized by Barry et al. 2013, p. 1127.

[101] Easterbrook and Fischel 1983, p. 411.

words, deviating from the one share–one vote principle would create unnecessary transaction costs.

The argument about the disadvantages of transaction costs is reasonable, but it is not the whole picture. Prohibiting voting mechanisms other than one share–one vote would impose unnecessary restrictions on shareholders freedom of contract. It is true that some of the shareholders would save in transaction costs, but at the same time some other shareholders wishing to deviate from the principle would incur costs, as they would be forced to settle for a peremptory and inefficient model made by the legislator. Vahtera argues that deviating from the one share–one vote principle is efficient, when shareholders willing to acquire multi-vote shares or just more votes pay a premium exceeding the value reduction in single vote shares. Vahtera also points out that Easterbrook and Fischel do not consider this kind of situation possible,[102] which appears counterintuitive. Easterbrook and Fischel's argument is that every vote buyer takes into account the risk of not achieving the majority of votes. The amount a vote buyer is willing to pay for votes incorporates this risk. For this reason, the consideration for acquired votes will always be smaller than the value reduction incurred by the shares to which the votes were originally attached.[103] Kaisanlahti rejects this argumentation by noting that the risk incorporation process is similar also in a one share–one vote environment. A shareholder trying to acquire the majority of votes in a one share–one vote setting also incorporates the same risk of not achieving the majority of votes. This risk is shown as reduced consideration paid for the acquired shares.[104]

Vahtera has dismissed the transaction costs argument as non-problematic, when deviation from one share–one vote principle is based on company by-laws. If the deviation is stipulated in company by-laws, the existence of voting mechanisms other than one share–one vote is transparent. On the other hand, if deviations from the principle were prohibited, this could very well lead to circumvention of the prohibition provisions by contractual methods. In this case,

[102] Vahtera 2007, p. 256.

[103] Easterbrook and Fischel 1983, p. 411.

[104] Kaisanlahti 1998, p. 88.

the transaction cost would become more problematic as transparency would disappear and valuation of votes and shares would become more difficult.[105]

[105] Vahtera 2007, p. 257.

# 3 CHANGING LANDSCAPE OF SHARE OWNERSHIP

## 3.1 Changes brought by new financial innovation

The above perception of the indivisibility of shares has been criticized. Martin and Partnoy note that the seminal paper by Easterbrook and Fischel has become canonical and has not received enough of in-depth critical scrutiny.[106] The main thesis of Easterbrook and Fischel was that 1) shareholders are *the* group with voting rights, since they are the bearers of residual risk as well as residual claimants to a company's profits; and 2) the one share–one vote principle properly allocates voting rights in a way that minimizes agency costs and mimics the rules for which shareholders and other corporate constituents would contract absent transaction costs.[107]

Martin and Partnoy argue that changes in financial markets and financial theory have contributed to the fact that the classic assumptions of corporate voting no longer hold, if they even ever did. They also refer to the statement that preferences of shareholders are likely to be similar if not identical[108] and argue that shareholders are not necessarily, or even commonly, in the residual claimant position that the academic literature has assumed. They note that parties instead routinely utilize financial derivatives and structured finance techniques to reallocate various interests in the firm, including both residual claims and voting rights.[109]

---

[106] Martin and Partnoy 2005, p. 777.

[107] Easterbrook and Fischel 1983, pp. 403–406.

[108] Ibid., p. 405.

[109] Martin and Partnoy 2005, p. 778. In this respect, Martin and Partnoy make the following division: 1) First, are the shareholders who are according to Martin's and Partnoy's terminology economically encumbered. Economically encumbered shareholders are those, who have hedged the economic exposure of their share ownership by equivalent short position or by use of derivatives, such as a put option or a total return swap. Such shareholders have lost the pure economic benefit of the shareholding and will therefore lack the same incentives as those shareholders who own the stock without any kind of hedge. 2) Secondly, the opposite side of the coin is the issue of whether voting rights should be granted to persons who, through derivatives or otherwise, have acquired an economic interest in a company without acquiring shares. Martin and Partnoy acknowledge that such persons may under some circumstances be more appropriate voters than encumbered shareholders since

The same kind of observation as Martin and Partnoy is made by Hu and Black, who note that the growth in equity swaps and other privately negotiated (so-called Over-the-Counter or OTC) equity derivatives and related growth in the share lending market are making it easier and cheaper to decouple economic ownership from voting power.[110] Kalay and Pant point out that in the presence of derivatives markets the one share–one vote principle is unenforceable. Furthermore, they argue that an active derivatives market enables a "home-made" separation of economic and control rights.[111] All this imposes challenges for 1) the traditional assumption of shareholder voting as a value maximizing mechanism and, by extension, for corporate governance too; and 2) mandatory ownership disclosure rules that have not generally been applicable to economic-only positions.

In their analysis Martin and Partnoy take a strong substance-over-form kind of approach and, in the author's view, fail to fully acknowledge that in the setting of institutional corporate law it is still not possible to separate votes from the economic interest of shares. The market value of a share comprises two distinguishable components already discussed above: 1) economic rights (to the firm's cash-flows); and 2) control rights (to exercise voting power to control firm decision-making). In the absence of derivatives markets, the two components are aggregated in fixed proportion and cannot be separated.[112] Corporate law itself has not evolved in a way that would make it possible to break the assumption of share indivisibility, but the fundamental

their interests are more closely aligned with traditional conceptions of shareholder incentives, like residual claimant position for example.

[110] Hu and Black 2006, p. 815.

[111] Kalay and Pant 2009, p. 1. See also Christoffersen et al. 2007, p. 2927, who note that according to their study "votes float separately from shares whether companies want them to or not."

[112] Kalay and Pant 2009, p. 9. See further pp. 1–2: "Even in markets where firms are forced to issue voting rights and cash flow rights in fixed proportions, shareholders can break the link by trading in the market. […] Essentially the presence of a derivatives market gives rise to time varying control rights. This is different from the traditional forms (dual-class shares, controlling blocks, etc.) of deviating from one share–one vote. Shareholders no longer have to pre-commit to holding a certain ratio of votes to cash-flows. They have the ability to change the voting structure optimally at any given time by trading in the derivatives market."

change has occurred outside the context of institutional corporate law. Thus the critique directed at Easterbrook and Fischel's thesis needs further discussion.

Martin and Partnoy, however, are right in their point that Easterbrook and Fischel's arguments do not *de facto* hold anymore as it is true that equity derivatives and other decoupling techniques do easily separate a vote from the economic returns of a share.[113] This does not, however, happen in a purely institutional corporate context, but is instead a construction that needs a third party (i.e. the derivatives counterparty) to complete the division of vote and economic ownership. In this sense, it can be argued that equity decoupling introduces a new party to the nexus of contracts of a corporation.

## 3.2 Drivers of change

### 3.2.1 Marketization and complete markets – supply of equity decoupling

But what has been the driver of the financial innovation previously described? It is not so long ago when stocks even in listed companies were physical stock certificates. These certificates had dividend checks attached and were moved around when stocks were bought and sold. However, since then something has changed. Technological and other innovations are the visible result of this change, but not the driver of it. In this respect Vahtera discusses the marketization of society and argues that both the operational environment as well as regulation of stock exchange listed companies have undergone marketization development. By using the term marketization Vahtera refers to the adaptation of society's institutions to meet the requirements of the exchange economy: markets are everywhere and for everything. Marketization can be crystalized as the need to change regulation to meet the challenges of an increasingly international operational setting and exchange.[114]

With reference to stock exchange listed companies, Vahtera[115] refers to the work of Deeg and notes that marketization is visible in five different dimensions: 1) firms are no longer restricted (by either regulation or market structures) in their financing options to domestic financial

[113] Martin and Partnoy 2005, p. 778.

[114] Vahtera 2011, p. 19.

[115] Ibid., p. 20.

institutions; 2) there is a general shift in firm financing patterns from bank to market and self-finance; 3) firms are increasingly subject to a common set of rules for financial transparency and financial practices; 4) firms are subject to increasingly common corporate governance rules and practices; and 5) firms' strategies and restructuring are increasingly subject to influence from outside firm management or corporate insiders, especially by financial market actors (notably institutional investors, hedge and equity funds), which leads to a more active market for corporate control and restructuring via takeovers, mergers and acquisitions.[116]

In terms of economic theory, Vahtera seems to be noting that *complete markets* are affecting society. In economics, complete markets mean that every actor in the economy is able to exchange every commodity, directly or indirectly, with every other actor and without transaction costs. In other words, a complete market means that there is a market for every kind of good in the society. This kind of thinking can be traced back, for instance, to the work of Arrow and Debreu[117] and their Arrow-Debreu general equilibrium model that suggests that there must be a set of prices such that aggregate supplies will equal aggregate demands for every commodity in the economy.[118]

The idea of complete markets has been used to explain the use of derivatives on the basis that they add value by providing investors with flexibility in fashioning their portfolios. Thus, derivatives can be said to make systems of markets less incomplete. The popularity of derivatives can be explained from a theoretical perspective involving complete markets. In some cases, the theory can even suggest new markets that would alleviate existing incompleteness.[119]

These developments can be used to derive an analogy: complete markets theory and marketization have been the key drivers behind the separation of voting rights and cash-flow

[116] Deeg 2009, pp. 556–557.

[117] Flood 1991, p. 34.

[118] See Arrow and Debreu 1954.

[119] Flood 1991, p. 34.

rights.[120] The evolution from physical share certificates to low-cost electronic trading, together with marketization, has created a new market as suggested above. This market comprises bits and pieces of what has traditionally been considered corporate shares. The need to be able to take either economic-only positions or acquire only votes has driven financial innovation that enables separation of economic and control rights.[121] Corporate law theory especially in the nexus of contracts field has long acknowledged that this is possible. Already in the 1970s Jensen and Meckling noted in their seminal paper the likelihood of the appearance of new corporate financial instruments, as creation and market maintenance for them would become more efficient.[122]

The divergence of economic and ownership rights of shares can perhaps be better understood by examining other sectors of the financial industry, because in the author's view exactly the same kind of developments have been observed in other sectors of the financial markets. The creation and spreading of e.g. mortgage backed securities (MBSs) and credit default swaps (CDSs) are driven by exactly the same factors. Let us consider securitization of home mortgages (RMBSs) for example and draw some similarities between equity decoupling, which can be understood as the equivalent of securitizing voting rights and economic rights to their own respective securities. Asset securitization can be understood as transforming illiquid assets into tradable securities. Before the creation of RMBSs, home lenders were forced to keep illiquid assets and the inherent risks on their balance sheet in a similar fashion to equity holders, who have been forced to keep either illiquid votes or corresponding economic interests on their "balance sheets", when it has been in their preferences to hold only either economic or control rights.

---

[120] In this respect see e.g. Gilson and Whitehead 2008, pp. 247–248, who argue that the benefits of risk management drive the demand that has led to growth in capital markets completeness.

[121] Similar kind of need has also existed in other parts of the economy. Demand for pooling and transferring risks in discrete slices has resulted in all kinds of financial derivatives ranging from currency forwards to weather derivatives. See discussion in Gilson and Whitehead 2008, pp. 243–247.

[122] Jensen and Meckling 1976, p. 356.

Several economic drivers of asset securitization can be distinguished, the first of which is risk transferring and diversification. In this respect, securitization helps the holder of the asset to sell the asset and transfer the respective risk to a party more capable of bearing that risk.[123] This also enables diversification of risks. This driver applies to banks holding mortgages on their balance sheet as well as equity investors, some of whom are more capable and willing to bear risk than other investors. Equity decoupling makes it easier and more efficient to transfer and diversify risks.

Second economic driver of asset securitization is the need for liquidity.[124] Pools of mortgage loans, for example, can only be sold as a whole, which makes them relatively illiquid assets. Securitization mitigates this problem. Equity decoupling mitigates a similar kind of problem in equity investing, since separation of economic and control rights creates liquidity, if an investor is willing to acquire only one of the two share components.

Thirdly, securitization makes the financial markets more efficient. Taipalus et al. note that it is traditionally thought that the existence of banks is based on market imperfections and banks' ability to mitigate these imperfections. As competition increases, markets become more efficient. In this sense, securitization is an example of markets becoming more efficient.[125] The same analogy can be applied to equities. Differentiating investor preferences has created asymmetries and imperfections that are resolved by equity decoupling. Hence, investors of high sophistication and resources are discovering more and more inefficiencies and possibilities of making a buck. The exploitation and correction of the inefficiencies is possible only if there is a market that allows trading with the instruments correcting the inefficiencies.

One practical example is the large collective value of votes. As Hu and Black note, corporate votes have limited individual value, but possibly a very large collective value due to the control

[123] Taipalus et al. 2003, p. 27.

[124] Ibid., p. 27.

[125] Ibid., pp. 29–30.

implications.[126] The marketization development and increasing efficiency can be argued to have contributed to the fact that those who have capital can nowadays more easily benefit from this collective value component as votes have become more of a commodity. Furthermore, there are also more investors who have this kind of capital, since decoupling of economic and voting rights requires less invested capital than ever before. Concentrated ownership base, which is addressed below, and the Internet have also contributed to the fact that putting together a momentary majority is nowadays easier.[127] In other words, buying votes and taking advantage of the collective value of votes is easier and more cost efficient than before.[128]

All in all, investors are increasingly sophisticated and have realized the possibilities of financial innovation. The need to take positions that are just in line with the investors' preferences and the fact that everything is for sale has driven a powerful fundamental change to the core of corporate and securities law. Marketization has, therefore, reached the foundations of corporate and securities law in a way that has transformed some of the key paradigms considered stable and lasting. Nevertheless, the questions of do legislators acknowledge these changes and, if so, how legislators respond to this new dynamism remain.

Marketization and financial innovation thus explain the supply of equity decoupling. Next, the aim is to explain the remaining demand side of the supply-demand equation. These two pieces together form a comprehensive explanation for the emergence of equity decoupling.

[126] Hu and Black, 2006, pp. 852–853. For empirical evidence see also Barclay and Holderness 1989, p. 394, who document that trades of blocks involving at least 5% of the common stock of NYSE- and Amex-listed corporations are typically priced at substantial premiums to the post-announcement exchange price. The average premium is 20%, which represents approximately 4% of the total value of the firm's equity. See also Zingales 1995, p. 1059, who reports voting premium of 10.5% in the U.S. market, Nenova 2003, p. 334, who reports voting premium of 2.0% in the U.S. market, and Kalay et al. 2014, who report a voting premium of 1.58% in the U.S. market.

[127] Strine 2014, p. 456.

[128] See the discussion regarding total return swaps in chapter 4.1.

### 3.2.2 New agency capitalism – demand for equity decoupling

#### 3.2.2.1 Traditional agency problem

In traditional law and economics theory,[129] an agency relationship is defined as a contract under which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent.[130] This agency relationship has its costs due to agency problems that arise because contracts are not written and enforced without cost. Agency costs consist of the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests as well as the value of output lost because the costs of full enforcement of contracts exceed the benefits.[131]

Fama and Jensen define unrestricted risk-sharing among residual claimants as one of the benefits of common stock residual claims. This means that common stock allows residual risk to be spread across many residual claimants who individually choose the extent to which they bear risk and who can diversify across organizations offering such claims.[132] Consequently, this means that diversified shareholders do not bear unsystematic firm-related risks, since these risks can be diversified away. The reduction of risk means lower cost of capital. The lower cost of capital is, however, accompanied by agency costs. In other words, someone must manage the capital provided by diversified shareholders.[133] This creates the traditional corporate law agency

[129] Although the agency problem became acknowledged as a result of seminal work by Berle and Means 1932, and more widely in academia only some 40 years ago, the truth is that the existence of the problem has been pointed out already in the classical economic theory a few centuries ago. For instance Smith 1776c, p. 121, summed up the agency problem of shareholder – manager relation as follows: "The directors of such companies, however, being the managers rather of other people's money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."

[130] Jensen and Meckling 1976, p. 308.

[131] Jensen and Meckling 1976, p. 308 and Fama and Jensen 1983a, p. 304.

[132] Fama and Jensen 1983b, p. 329.

[133] Gilson and Gordon 2013, pp. 869–870.

problem that has, however, undergone a change over the last few decades. This issue is addressed next.

#### 3.2.2.2 Investment intermediaries

The rise of agency capitalism can be seen as a practical extension to the developments discussed above. Gilson and Gordon[134] make a compelling argument that the ownership base of listed corporations has metamorphosed. The dispersed and passive ownership base of Berle and Means[135] era has transformed into a new concentrated ownership structure characterized by financial intermediaries that are "rationally reticent"[136] in their use of governance rights. Therefore, whereas the traditional agency problem existed mainly in the shareholder–manager relation, the modern agency problem has three parties: investors as the beneficial owners, financial intermediaries as shareholders and as the agents of investors, and managers as the agents of the financial intermediaries.[137]

Gilson and Gordon argue that, firstly, the transformation of ownership structure illustrates both the fact that corporate governance is bound up with the way capital markets support the transfer of risk to investors. Secondly, the transformation also illustrates that the direction of causation

---

[134] See Gilson and Gordon 2013 and Gilson and Gordon 2014. Also Strine 2014 discusses the issue ownership concentration. The authors' analysis mainly concerns the U.S., but similar analysis can be at least to a certain extent applied to Europe as well.

[135] See Berle and Means 1932, p. 333 who describe the dispersed ownership base and consequent separation of ownership and control of their era: "It is traditional that a corporation should be run for the benefit of its owners, the stockholders, and that to them should go any profits which are distributed. We now know, however, that a controlling group may hold the power to divert profits into their own pockets. There is no longer any certainty that a corporation will in fact be run primarily in the interests of the stockholders. The extensive separation of ownership and control, and the strengthening of the powers of control, raise a new situation calling for a decision whether social and legal pressure should be applied in an effort to insure corporate operation primarily in the interests of the "owners" or whether such pressure shall be applied in the interests of some other or wider group."

[136] In contrast to "rational apathy" of shareholders of dispersed ownership base described by Berle and Means 1932, p. 81: "The normal apathy of the small stockholder is such that he will either fail to return his proxy, or will sign on the dotted line, returning his proxy to the office of the corporation."

[137] Gilson and Gordon 2013, pp. 867–868.

is from capital markets' innovations to corporate governance so that capital markets determine the efficient structure of corporate governance. Hence, changes to the available mechanisms of risk transfer first drive ownership changes, before corporate governance institutions adapt to ensure an allocation of governance rights that facilitate the available risk transfer techniques.[138]

Gilson and Gordon see that the reason for the rise of the new agency capitalism is two-fold. Firstly, the political decisions relating to augmenting retirement security through private pensions rather than social security has created a large number of different types of pension and mutual funds that are the biggest actors in today's capital markets. Secondly, the triumph of modern portfolio theory (MPT) has also contributed to the development.[139] According to MPT, portfolio diversification is the ownership pattern that optimally balances the pursuit of highest expected return with the avoidance of unnecessary risk. This principle has guided pension and mutual funds, as well as individuals investing in mutual funds, to diversify their investments.[140]

Consequently, the two above-mentioned drivers and the resulting extensive use of financial intermediaries have led to the chronic undervaluation of governance rights.[141] This is due to the fact that effective use of governance rights requires firm-specific investigation and firm-specific activism, both of which are costly and will be undersupplied by traditional institutional investors. For example, the use of diversification discourages proactive use of governance rights. An intervention requires a lot of resources, but even a successful intervention provides a benefit too small for a well-diversified portfolio. In addition, the monitoring of investment performance is often based on benchmarking to a reference index, like the S&P 500 for example. When performance evaluation is based on this kind of benchmarking, portfolio management is based on asset, industry and sector allocation rather than use of governance rights.[142]

---

[138] Gilson and Gordon 2013, pp. 867–868.

[139] First publicized by Markowitz, 1952.

[140] Gilson and Gordon 2013, p. 867.

[141] Ihamuotila 1994, p. 61 makes the point that if shareholder does not value control highly, she will diversify. This is in line with the MPT argument made above.

[142] Gilson and Gordon 2013, pp. 891–893.

As spelled out above, the key point of Gilson and Gordon is that the concentration of ownership of the last 30 years to financial intermediaries has led to chronic undervaluation of voting rights and the rise of new agency costs.[143] As discussed earlier, marketization and financial innovation have created the supply for equity decoupling. The new agency capitalism has, in turn, been responsible for creating the demand side of equity decoupling. To be more specific, activist investors and especially activist hedge funds have accounted for most of the demand for equity decoupling tactics. Hedge fund activism and its role are discussed next.

#### 3.2.2.3 Shareholder activism

The idea of large shareholders as monitors of management is not new,[144] but taking into account the developments discussed above, activist shareholders, especially hedge funds, have risen to perform a new and unique role as gap-fillers in corporate governance. This benefits shareholders and the economy at large.[145] Hedge funds can be described as highly sophisticated investors, which have several different aspects that distinguish them from other financial institutions. For example, hedge funds usually require that investors lock their investments for a fixed period of time. This typically varies from 6 months to several years. Furthermore, whereas mutual funds have their independent boards and need shareholder approval for certain actions, hedge funds are able to more freely engage in strategies and activities as they see fit.[146] Hedge funds are also able to trade on margin and engage in short sales, which generally are not permissible tactics for mutual and pension funds. Hedge funds' ability to use significant amounts of leverage in their investments enables them to hold more concentrated positions than other investment institutions usually would. Consequently, this enables hedge funds to capture a greater percentage of the value created by their activist efforts.[147]

---

[143] Gilson and Gordon 2014, pp. 12–17.

[144] See e.g. Grossman and Hart 1988.

[145] The gap-filler role of hedge funds is discussed extensively by Partnoy and Thomas 2007.

[146] Ibid., p. 117.

[147] Ibid., p. 119.

In addition to their other strategies, Kahan and Rock[148] have argued that hedge funds engage in two types of corporate activism: corporate governance activism[149] and corporate control activism that are both important with respect to managing agency costs of agency capitalism, as discussed earlier. Corporate governance activists aim to change the way a corporation is run and managed. They can, for example, encourage larger profit distributions in the form of dividends or share buybacks or demand acquisitions, spin-offs or change of business strategy. Corporate control activists, in turn, strive for higher shareholder returns in a takeover. This goal is often pursued by negotiating with potential bidders and organizing holdouts in hope of better offers.

Both types of hedge fund activism receive their theoretical justification from agency costs arising from the separation of ownership and control in publicly listed companies. As Partnoy and Thomas note, hedge funds are well-informed large investors that can influence the managers of poorly performing companies to take action to stop value-destroying activities.[150] Well-informed investors with superior knowledge can leverage this knowledge and put it to use in three ways, by: 1) buying more shares and thus more voting power; 2) soliciting proxies; or 3) buying votes detached from shares' economic rights.[151] The problem with the first alternative is that it requires a lot of capital and is therefore very costly. Proxy solicitation is also an expensive alternative, which is, in addition, affected by the free rider problem. Buying mere votes (i.e. equity decoupling) may very well be cost-efficient way to leverage superior knowledge into use.[152] Thus, equity decoupling can be seen as a means to cost-efficient shareholder activism.

---

[148] Kahan and Rock 2007, pp. 1029–1042. Corporate activism is, however, only one of the strategies of hedge funds. See e.g. Partnoy and Thomas 2007, pp. 113–114 and pp. 120–131, who distinguish that hedge funds engage in 1) information asymmetry and convergence trades, 2) capital structure motivated trades, 3) merger and risk arbitrage and 4) governance and strategy activism.

[149] Corporate governance activism and its significance is also emphasized by Gilson and Gordon 2013, pp. 866–867.

[150] Partnoy and Thomas 2007, p. 128.

[151] Schouten 2012, p. 86.

[152] Ibid., pp. 87–89.

Gilson and Gordon see the activist shareholders as governance intermediaries or arbitrageurs, who monitor company performance and present to companies and institutional shareholders concrete proposals for business strategy through mechanisms that are less drastic than takeovers. Usually activist shareholders are not control seekers, in the sense that they are not motivated by the pursuit of private benefits of control and nor do they anticipate actually managing a portfolio company. Rather they are governance entrepreneurs, who arbitrage governance rights, which consequently become more valuable through their activities. This occurs when activist shareholders monitor companies in an effort to identify strategic opportunities and then present these opportunities to institutional investors for their approval. Therefore, as Gordon and Gilson put it, the role of the new entrant into the governance story, the activist, is to increase the value of the vote held by the institutions by teeing up the intervention choices at low cost to the institutional owners.[153]

The theoretical assumptions of hedge fund activism are also backed by empirical evidence, although the debate around the evidence has been colorful. For example Brav et al. examined a sample of 1,059 hedge fund activism events over the period 2001–2006. Among their analyses are stock market reactions to investor activism. Brav et al. find average cumulative abnormal returns of 8.4% over an event window of [-20, +20] around the disclosure date of schedule 13D filings indicating activism.[154] Furthermore, Clifford examined another sample of 1,902 activism cases over the period 1998–2005 and focused on stock price reactions and changes in operating performance. The author found 3.39% average cumulative abnormal returns over an event

[153] Gilson and Gordon 2013, p. 867 and p. 897. See also Zanoni 2009, pp. 6–9, who provides a cost benefit analysis of hedge fund activism and concludes that the costs implied by hedge funds' activism are at least offset by the relevant benefits.

[154] Brav et al. 2008. The authors measure document a cumulative abnormal return of 2.0% on the filing day and the day following the filing. After the filing the cumulative abnormal returns increase up to a total 7.2% in twenty days following the filing. The authors conclude that share prices adjust to a level reflecting the expected benefit of intervention, adjusted for the equilibrium probability that the fund continues with its activism and succeeds.

window of [-2, +2] around the activist Schedule 13D filings.[155] Klein and Zur also provide similar evidence.[156]

The empirical evidence is not, however, greeted with enthusiasm by everyone. For example Martin Lipton, a founding partner of the prominent law firm Wachtell, Lipton, Rosen & Katz, the inventor of the poison pill takeover defense and a vocal critic of hedge fund activism, has expressed concerns over the short-term nature of hedge fund activism.[157] Similar concerns has also been raised by Leo E. Strine, Jr., who currently serves as the Chief Justice of the Delaware Supreme Court.[158] As a response to the criticism, Bebchuk et al. conducted a study looking into the long-term effects of hedge fund activism and found that the initial positive returns of hedge fund activism persist.[159] Hence, the empirical evidence in favor of hedge fund activism appears quite compelling and backs up the case presented by law and economics theory.

When activism extends beyond corporate governance activism to corporate control activism, an explanation for the hidden ownership side of equity decoupling may exist. Buying just corporate control in the form of shares is costly.[160] These costs are then accompanied by costs relating to overcoming possible takeover defenses as well as price run-up after the takeover scheme has

[155] Clifford 2008.

[156] Klein and Zur 2009. The authors report mean cumulative abnormal returns of 7.2% over the [–30, +30] window around the schedule 13D filings and conclude that the market perceives substantial benefits upon learning that a firm is targeted by a hedge fund activist.

[157] The Wall Street Journal Mar 28, 2014.

[158] Strine 2014. See e.g. p. 459: ”For society as a whole, further empowering money managers with short-term holding periods subjects Americans to lower long-term growth and job creation, wreckage from corporate failures due to excessive risk taking and debt, and the collateral harm caused when corporations face strong incentives to cut regulatory corners to maximize short-term profits.”

[159] Bebchuk et al. 2014. The authors find that during the five-year period following the activist intervention, operating performance relative to peer companies improves consistently. Furthermore, on average the companies targeted by activists close two-thirds of their gap with peer companies in terms of return-on-assets and two-fifths of this gap in terms of Tobin's q.

[160] Schouten 2012, p. 87 and for empirical evidence Barclay and Holderness 1989, p. 394.

become public. These additional hindrances and costs have encouraged corporate control activists to avoid them by using stealth takeover tactics, i.e. hidden ownership. Hidden ownership has enabled corporate control activists to amass significant toehold positions without meeting resistance from management or other shareholders. Hidden ownership has also limited price-run ups and, therefore, made it more affordable to engage in corporate control activism.[161]

[161] For anecdotal evidence, see The New York Times, May 4, 2014 and The New York Times, May 20, 2014.

# 4 EFFECTS OF EQUITY DECOUPLING

## 4.1 Mechanics of empty voting

Empty or negative voting is the other of the phenomena resulting from the divergence of economic and control rights described earlier in this study. Empty voting means taking positions, where economic risk is smaller than what would normally be the case with the corresponding voting power. Negative voting on the other hand refers to inverse economic positions, where the economic interest of a vote holder is negative, i.e. profit is made, if the value of the company decreases. Empty voting can occur for example through hedging (the use of equity derivatives), share lending or by taking advantage of the so-called record date capture.[162]

Negative voting and its perils are perhaps best illustrated by giving an example of a real event. In 2004, the hedge fund Perry Corporation held a significant position of 7 million shares in the drug maker King Pharmaceuticals, when another drug maker, Mylan Laboratories, agreed to acquire King. In the event of the $4.1 billion merger being consummated, Perry stood to profit some $28 million due to the 61% premium the bid offered for King shareholders. However, in order for the deal to close, the proposed merger needed shareholder approval from Mylan's shareholders. However, a number of Mylan shareholders, including the prominent activist investor Carl Icahn, opposed the merger and consequently sued Perry for stock manipulation.

For ensuring that the deal would close Perry acquired 26.6 million Mylan shares or a stake of 9.9% to vote in favor of the merger. However, at the same time Perry hedged its economic exposure of its Mylan position by taking a short position in a total return swap.[163]

> A total return swap (TRS) or a contract for difference (CfD) is an OTC equity derivative instrument, in which one party agrees to make a series of payments to the counterparty at regularly scheduled dates. The counterparty of the transaction agrees respectively to make a series of payments to the first party. The payment series are tied to the performance of a stock and the payments are

[162] Hu and Black 2006, pp. 828–835 and Ringe 2013a pp. 1034–1055.

[163] Hu and Black 2006, pp. 828–829, The New York Times, Dec 13, 2004 and The Wall Street Journal, Dec 15, 2004.

> determined by the rate of return of the underlying stock applied to a predetermined notional principal.
>
> The first series of payments is the long side of the transaction. This means that the series of payments received by the long party are equal to the appreciation of the stock including also any distributions paid for the holders of the stock. The long party, in turn, is obliged to pay depreciation of the stock to the counterparty, i.e. the short party of the transaction. Furthermore, the long party usually pays a series of interest payments on the agreed notional principal. Interest payments may for example be EURIBOR or LIBOR plus an agreed margin. Hence, the economic position of the long party is similar to that of owning the underlying stock (i.e. $\Delta = 1$, $\Gamma = 0$) except for the interest payments and possible fees. Respectively, the economic position of the short party is similar to shorting the stock (i.e. $\Delta = -1$, $\Gamma = 0$), again except for the interest payments and possible fees.[164] Short parties to TRSs often hedge their exposure by acquiring the underlying shares or by further entering into offsetting derivatives transactions (i.e. $\Delta = 0$, $\Gamma = 0$), although this is not an obligation.[165]
>
> The benefits of TRSs include the fact that the long party does not need to invest the whole amount of capital, which would otherwise be required for acquiring the underlying asset to receive the full upside as well as downside return profile. Thus, TRSs produce a similar economic return profile to that of a direct investment to the underlying asset, but with a smaller amount of invested capital.[166]

Thus, Perry had almost a 10% voting stake in Mylan, but no economic interest. To be precise, Perry's economic interest in Mylan was negative: the more Mylan paid for King, the more Perry stood to profit. The deal never closed for unrelated reasons, but it still raised concerns over the detrimental effects of empty voting.

Hu and Black present a set of other similar kinds of empty voting events that have involved either the use of equity derivatives, share lending or record date capture.[167] Record date capture refers to activities taking advantage of the gap between record date and the general meeting where the votes are cast. This gap enables activist investors to borrow shares, be recorded as shareholders on the record date and then sell the shares short after the record date. Thus, on the

---

[164] Chance 2004, p. 75.

[165] Kettunen and Ringe 2012, p. 8.

[166] Ibid., p. 3.

[167] Hu and Black 2006, pp. 828–835.

day of the general meeting, these investors are eligible to vote, but hold a negative economic interest in the company.

One example of record date capture occurred in Hong Kong in 2006, when Henderson Land attempted to take its subsidiary Henderson Investment private by acquiring the 25% minority stake it did not yet own. It appeared that the acquisition of the minority stake and the consequent delisting transaction were viewed favorably and Henderson Investment's share price surged. However, the buyout failed as 2.7% of the votes were against the buyout. The peculiarity stemmed in part from Hong Kong law, which provided that buyouts can be blocked by 10% of votes of free-floating shares, which in this case was 2.5% of the total shares outstanding. Apparently a hedge fund had borrowed the necessary shares and held them on the record date. After the record date the hedge fund presumably sold the shares short and benefited from its private information that the buyout would not happen. The share price of Henderson Investments fell 17% on the day following the announcement of the voting outcome.[168]

## 4.2 Mechanics of hidden ownership

The mechanisms of hidden ownership are similar to those of empty voting, except that the mechanisms are mirror image transactions of empty voting, i.e. they acquire economic ownership without corresponding control rights. One high-profile case of a hidden ownership scheme occurred in the summer of 2008. The case involved Schaeffler AG, one of the largest privately owned companies in Germany, and the automotive supplier Continental AG, which is a publicly traded company and belongs to the prestigious DAX 30 stock index.[169]

In the summer of 2008 Schaeffler launched a takeover bid for Continental, although Continental was almost three times the size of Schaeffler. Before the launch of its takeover bid, Schaeffler had acquired a direct ownership stake of 2.97% in Continental. This stake was just below the first German mandatory ownership disclosure limit of 3% for direct ownership. In addition to its direct ownership stake, Schaeffler had entered into physically-settled swap contracts that increased its cumulative ownership stake to 4.95%, which was again just below the threshold

[168] Hu and Black 2006, pp. 834–835.

[169] Zetzsche 2009, p. 118.

limit of 5% concerning physically-settled derivatives. Furthermore, during the spring of 2008 Schaeffler had also entered into cash-settled TRSs that created an economic exposure equivalent of owning a 28% direct stake in Continental. Therefore, the economic interest of Schaeffler in Continental amounted to an overall stake of 36%, which did not have to be disclosed. Schaeffler operated with the investment bank Merrill Lynch, which had organized a syndicate of investment banks to take part in the scheme. Each of the banks had hedged their short exposure to the TRSs by acquiring the corresponding Continental shares. The banks held positions of 2.99%, which were below the 3% disclosure threshold.[170]

On 14 July 2008, Continental disclosed publicly that it had been informed on 11 July 2008 by Schaeffler that Schaeffler was looking to acquire up to 49% of Continental. On 15 July, Continental's shares surged from €55 to €71, an increase of 28%. On the same day, Schaeffler announced a cash offer for Continental at €69.37 per share (later revised to €70.12), which was the minimum price required by the German securities laws.[171] Schaeffler had the possibility to terminate the TRSs at any time. After the termination by Schaeffler occurred, the counterparties of Schaeffler had the incentive to tender the shares they held as a hedge to Schaeffler.[172]

On 30 July 2008 the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin), launched an investigation into the events that had occurred, but found no wrongdoing. BaFin held that the TRS scheme did not prompt disclosure obligations arising from the holding of other financial instruments pursuant to German disclosure rules, because the cash-settled TRSs did not grant a delivery right for the respective Continental shares. On the same day that BaFin cleared the transaction, on 21 August 2008, Schaeffler issued its unwind notice concerning the TRSs. By the end of the offer period on 2 September 2008, Schaeffler had reached its target and acquired a direct ownership stake of a little over 48% in Continental.[173]

---

[170] Zetzsche 2009, pp. 118–122.

[171] Ibid., pp. 124–125.

[172] Ibid., p. 127.

[173] Ibid., pp. 126–127.

The above example illustrates how hidden ownership occurs in practice. Since disclosure and takeover rules are often based on only ownership of actual shares, it is possible to circumvent these rules by acquiring only economic ownership. In practice, this economic ownership may often be transformed to actual share ownership by unwinding the derivative arrangements.

## 4.3 Understanding the problematic nature of equity decoupling

### 4.3.1 Empty voting

Empty voting *per se* may not be harmful.[174] The case where an investor has hedged a part of his financial risk relating to his share holdings can be compared to an investor who holds shares with multiple voting rights. Holding more votes than economic ownership is often criticized and viewed as inefficient as discussed earlier, in chapter 2.4.[175] These kind of holdings can be seen as form of vote trading, where votes are traded to better informed investors who are able and willing to monitor management more effectively.[176] This results in enhanced shareholder oversight that may very well outweigh the costs associated with an increased agency costs.[177] Furthermore, since all but negative voters have a positive economic exposure to changes in the market value of a company, no fundamental conflicts of shareholder behavior should occur.[178]

Easterbrook and Fischel note that the preferences of one class of participants in a corporation are likely to be similar if not identical and they emphasize that this is true of shareholders

---

[174] Schouten 2012, p. 4. “As long as the empty voter has a positive net economic interest, the fact that his economic interest does not perfectly correspond with his voting power need not be problematic and may indeed be beneficial.”

[175] See e.g. Easterbrook and Fischel 1983, pp. 408–410. They argue that making voting rights proportional to one’s share in the firm’s residual value reduces agency costs by matching economic incentives with voting power.

[176] Christoffersen et al. 2007, p. 2927. This of course requires that the interests of uninformed and informed shareholders are consistent with each other.

[177] Schouten 2012, p. 8. See however Bebchuk et al. 2000, p. 296, who note that when economic rights decrease, agency costs increase, not linearly, but rather at a sharply increasing rate. Thus, modest decrease in economic rights may result in significant increase in agency costs.

[178] Cohen 2008, pp. 241–242.

especially. They argue that investors are able to buy shares and use their normal exit right[179] in the market so that the shareholders of a given firm at a given time are reasonably homogeneous group with respect to their desires for the firm.[180] However, with respect to negative voting this assumption may no longer be valid. By definition, negative voters have an incentive to bring about a decrease in the market value of the company, which obviously is in strong conflict with the interests of other shareholders.[181]

With respect to the above, Martin and Partnoy note that homogeneity of preferences is a key assumption in the law and economics model of corporate voting.[182] In this regard they refer to the work of Easterbrook and Fischel, who make the assumption that each shareholder has an equal incentive to maximize firm value proportional to their share ownership.[183] The basis for the one share–one vote principle, as well as the prohibition of vote trading, stems from the homogeneity assumption. Easterbrook and Fischel state that when voters hold dissimilar preferences it is not possible to aggregate their preferences into a consistent system of choices.[184] In other words, if shareholders are not homogeneous in their preferences, then the efficiency justification of a one share–one vote principle does not hold.[185] Empirical evidence suggests that the homogeneity argument is controversial.[186] However, if vote buying is allowed on the

[179] Vahtera 2011, pp. 306–322.

[180] Easterbrook and Fischel 1983, p. 405 and Kobayashi and Ribstein 2006, p. 39.

[181] Cohen 2008, p. 241.

[182] Martin Partnoy 2005, p. 788.

[183] Easterbrook and Fishcel 1983, p. 405.

[184] Ibid., p. 405.

[185] Martin and Partnoy 2005, p. 788.

[186] Barclay and Holderness 1989, p. 394. ”These results call into question the widely held assumptions that shareholders are homogeneous and that corporate benefits are distributed to shareholders in proportion to their fractional ownership.” See also Ihamuotila 1994, p. 10: “The common feature in the theoretical and empirical literature is that large shareholders are considered homogenous. This is clearly not a realistic view, since large shareholders not only monitor management but also control firms according to their own preferences, and these preferences seem to vary much.” Representing the opposite position, see e.g. Dent 2010.

heterogeneity of preferences argument, vote buying may still cause problems of inefficiency. These problems arise when the harm done to a third party shareholder exceeds the benefits accrued by the parties that engage in the vote selling and buying transaction.[187] With reference to third party shareholders, vote buying breaks up the standardized bundling of economic and voting rights and this break-up is not visible in, for example, company by-laws.[188] Therefore, also third party shareholders incur information costs. These information costs arise because shareholders have to take precautions, make investigations and possibly rely on external advice on the properties of shares and voting, and economic ownership structure of a company. In particular, shareholders can no longer rely on following a traditional combination of economic risk and control rights.[189]

Furthermore, the whole justification for shareholder voting may lose its ground in cases of empty or negative voting.[190] As discussed earlier in this study, shareholders are generally viewed as bearers of the residual risk.[191] This means that shareholders are claimants to whatever remains after other constituencies have been satisfied and this is the only claim shareholders have. This implies that shareholders are in the best position to make decisions (i.e. to vote) for maximizing the value of the company due to their incentives stemming from the position of residual claimants. Thus, the residual risk characteristics of equity investment are the justification for voting rights of shares. Then what happens to the justification, if the risk characteristics are eliminated?[192] For example, Gilson and Whitehead have argued that risk-decoupled shares are closer to debt than equity in their instrumental substance.[193] In this case it seems to be quite

---

[187] Cohen 2008, pp. 240–241.

[188] Vahtera 2007, p. 257.

[189] Ringe 2013a, pp. 1070–1071.

[190] Ringe 2013a, pp. 1073–1074. See also Schouten 2012, p. 4.

[191] See e.g. Easterbrook and Fischel 1983, p. 403, Alchian and Demsetz 1972, p. 782 and Vahtera 2011, pp. 384–385.

[192] In addition to Ringe 2013a, pp. 1073–1074, this aspect is also discussed by e.g. Schouten 2012, p. 71.

[193] Gilson and Whitehead 2008, p. 231 and p. 251.

obvious that the traditional fundamental justification for voting rights of shareholders also disappears.

The problems of empty and negative voting are manifold and can vary in form. However, the main problem is the creation of agency costs between different shareholders groups. The agency costs arise when shareholders' incentives are distorted due to their less risky, neutral or even negative economic position or when shareholders engage in extraction of private benefits of control.[194] In such a case, the decision-making incentives of shareholders do not follow the traditional logic of the market to use voting rights in favor of the company as a whole.[195] This kind of behavior may lead to abusive and unpredictable use of voting rights that may have detrimental results for the company, other shareholders and the economy as a whole.

### 4.3.2 Hidden ownership

#### 4.3.2.1 Problem of hedging structures

Hidden ownership can be deemed harmful because it weakens the transparency of financial markets and raises concerns over information efficiency and asymmetries as well as market integrity.[196] The major problems of hidden ownership arise when acquiring economic ownership involves hedging structures.[197]

Although the creation of economic exposure through cash-settled equity derivatives such as TRSs does not necessarily involve physical shares, it is often the case that physical shares are acquired to hedge the exposure of the short party – typically an investment bank or similar financial institution. This enables the long party to gain access to corporate control. By setting up this kind of structure the investment bank may be inclined to use the voting rights of the

---

[194] Ringe 2013a, pp. 1059–1063.

[195] Ringe 2013b, p. 4 and Schouten 2012, pp. 82–84, who in this respect discussed conflicted voting that "occurs when a shareholder votes with the purpose of satisfying preferences that are different from the common preference to maximize future cash-flows."

[196] Kettunen and Ringe 2012, p. 13.

[197] Ibid., p. 4.

shares it uses as a hedge according to the voting preferences of the counterparty, which for example might be an activist investor. Due to its lack of economic exposure, the short party does not in principle have any incentive to use the voting rights, but in the name of good client relations, the short party may very well act according to the preferences of its counterparty, who in this kind of arrangement is also a customer of the short party. This kind of behavior does not, however, usually trigger mandatory ownership disclosure by the long party.[198]

Furthermore, although cash-settled equity derivatives are usually settled in cash as their name suggests, the derivatives may also be settled physically by delivering the underlying shares. As Schouten explains, once a derivative contract has expired, the short party will have to unwind its position by disposing of the reference shares it has acquired for hedging purposes. If it concerns a substantial stake, the short party may not be able to sell the shares in the market without depressing the share price. Thus, by resorting to physical delivery, the short party can efficiently dispose of the shares and at the same time accommodate the needs of its client. As mentioned above, this does not usually trigger mandatory ownership disclosure on the long party until it has acquired the physical shares.[199]

#### 4.3.2.2 Mandatory ownership disclosure rules

To be more specific with a practical example, hidden ownership enables the avoidance of mandatory ownership disclosure rules and mandatory bid rules.[200] Rules regarding ownership disclosure and takeover bids are connected to each other. Ownership disclosure rules act as an early warning system for the securities markets of a possible impending takeover. Empirical studies suggests that the appearance of a new major shareholder may indicate an increased likelihood of corporate control contest or acquisition.[201] This warning system enables market participants to measure the impact of some shareholder getting closer to a controlling position in the company and to price the shares accordingly.[202] For this reason, ownership disclosure and

[198] Schouten 2012, pp. 33–34.

[199] Ibid., p. 34.

[200] Hu and Black 2006, p. 839.

[201] See e.g. Mikkelson and Ruback 1985, Walkling 1985 and Akhigbe et al. 2007.

[202] Zetzsche 2009, p. 146.

mandatory bid rules should be both examined in any discussion of the problems of hidden ownership.

With reference to mandatory ownership disclosure rules, Schouten has further distinguished two functions the rules serve: market efficiency and corporate governance. Market efficiency is one of the cornerstones of financial markets, which is why regulating information, including information regarding ownership structures of listed companies, is of tremendous importance in financial markets.[203] Information asymmetries are a common reason for market failures, which is why regulating information has significance. Information asymmetries occur because market participants have different amounts of information. Usually sellers, whether on the primary or secondary markets, have some amount of private information, while buyers are more or less uninformed. There is no potential for screening or signaling, nor any mechanism for bargaining. A price is posted and buyers and sellers decide whether or not to enter the market. This causes the so-called adverse selection problem in the markets.[204]

Investors may possess fundamental information that is not yet incorporated in securities prices. This is not in line with the efficient market hypothesis (EMH) first publicized by Fama.[205] However, empirical studies show that of the three forms of market efficiency, markets are only efficient in the semi-strong form.[206] In any case, this implies that there is money to be made by trading on information that is public but that is not yet incorporated into prices. A trader with the resources to gather and analyze such information may conclude that the share is overvalued or undervalued and capitalize on this insight by selling or buying shares accordingly. Gosher and Parchomosky refer to these type of traders as information traders, comprising sophisticated

[203] See e.g. Goshen and Parchomovsky 2006, pp. 715–716, who divide the law of securities regulation into three categories: 1) disclosure duties, 2) restrictions on fraud and manipulation and 3) restrictions on insider trading and argue that securities regulation improves efficiency and liquidity of financial markets and, thus, improves allocation of resources in the economy.

[204] Akerlof 1970, pp. 488–489.

[205] Fama 1970.

[206] In the author's view, even the semi-strong form of market efficiency can be questioned. What is the well-established momentum anomaly other than predicting future price movements based on past price data?

professional investors and analysts.[207] This essentially captures the idea of the famous theory presented first by Grossman and Stiglitz, who showed that because acquiring and processing information is costly, prices cannot perfectly reflect all the available information. If this were the case, those who spent resources to gather and process information would receive no compensation and, thus, would have no incentive to continue their efforts. All this leads to the conclusion that informationally efficient markets are, even in theory, impossible.[208]

Therefore information is an essential piece of market efficiency. Information arising from mandatory ownership disclosures has two implications for market efficiency. Firstly, the disclosures provide information on the voting structure of a company and changes occurring in its structure. The voting structure determines who controls the company. The information on control constitutes fundamental information from the perspective of market efficiency, since future cash-flows may vary depending on the allocation of control.[209] For example, Ihamuotila has provided empirical evidence on the issue of ownership concentration and shareholder diversification. If the controlling owner is poorly diversified himself, the company may have too risk-averse a capital structure and project selection.[210] Furthermore, agency costs may

[207] Goshen and Parchomovsky 2006 p. 714. Same kind of analogy is also presented in the financial economics literature by Hong and Stein 1999, who argue that there are two classes of agents who process information in different ways. They suggest that so the called “news watchers” trade only on private information about fundamentals, whereas the second class, “momentum traders”, trade only on past price movements. Hong and Stein suggest that firm-specific information diffuses gradually among news watchers causing an initial under-reaction to new information. When the information diffuses across larger groups, more and more momentum traders arrive to the market driving a price movement and turning the initial under-reaction to a subsequent over-reaction. Hence, pursuant to this theorem prices underreact to new information on short and intermediate time horizons, but overreact over longer periods.

[208] Grossman and Stiglitz 1980.

[209] Schouten 2012, p. 18.

[210] Ihamuotila 1994, p. 98 and p. 138. Ihamuotila for instance finds that ownership concentration and shareholder diversification increase idiosyncratic risk and firm debt level. The impact is more significant the more control the shareholders have over the firm. Ihamuotila also points out (p. 10) that ownership concentration may increase or decrease profitability of a firm depending on the type of the large shareholders and that (p. 98)

increase if no individual shareholder has a strong enough incentive to devote resources to ensure that company management acts in the interest of the shareholder.[211] Thus, even the presence of a controlling shareholder does not guarantee effective monitoring of management, if the controlling shareholder has a broad diversification in his own personal wealth. This may apply to well-diversified pension and mutual funds for instance. For the reasons mentioned above, changes in voting structure also constitutes fundamental information.[212]

Secondly, transparency of capital movements constitutes fundamental information. Transparency of capital movements can be divided into three parts: transparency 1) economic rights, 2) trading interest, and 3) free float. Transparency of economic rights is significant, since economic rights determine the extent to which a controlling shareholder bears the cost of private benefit extraction and the benefit from increased monitoring.[213] Therefore, if voting and economic rights are not matched, imbalances in decision-making incentives leading to suboptimal behavior may occur.[214] Also the transparency of trading interest may be important for market efficiency. As discussed above, perfectly efficient markets are not possible and the current state of the financial markets can be regarded as semi-strong efficient, if even that. Thus, investors may possess fundamental information about the prices of securities that is not yet incorporated into those prices. Once investors start to trade, the information is incorporated to the prices through a shift in the demand–supply equilibrium, and mechanisms of price decoding and trade decoding, the latter of which is possible *inter alia* through disclosures on major transactions.[215] Consider for example a sale or purchase of a large stake by an investor of high resources, let's say Warren Buffet for example. The trade may be driven by portfolio rebalancing

---

whether a large shareholder is valuable for the firm or not depends on diversification and control preferences of the shareholder.

[211] Grossman and Hart 1988, p. 176. See also Jensen and Meckling 1976, pp. 312–313.

[212] Schouten 2012. pp. 19–20.

[213] Ibid., p. 21.

[214] Hu and Black 2006, p. 851, Bebchuk et al. 2000, pp. 301–306. Grossman and Hart 1988 and Hart 1995, pp. 95–125.

[215] Schouten 2012, p. 22.

needs, but the trade may also be driven by fundamental information on the value of the security and this information may also be of value to other investors as well.[216] Finally, transparency of free float enables investors and other market participants to estimate the amount of stock that is freely available for trading and estimate the liquidity of that stock.[217] Lack of transparency in free float may lead to unusual price movements in the financial markets and, thus, have an effect on market efficiency.[218]

As mentioned above, mandatory ownership disclosure also serves the objectives of corporate governance. First of all, disclosure can act as an enforcement mechanism. In this sense, disclosure can facilitate 1) detection of misappropriation of corporate funds and assets; 2) informed corporate decision-making; and 3) the functioning of the market for corporate control.[219] With respect to corporate governance, ownership disclosure can also act as a communication tool. Knowing who the shareholders are can facilitate communication between the company and its shareholders and among shareholders. This is particularly the case in firms with a dispersed ownership base.[220]

Hidden ownership can be problematic, because it has crippling effects on all of the functions that mandatory ownership disclosure rules serve. Hidden ownership eliminates the transparency of voting structures and has pernicious effects on the transparency of capital movements. Therefore, the effects of hidden ownership may detrimental for market efficiency. The same logic applies to the corporate governance issues discussed above. The lack of transparency caused by hidden ownership undermines the functioning of the enforcement and communication tools of ownership disclosure.

---

[216] Schouten 2012, p. 23.

[217] Ibid., p. 25.

[218] For anecdotal evidence, see e.g. The New York Times, Oct 30, 2008.

[219] Schouten 2012, pp. 26–30.

[220] Ibid., p. 31.

#### 4.3.2.3 Mandatory bid rules

In addition to avoiding disclosure rules, hidden ownership may be problematic because it enables the avoidance of mandatory bid rules. In most countries, an investor who reaches or exceeds a certain level of ownership – usually the first threshold is 30% – is obligated to offer to buy all the remaining shares at a minimum price stipulated by mandatory bid rules.[221] The goal of mandatory bid rules is to protect minority shareholders under certain circumstances where corporate control or significant influence in the company is becoming concentrated. In such circumstances, mandatory bid rules offer shareholders the opportunity to dispose of their holdings in the company at a fair price. Furthermore, due to control implications, financial markets value large blocks of shares at a higher price on a per share basis than individual shares.[222] Because of this, mandatory bid rules also aim to extend the control premium to minority shareholders.[223] Circumvention of mandatory bid rules disables or impairs minority shareholders' abilities to use their normal exit right.[224] This happens under circumstances, where control becomes concentrated and allows controlling shareholders to retain the entire control premium at the expense of minority shareholders or to gain control at a lower cost.[225]

One concrete example of this kind of behavior occurred in 2005, when the Fiat controlling Agnelli family entered into TRSs with the investment bank Merrill Lynch. The background for the transaction was convertible loan arrangement of Fiat, which was supposed to dilute the holdings of the Agnelli family to 23%. In such a case, the family would not have been able to increase its holdings to 30% or above, without making a tender offer for all the remaining shares.[226] The family however, wanted to retain its ownership position. For this reason, the family acquired an economic stake of 7% through TRSs. If an equivalent stake of shares was

---

[221] Hu and Black 2006, p. 839.

[222] Barclay and Holderness 1989, p. 394. For value of control and votes, see also Zingales 1995, Nenova 2003 and Kalay et al. 2014.

[223] Grant et al. 2009, p. 234.

[224] Vahtera 2011, pp. 306–322.

[225] Grant et al. 2009, p. 234.

[226] Ibid., pp. 245–246.

acquired directly, this would have triggered the mandatory bid obligation pursuant to Italian securities laws. After the dilution occurred, the Agnelli family unwound the TRS arrangement and acquired the shares that had acted as a hedge for Merrill Lynch.[227] The terms of the TRS and the changes made thereof enabled the Agnelli family to avoid mandatory bid obligation. In principle, when the Agnelli family's stake in Fiat fell below 30%, Fiat became vulnerable to potential takeover bids. The TRS scheme, however, provided that 7% of Fiat's voting stock was removed from the market, which in practice prevented the possibility of change in control by a tender offer. Therefore, the scheme effectively deprived the Fiat minority shareholders the opportunity to earn a takeover premium.[228]

## 4.4 Possible benefits of equity decoupling

### 4.4.1 Empty voting

Generally equity decoupling is viewed in a critical light and it is true that equity decoupling introduces some troubling aspects as illustrated earlier. However, equity decoupling may have its benefits as well. The classical law and economics theory assumes that maximizing the value of a corporation is efficient.[229] This assumption can be used to conclude that what is best for a corporation is best for society.[230]

Barry et al. disagree with this argumentation and posit that in practice there are instances in which the course of action that is best for a corporation is not the best for society at large. An

[227] Hu and Black 2006, pp. 839–840.

[228] Grant et al. 2009, pp. 246–247.

[229] See e.g. Easterbrook and Fischel 1983, p. 403, Grossman and Hart 1988, p. 175 and Black and Kraakman 1996, p. 1945.

[230] Jensen 2001, pp. 11–12. "200 years' worth of work in economics and finance indicate that social welfare is maximized when all firms in an economy attempt to maximize their own total firm value. The intuition behind this criterion is simple: that value is created – and when I say "value" I mean "social" value – whenever a firm produces an output, or set of outputs, that is valued by its customers at more than the value of the inputs it consumes (as valued by their suppliers) in the production of the outputs. Firm value is simply the long-term market value of this expected stream of benefits."

example of this is an acquisition that would benefit the acquirer with monopoly position, but would be to the detriment of customers and society.[231] Thus, the private benefit is positive, but the net social benefit is negative. In such circumstances, it is better for the society if the corporation's shareholders do not select the option that maximizes the value of the corporation. Empty voting makes such outcomes more likely. The more there are constituencies with voting rights other than the shareholders of the acquirer, the more likely the acquisition is to fail. Therefore, empty voting may indeed be socially beneficial.[232]

Brav and Mathews make an interesting point in their study by modeling corporate voting outcomes. In their model an informed trader, such as a hedge fund, can establish separate positions in a firm's shares and votes, i.e. is able to be an empty voter. They find that the empty voter's presence can improve overall efficiency despite the fact that the voter sometimes ends up selling to a net short position (i.e. becomes a negative voter) and, thus, votes to decrease firm value. According to the study, an efficiency improvement is likely if other shareholders' votes are not highly correlated with the correct decision[233] or if it is relatively expensive to separate votes from shares on the record date.[234] On the other hand, empty voting tends to decrease efficiency if it is relatively inexpensive to separate votes from shares and other shareholders are

[231] Jensen 2001, p. 11.

[232] Barry et al. 2013, pp. 1124–1126 and Dombalagian 2009, p. 1277.

[233] This is emphasized also by Schouten 2012, p. 69, who notes that "when shareholders have heterogeneous preferences and some vote with a view to maximizing their private interests rather than their pro-rata share of the firm's future cash-flows, the probability that a majority of the shares is voted for the correct option decreases dramatically." This kind of behavior is possible, for example, when entrenched management has a lot of votes or when there is a poorly diversified controlling shareholder who due to his poor diversification makes suboptimal decisions with respect to project selection, firm size, capital structure and roles of control. See e.g. Ihamuotila 1994, p. 98 and p. 138 and Bebchuk et al. 2000, pp. 301–305.

[234] In this respect see also Esö et al. 2014, p. 23, who find that positive price above zero for votes may help to filter out biased voters. In other words, free or inexpensive votes may encourage opportunistic voting by biased shareholders.

likely to vote the right way.[235] In other words, the hedged empty voter may very well be the one with the value maximizing agenda, if other shareholders are likely to vote the "wrong" way from a value maximization perspective.

> An interesting example in the light of the abovementioned evidence is the case of Telus Corporation, which is a Canadian telecom company. Telus had two classes of common stock, only one of which was voting stock. The voting stock had historically traded at a premium to the non-voting stock equal to approximately 5%. In early 2012 Telus proposed to combine the two classes with zero premium for voting shares despite the historical premium and, thus, offered no compensation for the holders of the voting stock. As a consequence of the proposal, the historical price difference of the two classes narrowed.[236]
>
> Along came the hedge fund Mason Capital that took a long position in the voting stock and an equivalent short position in the non-voting stock. By this arrangement Mason acquired almost a 20% voting stake in Telus, but at the same time its economic position was neutral. The goal of Mason was to get the zero premium share swap rejected and introduce a new plan for combining the two classes of common stock that would assign a fair value for the votes of the voting class. In addition, Telus stood to make a significant profit, if the price difference of the two classes re-emerged.[237]
>
> The management of Telus did not welcome the activist campaign and they sued Mason, alleging that Mason was engaging in empty voting. On the other hand, the management of Telus has been accused of breaching its fiduciary duties. This was due to the fact that the management held primarily non-voting shares and options to acquire non-voting shares. Therefore, management was among the beneficiaries of their own proposal that at the same time disregarded the interests of shareholders holding voting stock.[238]

---

[235] Brav and Mathews 2011, p 289. See also Esö et al. 2014, who provide a complementary model. The authors find that allowing vote trading at a zero price improves social welfare because informed voters pick up votes in the market, increasing their power in the election. Meanwhile, biased voters with the same intensity of preference as unbiased voters are discouraged from acquiring votes and from voting in favor of their bias when they lack information about the correct decision, because they know that they are more likely to be voting against informed voters.

[236] Black 2012, p. 4 and Ringe 2013b, p. 2.

[237] Black 2012, p. 4 and Ringe 2013b, pp. 2–3.

[238] Black 2012, p. 5.

Kobayashi and Ribstein take an even more radical approach than Brav and Mathews above. They refer to the King-Mylan case discussed earlier in this thesis and state that the case regarding the actions of hedge fund Perry was not socially inefficient, but rather a way to maximize the joint capital of the participating firms without interference from self-interested managers or undiversified shareholders. The view of Kobayashi and Ribstein is based on the fact that the stake acquired by Perry was less than 10%. This clearly indicates that it was a close call whether or not the merger created a net benefit for Mylan, since the relatively small percentage acquired by Perry had the potential to swing the vote. Kobayashi and Ribstein conclude that there was likely a net benefit from the merger for diversified shareholders owning both companies, but a loss for undiversified shareholders owning only Mylan shares. Therefore, in terms of social economic efficiency, they argue that the deal should have been consummated. They provide the following interesting example.

> "To illustrate this, consider the following situation of two firms in the same industry, K and M, where firm K is currently mismanaged. In the absence of a takeover, stock prices of the two firms equal $S_{K0}$ and $S_{M0}$. Let $a_K$ and $a_M$ denote the number of existing shares, and let $a_{KM}$ denote the number of shares that would be issued by the merged firm. A takeover of firm K by firm M, a well-managed firm, would increase the value of the merged firm so that
>
> $$a_{KM}S_{KM} > a_K S_{K0} + a_M S_{M0}$$
>
> If the distribution of gains favors the target, successful completion of the merger may decrease the acquirer's price (i.e. $S_{M1} < S_{M0}$) and increase the target's price (i.e. $S_{K1} > S_{K0}$).
>
> Suppose that 60% of both companies are owned by diversified shareholders who have value-weighted proportions of both K and M in their portfolios. Suppose further that such shareholders vote with probability .65, and that such votes are consistent with the shareholders' interests. Assume that the undiversified shareholders in each company vote with probability 1.0. Under these assumptions, both the diversified and undiversified shareholders at K vote for the transaction. In contrast, M's diversified shareholders vote for the transaction, but its undiversified shareholders vote against it. Thus, at firm M, without intervention, 79% of the shares will be voted, and the merger will be rejected by a 50.6 to 49.4% margin. That is, although the transaction is favored by a majority of shareholders in both firms, the transaction will fail.
>
> Anticipating this uncertain outcome, shares in firm K sell at a discount relative to $S_{K1}$ and shares of firm M sell at a premium relative to $S_{M1}$. By purchasing shares and their attached voting rights from undiversified shareholders, a hedge fund operator can increase the probability that these shares

> would be voted. A hedge fund's purchase of a 10% stake from diversified shareholders would increase the probability that these shares are voted — that is, it increases the expected percentage of yes votes to 42.5%, resulting in the merger being approved 51.5 to 48.5%. By hedging the purchase, the hedge fund can increase the probability that the transaction is approved by firm M's shareholders without having to become an undiversified shareholder in M. Moreover, the hedge fund votes the shares consistent with the interest of the diversified shareholder who sold the voting rights."[239]

The above example makes the assumption that shareholders are able to observe the economic effects of the contemplated merger. If there are information asymmetries so that only sophisticated investors can observe the economic effects, the setting changes. This is a reasonable assumption and arises naturally, when some of the shareholders lack time and resources to determine economic effects of a certain course of action.[240]

Let us assume that:

$$a_{KM}S_{KM} < a_K S_{K0} + a_M S_{M0}$$

From the above we can see that the circumstances have changed upside down so that the merger would not be socially beneficial. Again, the distribution of gains favors the target K. Successful completion of the merger decreases the acquirer M's price (i.e. $S_{M1} < S_{M0}$) and increases the target company K's price (i.e. $S_{K1} > S_{K0}$). Let us further assume that the target K would have one single shareholder C that would realize a private benefit at the cost of social welfare if the deal were consummated.

If shareholders of M do not have the resources to gather and process information so that they are able to observe the value-destroying effects of the merger for M and for the whole economy, we could make the assumption that some 50% of the shareholders of M would be in favor of the merger and some 50% against it. As a result the sophisticated shareholder C of the target company with superior resources could easily buy enough votes with no economic risk in the acquirer company and tip the scales in favor for the merger. In such a case the target's single

---

[239] Kobayashi and Ribstein 2006, pp. 43–44.

[240] Esö et al. 2014, p. 1.

shareholder C would realize a private benefit at the expense of M's shareholders and social welfare, since the merger would in overall economic terms be value-destroying.

However, it may not be realistic to assume that all of M's shareholders are incapable of observing the effects of the merger. If we assume that, for example, an informed investor or a group of investors, B, holding a stake of for example 20% in M are able to observe the value-destroying effects, B will vote against the merger independent of whether B is a diversified or undiversified shareholder.

In this case, it is reasonable to assume that the rest of the 80% of votes of M are divided half in favor and against the merger. Therefore, without empty voting intervention of the shareholder C of the target company the merger would be rejected by votes dividing 60% against and 40% in favor. In such a case, C would again have the incentive to buy enough votes in M for the deal to go through. However, B would have a similar incentive to counter-attack, i.e. to engage in vote buying, proxy contest or other similar measures. The outcome would depend on the magnitude of economic incentives of the parties participating in the fight.

The following assumptions can be made to illustrate the point:

$$a_{KM}S_{KM} = a_K S_{K0} + a_M S_{M0} - 150$$

$$a_M S_{M1} = a_M S_{M0} - 200$$

$$a_K S_{K1} = a_K S_{K0} + 50$$

As laid out before, it is also assumed that the sophisticated shareholder C owns the target company K entirely, i.e. it has an upside of 50, if the deal is consummated. The informed shareholders B of the acquirer M own 20% of M and, thus, stand to lose 40.

| | | K | M |
|---|---|---|---|
| Ex ante | No. of shares | 100 | 100 |
| | Price per share | 5 | 5 |
| | Market cap | 500 | 500 |
| Ex post | No. of shares | 100 | 100 |
| | Price per share | 5.5 | 3 |
| | Market cap | 550 | 300 |

Now if C owns K entirely, it has the incentive to use up to 50 to acquire the votes of the uninformed shareholders of M so that it reaches a majority of votes. In other words, C is willing to pay up to 0.98 per vote to achieve 51 votes to ensure the deal.

If B owns a stake of 20% in M, i.e. 20 shares worth 5 per share, he stands to lose 40. However, if B is a long-time committed shareholder, he is willing to buy all the votes needed for the majority of votes, i.e. 31 new votes at the maximum price of 1.29 per vote. B however only needs to pay more per vote than C to ensure that the deal is rejected. Thus, in the presence of an informed and committed long-term shareholder (B) holding a significant stake, no abuses of empty voting detrimental to social welfare should occur.[241]

The above example can be further extended to the following circumstances:

$$a_{KM}S_{KM} = a_K S_{K0} + a_M S_{M0} - 100$$

$$a_M S_{M1} = a_M S_{M0} - 200$$

$$a_K S_{K1} = a_K S_{K0} + 100$$

| | | K | M |
|---|---|---|---|
| Ex ante | No. of shares | 100 | 100 |
| | Price per share | 5 | 5 |
| | Market cap | 500 | 500 |
| Ex post | No. of shares | 100 | 100 |
| | Price per share | 6 | 3 |
| | Market cap | 600 | 300 |

Now the setting has changed so that C has the possibility of realizing a private benefit of 100 by engaging in empty voting in M. Therefore, C is willing to pay up to 1.96 per vote in M. The upside of C is much greater than the downside of B. B is better off by suffering a loss of 40 than engaging in vote buying that would cost it 1.97 per vote and amount to a total out-of-pocket cost of 61.07. In such a case, the target's shareholder C would have stronger incentives to acquire the votes of the uninformed shareholders of M than M's informed shareholder B.

[241] Dombalagian 2009, pp. 1280–1282.

In this latter example, the problem relating to the creation of a socially inefficient outcome is two-fold: 1) B's stake in M is too small so that B does not have sufficient economic incentive to engage in vote buying; and 2) the acquired votes are single-use in nature, i.e. the investment made to acquire the votes loses its value after the votes are exercised. This two-fold problem is avoided if a somewhat unrealistic assumption of no budget constraints is made with respect to B. In the absence of budget constraints, B can make an investment and buy 31 shares with the price of 5 per share. After the transaction, B has the majority of votes and is able to reject the privately and socially inefficient merger. After the votes are exercised, the acquired shares do not decrease in value and can be sold back to markets to achieve optimal *ex ante* asset allocation.

Hence, in the absence of budget constraints, the informed shareholder B should always prevail in the control contest against C and no inefficient transactions should occur. The assumption with respect to budget constraint is, however, unrealistic and irrelevant in the context of vote buying.

Empty voting may thus be beneficial for social welfare, but only in the presence of certain criteria. Dombalagian argues that empty voting is not undesirable if it increases social wealth and if mechanisms for preventing or repairing unfair treatment of shareholders exist. According to Dombalagian, empty voting is socially beneficial, if the following criteria are met:

1) a significant percentage of institutional shareholders are committed to maximizing the long-term wealth of the individual firms in which they invest;
2) those institutional shareholders are empowered to exercise empty votes in opposition to or in support of, and on equal or better terms with insurgents;
3) the fiduciary duties of these institutional shareholders to their clients, and the manner in which they communicate and consult with the firms in which they invest, are reimagined in a way to give them sufficient incentive to buy votes; and
4) courts continue to scrutinize transactions effected with the use of empty votes and intervene in instances of substantial unfairness to affected shareholders.[242]

[242] Dombalagian 2009, p. 1273.

Thus, even after some extensions to the theoretical model of Kobayashi and Ribstein, it appears that in the above-illustrated setting empty and negative voting primarily promote socially efficient outcomes. The outcomes may not be privately efficient for all participants, but under the circumstances discussed above empty and negative voting should promote socially efficient outcomes. This is also indirectly backed by the arguments of Kalay and Pant, who show that the ability to dynamically change voting structure unambiguously increases the market value of a firm.[243]

Defenders of empty voting follow the logic of Manne and argue that vote selling and buying can be viewed as a way for the vote seller to share in the benefits from Perry's information gathering, and for the control rights associated with the votes to flow to the person with the most reliable information and, therefore, the ability to use the rights most profitably.[244] As votes cannot appear out of thin air, some shareholders ultimately took the other side of the transaction and sold the votes to Perry. In light of this, the arguments and model provided by Kobayashi and Ribstein appear quite compelling.[245] It can be seen as a theoretical extension to the model of Brav and Mathews, who show that empty voting may be beneficial, but can reduce efficiency from a firm value perspective when empty voting turns to negative voting.[246] However, as Kobayashi and Ribstein show, even negative voting may be efficient if the scrutiny is extended beyond the firm value perspective to an overall social welfare perspective.

---

[243] Kalay and Pant 2009, p. 52.

[244] Kobayashi and Ribstein 2006, pp. 38–45.

[245] In general legal scholars seem to have disregarded the point of view that empty and negative voting could be socially beneficial. Take for example Cohen 2008, p. 243, who notes that there clearly are shareholder votes that are won or lost by small margins and that in those votes even modest amounts of negative voting can translate into big losses for shareholders. This is not a convincing argument. If the decision of the vote is close, there clearly are differentiating views on the decision to be made. Hence, shareholders should have an incentive to pay such prices for votes that would ensure the vote to tilt in their favor. In some rare exceptions, this may include negative voting.

[246] Brav and Mathews 2011, p. 290.

This is in harmony with the theoretical framework discussed above: allowing equity decoupling should lead to an efficient market for corporate votes and this market should provide fair compensation for voting rights.[247] According to Manne,[248] the market for voting rights firstly gives the advantage of someone else's information gathering to all the shareholders willing to sell their votes.[249] Secondly, the voting rights market also causes votes to move into the hands of those shareholders for whom the vote itself is most valuable. These are also often the defending arguments of empty voting activists because they usually defend their strategy by arguing that decoupling risk allows the activists to more effectively discipline the incompetent and entrenched[250] management.[251]

The arguments made by Manne are supported by empirical evidence. The key insight of Christoffersen et al. is that vote trading in the share lending market may increase efficiency. As already established, information is costly to acquire and process. Uninformed shareholders who are not willing to pay the cost to become informed can sell their votes to informed parties in order to increase the efficiency of the voting outcome.[252] This is also supported by Kalay and Pant, who establish a model that shows that the optimal voting structure is time varying and that the ability to dynamically change voting structure increases firm market value.[253]

---

247 Kaisanlahti 1998, p. 85 and Black and Kraakman 1996, p. 1946.

248 Manne 1964, p. 1444. See also Esö et al. 2014, p. 23 arguing in this respect in favor of allowing vote trading based on their model.

249 See also Barry et al. 2013, p. 1127.

250 Shleifer and Vishny 1989, pp. 137–138. Management entrenchment refers to management behavior of making investments that are not value maximizing *ex ante*, but that have a higher present value under the incumbent management than under their potential replacements. See also Morck et al. 1988, pp. 294–295.

251 Ringe 2013b, p. 4.

252 Christoffersen et al. 2007, p. 2927.

253 Kalay and Pant 2009, p. 3 and pp. 51–52. The authors show that the one share–one vote principle is both privately and socially optimal choice for the majority of the life cycle of the firm. However, under circumstances of corporate control contests, shareholders will optimally depart from the principle to extract part or all of the surplus of the contest winning team. This can help encourage entrepreneurial activity. The authors argue that in

Thus, although empty voting may increase agency costs between different shareholder groups as discussed earlier, it may also facilitate reduction of those costs. This reduction occurs in the relationship between shareholders and management and is due to more efficient monitoring and control of management.[254] The views presented by Brav and Mathews, Kobayashi and Ribstein and Kalay and Pant are very interesting and raise the question, should empty and negative voting be regulated at all? Should the protection of undiversified shareholders and self-interested managers be more important than overall social welfare?

### 4.4.2 Hidden ownership

#### 4.4.2.1 Issues of management and controlling shareholders

Like empty voting, hidden ownership may also have certain benefits. Posner has distinguished that incentive pay and the threat of a takeover are the two dominant mechanisms that incentivize corporate managers to perform to the best of their ability.[255] Therefore, reasonably organized pay for performance and active market for corporate control should lead to best results from value maximization perspective. This is supported by empirical evidence. For example, Gompers et al. found strong evidence that firm values increase with managers' economic interests and decreases with managers' voting interest.[256] Managers' economic interest can be

---

the absence of a market for votes there is a disadvantage to going public since small and dispersed shareholders cannot negotiate to extract any of the surplus from the acquirer in the event of a tender offer Further, the authors show that the market for votes eliminates this disadvantage since shareholders can change the security voting structure to extract the surplus from the acquirer.

[254] Ringe 2013a, pp. 1063–1064. Also the magnitude of agency costs occurring in inter shareholder relations can be challenged. For instance Chattopadhyaya 2011, p. 330 argues that risks relating to extraction of private benefits of control are exaggerated, because "the reputational sanction of not playing fair is high and being a repeat game with similar participants, the pay-off just does not warrant such flippant behavior." On the opposite view, Clottens 2012, p. 463, points out that reputation does not have similar kind of relevance for hedge funds and other activist investors as it does to banks and other similar financial institutions. Providing a similar view as Clottens, see Anabtawi and Stout 2008, p. 1304.

[255] Posner 2003, pp. 426–430. Same argument is also presented by Holmström and Tirole 1993, p. 679.

[256] Gompers et al. 2010, p. 1054.

viewed as the incentive pay that encourages managers to work harder. However, control rights may encourage management entrenchment[257] and also limit the number of takeovers, which may lead to poor economic performance.[258]

Hidden ownership may also mitigate the private benefit extraction problem that is also known as tunneling. This issue was discussed earlier in chapter 2.4.2.2. Tunneling is costly, because it reduces firm value. If controlling shareholders and managers have higher economic ownership, they bear a greater share of the costs of tunneling and should, therefore, engage less in value-decreasing tunneling activities.[259] Because of these reasons shareholders may wish to give controlling shareholders and managers more economic than voting ownership and, thus, make managers hidden owners.[260]

#### 4.4.2.2 Information acquisition, aggregation and decision-making

Hidden ownership may also be beneficial for avoiding the free-rider problem in information acquisition and processing. Acquiring and processing information requires time and other resources. In other words: it is costly. The investor alone bears the costs of gathering and

---

[257] Shleifer and Vishny 1989, pp. 137–138 and Morck et al. 1988, pp. 294–295.

[258] Similar kind of evidence as Gompers et al. 2010 is found also by Morck et al. 1988, pp. 294–295. "The results seem to suggest a positive relation between ownership and Q in the 0~ to 5~ board ownership range, a negative and less pronounced relation in the 5~ to 25~ range, and perhaps a further positive relation beyond 25%. One interpretation of these results is that conditions necessary for entrenchment (voting power, control of the board of directors, status as a founder, etc.) are significantly correlated with increased managerial ownership beyond 5%, but that these conditions are not much different for firms with greater than 255 t,~3ard ownership than they are for those with 20-25% ownership. The convergence-of-interests effect, in contrast, operates throughout the whole range of ownership."

[259] Hu and Black 2006, p. 851 and Schouten 2012, p. 21.

[260] See reference 258 above. The key insight of Morck et al. 1988, is that managers respond to two opposing forces, incentives alignment and managerial entrenchment, and that the relation between ownership and firm value depends on which force dominates over any particular range of managerial equity ownership. Thus, a trade-off exists, where economic ownership increases incentives alignment, but control ownership increases managerial entrenchment. Making managers hidden owners increases incentives alignment without increasing managerial entrenchment.

processing information, but yet he benefits only if the information regarding the value of a particular security is correct or, if an activist campaign is in question, the investor prevails in corporate voting. The obligation to disclose ownership well before an activist campaign or a takeover bid is announced limits the activist's potential profits. This subsequently reduces corporate control contestability.[261] Furthermore, the potential benefits are distributed among shareholders *pro rata* to their ownership stakes.[262] Consider the following example:

> "For example, in 2002 Gotham (Partners) published a sixty-six-page report indicating that MBIA, the AAA-rated municipal insurance company was engaging in dubious accounting practices. The report contributed useful information not previously available in the market, which led others to investigate MBIA. […] MBIA's share price fell in response to the Gotham report and as of October 2006 was still at early 2002 levels."[263]

Extensive ownership disclosure rules practically socialize privately acquired information and turn it into a public good, which disallows investors from internalizing the benefits of their efforts.[264] This is obviously worrying, since high-resource investors have an important role as monitors of management as well as exploiters of asymmetric information.[265] Thus, the divergence between cost and benefit discourages investors to spend any resources for acquiring and processing information and, instead, encourages freeriding off other investors' efforts.[266] The result is a market failure by regulation that discourages investors to engage in the market.

---

[261] Ferrarini 2000, p. 4.

[262] Schouten 2012, p. 86 and Bebchuk and Jackson 2012, p. 47. See also Grossman and Stiglitz 1980, p. 405, who were the first to point out that "there is a fundamental conflict between the efficiency with which markets spread information and the incentives to acquire information."

[263] Partnoy and Thomas 2007, p. 122. The effects of disclosure may be substantial and cause changes of billions of dollars in market valuations. See e.g. The New York Times, Jan 1, 2013.

[264] Chattopadhyaya 2011, p. 307.

[265] Partnoy and Thomas 2007, pp. 121–122. Exploiting asymmetric information should make the markets more efficient by correcting the asymmetries and by reducing volatility.

[266] Easterbrook and Fischel 1983, p. 413. See also Fischel 1978, p. 13, who already almost 40 years ago acknowledge the problem: "For the market for corporate control to function effectively, outsiders must have adequate incentives to produce information. Outsiders are not generally privy to inside information about a

Allowing hidden ownership can make it easier for existing shareholders to increase their economic interest, which encourages information gathering and combats the free-rider problem.[267] Thus, hidden ownership may firstly make it easier to acquire a stake large enough that it internalizes the externalities of a collective action.[268] Secondly, it may help avoid the problem of *pro rata* benefit distribution. Thirdly, strict ownership disclosure rules may be detrimental to the threat of takeovers, as mentioned above. Mandatory disclosure of an upcoming takeover attempt may discourage the corporate control activist from making a bid in the first place. This is because mandatory ownership disclosure threshold limits the size of the toehold a potential bidder can silently purchase and, by extension the profit on that toehold.[269] Bidders' ability to amass stealth toehold positions may facilitate takeover bids.[270] Strict disclosure rules on the other hand may enable entrenched and poor performing managers to adopt defenses against unsolicited takeover attempts and other attempts of disciplining the

---

potential target. A decision to tender only occurs after an offeror determines that the target will be more profitable in its control and that a tender offer is likely to succeed. These decisions involve research costs. The incentive to produce this information is the expected gain from the appreciation of the offeror's equity investment after obtaining control. Any legal constraint that limits the ability of owners of privately produced information to realize its exchange value will discourage devoting resources to produce new information. In other words, a failure to recognize a property right in privately produced information will decrease the incentives to produce this information."

[267] Barry et al. 2013, p. 1128 and Chattopadhyaya 2011, p. 313.

[268] Grossman and Hart 1988, p. 176. "We would expect monitoring of management to be effective only when a single party becomes large enough to internalize the externalities of collective action, e.g., by making a takeover bid." See also Jensen and Meckling 1976, pp. 312–313.

[269] Schouten 2012, p. 30. Once the information on a takeover attempt is public a share price run-up usually follows. In addition, the information enables the management of the target company to adopt excessive takeover defenses.

[270] Hu and Black 2006, p. 857.

management.[271] Less strict ownership disclosure rules may in this sense prove beneficial to social welfare.[272]

Gordon and Gilson use a partly similar kind of logic as they criticize the current U.S. ownership disclosure reform proposal. According to Gordon and Gilson, the proposal is an attack against the activist investors' business model as the proposed earlier disclosure would limit pre-disclosure stock acquisition and the activist investors' ability to make money by arbitraging the value of governance rights.[273] The point is that stricter disclosure requirements discourage investor activism that should, in principle, benefit all shareholders by limiting money making opportunities.[274]

With respect to the benefits of hidden ownership, some commentators have discussed the problems relating to decision-making and especially the problem of strategic voting, which means that individuals do not vote according to their individual preferences in a large group. Instead, for maximizing personal benefits individual voters make their choices based on how other shareholders vote and not purely on an individual preference basis.[275] The problem is especially accentuated in circumstances involving changes in corporate control. Disclosure of an increasing stake of a potential bidder distorts the decision-making process by the incumbent shareholders, who either free ride or hold out in hope of a higher premium. According to Chattopadhyaya, when shareholders are unaware of the bidder's real tactics, they are making a

---

[271] Bebchuck and Jackson 2012, pp. 49–51. This has detrimental effects for shareholders, since weak shareholder rights and strong takeover defenses are associated with poor economic performance. See e.g. Gompers et al. 2003, who found that companies with weak shareholder rights had lower profits and lower sales growth. Such firms were also associated with lower firm value, as measured by Tobin's Q. The effect of lower firm value was found to become more pronounced over time. For anecdotal evidence, see The New York Times Jun 6, 2014 and subsequently The New York Times Jun 9, 2014.

[272] Schouten 2012, p. 30.

[273] Gordon and Gilson 2014, p. 20.

[274] See Bebchuk and Jackson pp. 49–51 and Bebchuk et al. 2013. For anecdotal evidence see also The New York Times, May 4, 2014 and The New York Times, May 20, 2014.

[275] Chattopadhyaya 2011, p. 316 and Schouten 2012, pp. 76–78.

free choice decision to sell the shares as long as the value they get is equivalent to the value they ascribe. Thus, hidden ownership should help to ensure that shareholders vote sincerely according to their individual preferences, due to the suppression of the information.[276]

[276] Chattopadhyaya 2011, pp. 316–317 and Schouten 2012, pp. 84–85.

# 5 REMEDIES FOR DEALING WITH EQUITY DECOUPLING

## 5.1 Current rules and regulatory actions to date

### 5.1.1 Nordic countries

The traditional disclosure regime – still prevailing for example in the Nordic countries[277] – relies on the disclosure of direct share ownership and the right or obligation to acquire shares. The Nordic countries follow the disclosure regime of the Transparency Directive[278] (hereafter "TD").

> The basic notification of the acquisition or disposal of major holdings is mandated in Article 9 as follows: "[…]where a shareholder acquires or disposes of shares of an issuer whose shares are admitted to trading on a regulated market and to which voting rights are attached, such shareholder notifies the issuer of the proportion of voting rights of the issuer held by the shareholder as a result of the acquisition or disposal where that proportion reaches, exceeds or falls below the thresholds of 5 %, 10 %, 15 %, 20 %, 25 %, 30 %, 50 % and 75 %."

Empty voting is currently unregulated in the Nordic countries. The TD provides hardly any transparency with respect to empty voting. In some Member States, stock lending activities are treated as a temporary transfer of voting rights pursuant to Article 10(b) of the TD, but most Member States assume that stock lending is covered by the general rule of Article 9.[279] Holding

---

[277] In this context the Nordic countries refers to Denmark, Finland, Norway and Sweden.

[278] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC. Although closely related, other directives and regulations such as the Regulation (EU) No. 596/2014 on market abuse (MAR) or the Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) do not provide any meaningful rules with respect to equity decoupling.

[279] Clottens 2012, p. 454. For example in Finland the disclosure obligation is based on Article 9 of the TD and applies to both the lender and the borrower (see FIN-FSA 8/2013, p. 17). Therefore, this disclosure obligation captures empty voting schemes relating to share lending. Still it does not prevent possible abuses as disclosure is not an effective remedy in this sense.

a major stake of direct share ownership is transparent, but the problem is the lack of transparency with respect to the reduced or inverse risk position of the empty voter.

The TD also covers derivative instruments, but only those that give a right to an investor to acquire voting rights with his own initiative alone and under a formal agreement. Hence, currently no disclosure of cash-settled equity derivatives is required in the TD.

> Article 13 stipulates that the disclosure obligation also applies to a natural person or legal entity who holds, directly or indirectly, financial instruments that result in an entitlement to acquire, on such holder's own initiative alone, under a formal agreement, shares to which voting rights are attached, already issued, of an issuer whose shares are admitted to trading on a regulated market.

Schemes of hidden ownership do not usually include any formal agreement that would contain an entitlement to acquire shares. Therefore, Article 13 does not capture hidden ownership. The most relevant transparency rules with respect to the analysis of TD's applicability to hidden ownership are found from Article 10(g).

> Pursuant to Article 10 that regards acquisition or disposal of major proportions of voting rights apply to a natural person or legal entity to the extent it is entitled to acquire, to dispose of, or to exercise […] (g) voting rights held by a third party in its own name on behalf of that person or entity.

In addition to extending duty disclosure to shareholders, the TD also aims to extend disclosure duty to all beneficial owners by extending the duty to those who are deemed to have access to voting rights. Therefore, mandatory ownership disclosure obligation arises e.g. when voting rights are held through controlled entities. The TD does not, however, according to most interpretations capture hidden ownership in this respect, but for example Zetzsche has discussed the possibility and noted that Article 10(g) has had differentiating interpretations among EU Member States. Zetzsche has pointed out that among German lawyers a contractual scheme has been deemed to the short counterparty holding shares on the long counterparty's behalf if the long party 1) bears the economic risk of the underlying shares; and 2) is capable of influencing how voting rights are exercised. Therefore, Zetzsche has argued that Article 10(g) of the TD covers instances of hidden ownership.[280] On the other hand, Schouten has referred to the former

---

[280] Zetzsche 2009, pp. 133–134.

Committee of European Securities Regulators (CESR) and its implementation advice regarding Article 10. CESR has offered the example of a trust, which according to Schouten suggests a somewhat narrower interpretation of Article 10 than what Zetzsche has advocated.[281] The general view and rulings of national securities authorities' have leaned towards the aforementioned stance articulated by Schouten. The implication is that the TD does not capture building of hidden ownership through cash-settled equity derivatives.

### 5.1.2 United Kingdom and Germany

The UK has taken a more strict approach than the Nordic countries, as is discussed above. At the same time, the UK has been a pioneer for extending disclosure rules to cover also cash-settled equity derivatives. The UK approach involves a two-tier set of transparency rules, where additional disclosure obligations are imposed in connection with takeovers, falling under the scope of the City Code on Takeovers and Mergers (the Code). Since 2005 the Code has required disclosure of pure economic interests of more than 1% of the share at the beginning of a public takeover and during it. Furthermore, the general UK Disclosure and Transparency Rule chapter 5 (DTR5) has since 2009 included provisions that generate disclosure obligations for holders of instruments with a similar economic effect as direct shareholdings, if such instruments constitute an exposure equivalent to a 3% stake in a UK listed company.

The similar economic effect means that it makes no difference whether the derivative instruments are settled in cash or in kind. The economic effect is computed through delta adjustment, where the aggregate delta exposure of an instrument or a set of instruments triggers mandatory ownership disclosure. Thus, the delta adjustment allows an investor to set off opposite economic exposures and therefore leaves only the net exposure to be compared with disclosure thresholds. However, this does not apply to aggregation of direct physical ownership and synthetic derivative ownership. Therefore, an investor is not in this context able to create an opaque empty voting position by being long through direct share ownership and then setting it off against short synthetic exposure.

The example set by the UK was followed by Germany, among other countries. As discussed earlier, Germany witnessed a couple of high-profile cases of hidden ownership in a short period

[281] Schouten 2012, pp. 36–37.

of time, which prompted it to make changes to its disclosure regime especially with respect to cash-settled equity derivatives. Since 2012, disclosure has been required for all instruments that due to their terms and conditions facilitate the acquisition of voting shares by the instrument holder or third parties. This requirement covers also derivatives, which allow the parties to alter their economic exposure under the derivative by acquiring the underlying shares as a hedge for their economic position under the contract. Thus, the German disclosure regime closely resembles the UK one, but with one major exception. The German regime does not offer any delta adjustability, which makes the coverage of the German regime even broader, albeit less complex, than the British.

The sanctions of the German regime are also worth noting. Failure to disclose voting rights results in the disenfranchisement of the votes attached to such shares and, thus, the investor loses the ability to use governance rights, if the possession of those rights is not properly disclosed. On the other hand, failure to disclose positions in cash-settled equity derivatives may result in a fine. One aspect of the sanctions that is interesting and even somewhat illogical is that an empty voter, who directly holds physical shares and a corresponding short exposure through derivatives and who has disclosed their shareholdings but not the derivatives positions, may continue to exercise voting rights for the directly held shares. Thus, this enables investors to fully use empty votes in the governance sense, because only a fine might result under such an empty voting arrangement.

### 5.1.3 Amendment of the Transparency Directive

The occurred equity decoupling events and the national changes adopted by Member States have also prompted disclosure rules changes at EU level. In June 2013, the European Parliament adopted the agreement text of a new directive[282] amending the TD. The adoption was the culmination of the EU Commission review of the Transparency Directive, initiated in 2009, and

[282] Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC.

put in place a set of proposals for reform proposed in 2011. The amendments entered into force on November 26, 2013 and from then Member States have until November 26, 2015 to implement the changes to their national legislation. The amendments to the TD have three goals: 1) make regulated markets more attractive for raising capital for small and medium-sized issuers by simplifying certain obligations; 2) improve legal clarity and effectiveness, particularly with respect to the disclosure of corporate ownership; and 3) ensure that the sanctions for breach of the transparency requirements are sufficiently dissuasive in the event of a breach.[283]

The amendment of the TD will have numerous effects, but one of the most significant is the expansion of the mandatory ownership disclosure obligation to cover cash-settled derivatives. The amendment follows the path set by the UK as the new provisions take into account the delta adjustability of derivative positions. However, only long positions will be taken into account, with no netting of long and short positions. It will be mandatory to aggregate holdings of voting rights with holdings of financial instruments in computing total holdings. Furthermore, disclosure notifications will be required to include a breakdown by type of financial instruments held and the distinguishing between physically-settled and cash-settled instruments. Member States will be allowed to set lower notification thresholds than the thresholds mandated by the TD, which has already been the case before the amendment. However, Member States will not be allowed to impose different requirements regarding computation or aggregation of interests.

The amendments of the TD will tackle the detrimental effects of hidden ownership, but not so much those of empty voting. The new TD will increase transparency, but it has two problems with respect to empty voting. Firstly, only long positions will be taken into account, which does not resolve the lack of transparency in empty voting. An investor may hold shares and a short derivatives position offsetting the economic exposure of the shares. This offsetting effect is not, however, visible to the markets and no information regarding the empty voting opportunity is therefore generated. Secondly, transparency is not a real remedy nor a sufficient deterrent for empty voting. Transparency may be a hindrance for empty voting, but it does not affect the economic incentives driving empty voting. Therefore, it seems that possible legislative action

[283] Council Press Release 2013.

against empty voting will be left to the legislators of each Member State. Portugal and France, for example, have already adopted national measures against empty voting activities.[284]

### 5.1.4 United States

The U.S. has a somewhat different approach than its European counterparts, perhaps because of reasons related to their common law system. The U.S. disclosure regime is based on five different levels, which treat economically similar exposures differently both within and across disclosure levels. Therefore, as Hu and Black point out, the U.S. regime allows much of hidden ownership to remain hidden and imposes few restrictions on empty voting. The current disclosure levels of ownership in the U.S. are the following:

1) Schedule 13D
   - Disclosure of active 5% shareholders with respect to their voting ownership and material changes in that ownership
2) Schedule 13G
   - Annual disclosure of voting ownership by passive investors and a disclosure if a stake of 10% is crossed
3) Form 13F
   - Quarterly disclosure of share ownership by institutional investors holding over 100 million USD in U.S. equity securities
4) Section 16 of the Securities Exchange Act
   - Insiders consisting of directors, officers and 10% shareholders report their economic ownership
5) Forms N-1A, N-CSR and N-Q
   - Quarterly reporting of economic ownership by mutual funds

In addition to the above, proxy rules and tender offer rules may require further disclosures.[285]

With respect to equity decoupling, the most relevant disclosure levels are the Schedules 13D and 13G that are based on sections 13(d) and 13(g) of the Securities Exchange Act of 1934.

[284] ESMA 2012/414, pp. 15–16.

[285] Hu and Black 2008, p. 682.

Sections 13(d) and 13(g) were amended by the Dodd-Frank Wall Street Reform Protection Act of 2010 and its section 766(b) that specifically extended beneficial ownership reporting requirements to any person who becomes or is deemed to become a beneficial owner of equity securities upon the purchase or sale of a security based swap. However, even after the enactment of the Dodd-Frank Act it is still uncertain whether the disclosure requirement extends to cash-settled equity derivatives. It is clear that for example physically-settled TRSs trigger beneficial ownership, but there is no definitive answer with respect to cash-settled TRSs. This is the case even after the appeal on the famous CSX v. Children's Investment Fund Management[286] case, where the 2nd Circuit Court of Appeals did not reach the question of whether or not TRSs constitute beneficial ownership. However, based on the case, TRSs may constitute beneficial ownership under the following circumstances: 1) counterparties buy reference assets to hedge their exposure; 2) the long party has the ability to make the counterparties deliver the hedge shares to the long party; and 3) the long party has the ability to influence voting of the underlying shares.[287]

Similar to Europe, the U.S. regime – especially sections 13(d) and 13(g) of the Securities and Exchange Act of 1934 – has been targeted with reform proposals, but mainly by outside law firms.[288] The proposals put forth include two reform suggestions. Firstly, the ten-day reporting period for Schedule 13D is proposed to be shortened to a single business day.[289] Secondly, it is proposed that the concept of beneficial ownership be expanded to include synthetic or cash-settled derivatives to widen the scope of positions that count towards the threshold for disclosure in section 13(d).[290]

In addition to disclosure rules, Lee for instance has analyzed Delaware case law and its applicability to empty voting side of equity decoupling. Firstly, the case Deephaven v.

---

[286] *CSX Corp. v. Children's Investment Fund Management (UK) LLP*, 562 F. (S.D.N.Y. 2008).

[287] Cuillier and Hall 2011, pp. 1–5.

[288] See e.g. WLRK Petition, Mar 7, 2011.

[289] Ibid., pp. 3–7.

[290] Ibid., pp. 7–9.

UnitedGlobalCom[291] questions the ability of empty shareholders to seek inspection rights under Delaware law. In the case it was argued that inspection rights should not be available to shareholders who have an economic exposure that is net short. However, the Delaware court ruled in favor of the shareholder. According to Lee the court distinguished the inspection rights from voting rights, reasoning that unlike in other situations such as voting, the inspection rights analysis includes its own safeguard against plaintiffs with economic incentives that are not aligned with other stockholders: the proper purpose analysis. The language used clearly indicates the court's willingness to intercede in situations lacking safeguards against distorted economic incentives, and in voting contexts in particular.[292]

Lee has also discussed the Delaware vote-buying doctrine for example in the light of the leading case Schreiber v. Carney.[293] Delaware law defines vote buying as any transaction by which a party directs a shareholder's vote for consideration personal to that shareholder.[294] Lee acknowledges that empty voting may not fit in the definition of Delaware law, but the underlying vote-buying prohibition should still be applicable to empty voting. If the applicability of the vote-buying doctrine rested on who had the unsevered share to begin with, it could easily be avoided by arranging every vote-buying agreement as a two-step process.[295] Lee argues that the Delaware vote-buying doctrine prevents empty voting under circumstances where it would: 1) itself be sufficient to preclude the outcome of a vote; or where it 2) is done by management in breach of fiduciary duty. However, the doctrine does not cover circumstances, under which empty votes are exercised against the interests of other shareholders by a minority shareholder

[291] *Deephaven Risk ARB Trading Ltd. v. UnitedGlobalCom, Inc.*, 2004 WL 1945546 (Del. Ch. 2004).

[292] Lee 2007, p. 886.

[293] *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982). In the case the Delaware Chancery court held that although vote buying itself is not prohibited, an intervention will be where the object or purpose is to defraud or in some way disenfranchise the other stockholders. In addition, the court held that vote buying is subject to a test of intrinsic fairness for testing the legality of vote buying.

[294] Lee 2007, p. 887.

[295] Ibid., pp. 887–888.

who has no control over the affairs of the company. This can be considered perhaps the most common of the empty voting scenarios.[296]

## 5.2 Suggested future remedial approaches

### 5.2.1 Non-regulation

The simplest of the suggested regulatory solutions for equity decoupling is to do nothing at all. This is a good starting point for further analysis. Rules and regulations have no value if they are not capable of correcting market failures and adding more value than costs. Assessing the effects of non-regulation also prevents regulators from jumping into interventionism without assessing whether regulatory intervention is even useful in the first place.[297]

With respect to empty voting, a large number of academics have long argued in favor of allowing free vote trading. For example, already in the 1960s Manne advocated for vote trading by arguing that the market for votes gives the advantage of someone else's information-gathering to all the shareholders willing to sell their votes and also causes votes to move into the hands of those shareholders for whom the vote itself is most valuable.[298] The views of Kobayashi and Ribstein, discussed earlier in this thesis, also reflect the same kind of logic and can be considered supportive of vote trading and empty voting.[299] Dent, on the other hand, has referred to the insignificance and rareness of the problems caused by empty voting.[300]

Ringe has discussed non-regulation with respect to empty voting and some aspects of the discussion can also be extended to hidden ownership. Ringe argues that comments in favor of non-regulation of empty voting are based on two key assumptions. First, it is assumed that markets are efficient for establishing prices for full shares and mere voting rights. This logic can

---

[296] Lee 2007, pp. 897.

[297] Ringe 2013a, pp. 1074–1075.

[298] Manne 1964, p. 1444.

[299] Kobayashi and Ribstein 2006, p. 21 and p. 39.

[300] Dent 2010, p. 112. " Despite the scholarly jeremiads over empty voting, it has never yet altered the result of a shareholder vote, and problems from it are likely to remain rare or nonexistent."

be extended also to hidden ownership. Secondly, it is assumed that decoupling does not create distorting effects. Ringe rejects these assumptions by arguing that prices are not formed efficiently under all circumstances and that distorting effects are created for third parties. This occurs although the pricing process and the overall transaction would produce efficient outcomes *inter partes*.[301] Arguments of Ringe are in the author's view imperfect. When assessing the effects of non-regulation, the focus should not be on the absolute effects, but on the relative ones. Thus, regulators should be asking, is the price-forming process efficient *enough* to a *reasonable* extent? Are the distorting effects caused for third parties *greater* than the efficiency gains of allowing equity decoupling? When assessing whether or not an issue should be regulated or not, the focus should be on the lesser of the two evils.

Regarding hidden ownership Chattopadhyaya has put forward strong arguments concerning the beneficial effects of hidden ownership already discussed earlier in this thesis.[302] Due to the beneficial effects of hidden ownership Chattopadhyaya has been cautious with respect to creating stricter ownership disclosure rules.[303] Gilson and Gordon employ the same kind of logic in the context of U.S. ownership disclosure regime. The authors argue that the 1968 Williams Act governing mandatory ownership disclosure was adopted to correct what was perceived to be a takeover market gone awry to the detriment of dispersed small shareholders. According to their analysis, in 1968 some 83% of equities were held directly by small shareholders and 17% were held through financial institutions. By 2010 the numbers had turned the other way round. Due to this concentration in the U.S. markets, the authors have not only argued against the proposed amendments of the Williams Act making disclosure stricter, but also implicitly in favor of repealing the disclosure obligation altogether.[304] In this respect Gilson and Gordon argue in favor of a regulatory regime that embraces conditions, where activist investors

[301] Ringe 2013a, pp. 1076–1077.

[302] See e.g. Chattopadhyaya 2011, p. 332 that boils down the point of view: "[…] it nurtures private entrepreneurial information development and infuses efficiency into the securities markets and simultaneously incentivizes monitoring to curb managerial rent seeking."

[303] Ibid., pp. 327–332,

[304] Gilson and Gordon 2014, pp. 19–21.

specialize in framing alternatives to existing company strategies and thereby increasing the value of governance rights to institutional investors.[305]

### 5.2.2 Self-regulation

The approach of non-regulation by a regulator would still leave the possibility of self-regulation by the relevant market participants.[306] This has partly happened at least in the U.S., where public companies have reacted to empty voting schemes by amending their by-laws. For example in the spring of 2008 Sara Lee, the U.S. based consumer goods company, now split to Hillshire Brands and D.E. Master Blenders 1753, was reported to have amended its by-laws "*in a novel defensive move that aims to ferret out hedge funds or activist shareholders that might not have the company's best interests at heart*."[307] The so-called second-generation advance by-laws (ANBs) started to appear in 2008 and in 2009 they had already been inserted into some 550 by-laws.[308]

> "As amended, Article I, Section 10(a)(2) of Sara Lee's Bylaws states that a stockholder's notice to be proper must set forth ... '(iii) as to the stockholder giving the notice and any Stockholder Associated Person ... (C) whether and the extent to which any hedging or other transaction or series of transactions has been entered into by or on behalf of, or any other agreement, arrangement or understanding (including any short position or any borrowing or lending of shares) has been made, the effect or intent of which is to mitigate loss to or manage risk or benefit of share price changes for, or to increase or decrease the voting power of, such stockholder or any such Stockholder Associated Person with respect to any share of stock of [Sara Lee].'"[309]

As the Sara Lee example illustrates, these so-called second generation ANBs may, for instance, require the shareholders who seek to take action in a general meeting to disclose not only their beneficial ownership position but also any derivative positions that they hold, such as cash-

---

[305] Gilson and Gordon 2013, p. 901.

[306] See for instance Lee 2007, p. 907, who argues in favor of adopting by-laws amendments that would tackle problems caused by equity decoupling.

[307] Marketwatch, Apr 2, 2008.

[308] Nathan and Amdur 2009.

[309] Sara Lee Form 8-K 2008.

settled swaps.[310] The disclosure duty, however, applies only in a very specific situation, as Ringe points out. ANBs are applicable only where the shareholder, at his own initiative, makes proposals for the agenda of the general meeting, which may be for the appointment of managers or any other resolution. These kinds of initiatives are relatively rare in the U.S.[311]

The ANBs may indeed increase much-desired transparency, but they may include their own problems as well. Weingarten and Magnor point out, for example, that by-law provisions may require that once a shareholder has obtained a certain percentage of economic interest in the company, combining long ownership with any derivative or synthetic interest results in an obligation to continuously inform the company of the shareholder's interest level. This obligation arises even if the shareholder at that time has no intention whatsoever of taking governance action. Furthermore, if the shareholder does not comply with the provision, the company will disqualify the shareholder from later seeking to take action at a shareholder meeting.[312] It goes without saying that the strictness of these kinds of provisions may very well raise issues and act against efficient monitoring of management and functioning of the market for corporate control. As Nathan and Amdur note, it is likely these provisions will be the subject of litigation attack by event-driven hedge funds and other activist shareholders, who are likely to challenge the asserted breadth of the new provisions and their asserted vagueness.[313]

The hedge fund industry itself has also taken steps to curb harmful practices. The Hedge Funds Standards Board (HFSB), which is a standard setting body for the hedge fund industry, has published a code of conduct standards called The Hedge Fund Standards (HFSs). The HFSs are not strictly binding, but follow comply or explain approach that is peculiar to self-regulatory rules. Regarding equity decoupling, perhaps the most relevant part of the HFSs is the standard 28.1. Pursuant to the standard, a hedge fund manager should not borrow stock in order to vote.[314] Thus, the standard aims to curb empty voting activity relating to stock lending. The standard is

[310] Weingarten and Magnor 2009.

[311] Ringe 2013a, p. 1079.

[312] Weingarten and Magnor 2009.

[313] Nathan and Amdur 2009.

[314] HFSB 2012, p. 33.

not with any means perfect or comprehensive with respect to equity decoupling, but it shows that the industry itself has acknowledged at least a part of the equity decoupling problem and taken the first step to eliminate possible harmful practices.

### 5.2.3 Increased disclosure and transparency

Disclosure and transparency is a widely discussed issue and a number of academics have advocated for increasing disclosure and transparency with respect to equity decoupling schemes.[315] On the other hand, disclosure and transparency has not gained the unreserved trust of everyone in academia.[316] For instance, Hu and Black have proposed "integrated ownership disclosure", which would contain four steps. Firstly, Hu and Black have suggested moving towards common standards for triggering disclosure and for disclosing positions once disclosure is required. Secondly, they argue in favor of providing a single set of rules for which ownership positions to disclose and how to disclose them. Thirdly, they would require disclosure of all positions conveying voting or economic ownership arising from shares or coupled assets. Finally, they would extend ownership disclosure to both positive and negative economic ownership.[317] The integrated ownership disclosure model has been criticized on the grounds that it underestimates the cost of implementation and that it primarily targets hidden ownership and disregards empty and negative voting,[318] which Hu and Black themselves have also acknowledged.[319]

---

[315] See e.g. Hu and Black 2006, Schouten 2012, Ringe 2013a and Strine 2014, p. 472, who notes that "the need for fuller and more timely disclosure about the interests of activist investors who propose changes in the business plans of corporations but are not prepared to make a fully funded, all-shares offer to buy the corporation is arguably made more advisable because of these market developments."

[316] See e.g. Zetzsche 2010b, Chattopadhyaya 2011, Kettunen and Ringe 2012, Gilson and Gordon 2013 and Gilson and Gordon 2014.

[317] Hu and Black 2006, p. 876.

[318] Cohen 2008, pp. 250–251.

[319] Hu and Black 2006, p. 886.

Ringe has also made a concrete proposal[320] for combatting the detrimental effects of equity decoupling. Whereas the Hu and Black proposal discussed before mainly concerns hidden ownership, Ringe's proposal is intended primarily for empty voting. Ringe's argument is that the main concern of equity decoupling schemes is their lack of transparency.[321] Therefore, information costs, agency costs and issues relating to efficient pricing of decoupled shares should be addressed with transparency.[322] In particular, Ringe emphasizes broad coverage of the disclosure obligation, continuity with respect to disclosure frequency and a reasonably high disclosure threshold of 5%.[323]

### 5.2.4 Bans and alternations of voting rights

Hu and Black have also proposed to impose a corporate law ban on voting on shares with negative economic exposure. According to their analysis, the presumption of banning negative voting could either be rebuttable,[324] where a shareholder could then illustrate his positive economic interest, or it could be a flat rule that would not allow a separate assessment of overall economic exposure.[325] In a nutshell, voting bans and restrictions would mean disqualifying the votes of any shareholder who has hedged or is otherwise structurally indifferent to the price movements of the stock that is used to vote.

Voting restrictions have also received criticism. For example, Ringe has discussed whether it is overall desirable to respond to equity decoupling with a general prohibition to vote. Ringe has

---

[320] Ringe 2013a, pp. 1112–1114.

[321] Strine 2014 appears to be reflecting similar kinds of views. See for example the logic on the p. 473: "When a buyer purchases the entire company, it signals that it and its financing partners are willing to fully absorb the future risk of its business strategy. By contrast, when an activist argues that a corporation would be more valuable if it changed its business strategy, but is not prepared to buy the company or to even commit to hold its stock for any particular period of time, there is good reason to make sure that the other stockholders have full information about the precise economic interests of that activist."

[322] Ringe 2013a, p. 1087.

[323] Ibid., pp. 1096–1099.

[324] This is also proposed by Cohen 2008, pp. 254–255.

[325] Hu and Black 2008, pp. 701–702.

observed that a ban to use voting rights is a suitable instrument to prevent any undesirable and cost-creating effects of equity decoupling. At the same time however, Ringe has criticized bans to vote as too "black and white" a type of solution that only allows either–or use of voting rights. Due to the possible benefits of equity decoupling discussed earlier in this thesis, a simple ban on empty and negative voting would also prevent the occurrence of the possible positive effects. Furthermore, the loss of a right to vote is a far-reaching intervention getting to the very core of an investor's position as a shareholder. Therefore, Ringe has argued that voting restrictions should be limited to exceptional cases.[326]

Furthermore, totally new kinds of solutions have been put forward that would practically constitute new forms of equity ownership. For example, some commentators have argued in favor of giving shareholders the ability to buy and sell their voting rights independently from their shareholdings.[327]

In the opposing camp are Martin and Partnoy, who have come to a conclusion that is – according to their view – apparent from financial innovation: not every share should be entitled to a vote.[328] The authors have suggested that each economic net share should receive one vote. In other words, anyone with an economic net share position receives a vote, regardless of their portfolio. They have argued that because financial engineering is zero-sum,[329] the number of economic

[326] Ringe 2013a, pp. 1107–1109. Similar kind of approach is also adopted by Cohen 2008, p. 252, who points out that simple ban on empty voting would curtail also the beneficial instances of empty voting.

[327] Ringe 2013a, p. 1076.

[328] Martin and Partnoy 2005, p. 813.

[329] In this Martin and Partnoy are not quite right. Financial engineering is not a zero sum game. Take for example total return swaps. Total return swaps can be used to create an infinite amount of economic exposure and in this sense it is not zero sum. The use becomes zero sum, if we assume that the other side of the transaction is always hedged. This is often the case, but not by any means always and certainly it is not a requirement. Martin and Partnoy recognize this point later in their paper (see Martin and Partnoy 2005, pp. 808–809).

net shares will equal the number of shares issued and outstanding. They have noted that this is true even if the holders of the shares do not actually have a vote.[330]

Kobayashi and Ribstein have criticized the analysis of Martin and Partnoy by arguing that their own analysis of control transactions casts doubt on the efficiency of the broad substantive regulation of vote buying proposed by Martin and Partnoy. The definition of encumbered shares introduced by Martin and Partnoy would cover many diversified investors, including institutional investors that are often the centerpiece of corporate voting reform. Kobayashi and Ribstein have argued that such diversified investors might favor mergers that would reduce the value of one of the firms but increase the value of the portfolio. According to Kobayashi and Ribstein, the inefficiency of deviations from the incentives of a pure residual shareholder is not as obvious as Martin and Partnoy[331] argue.[332]

### 5.2.5 Expansion of fiduciary duties and liability for damages

Some commentators have argued in favor of effectively expanding fiduciary duties to activist shareholders who engage in harmful equity decoupling. This is based on the understanding that the purpose of corporate fiduciary duties is to restrain self-interested behavior by people who are in a position to exert control over the corporate entity.[333] This is why the same fiduciary duties already applicable to corporate managers should also be extended to shareholders too. The main logic of this approach follows from the idea that greater shareholder power, the trend *du jour*, should be coupled with greater shareholder responsibility.[334] Like corporate managers, activist shareholders face the same temptations of greed and self-interest.[335]

---

[330] Martin and Partnoy 2005, p. 806.

[331] Ibid., p. 810.

[332] Kobayashi and Ribstein 2006, p. 45.

[333] Anabtawi and Stout 2008, p. 1296.

[334] Ibid., p. 1256.

[335] Ibid., p. 1262.

Following on from that, Anabtawi and Stout have proposed that all shareholders, like all directors and officers, be viewed as owing latent duties to the firm and their fellow shareholders. The latent duties would come into play when a shareholder manages to successfully influence the company's course of action with respect to an issue, where the shareholder has a material and personal economic interest.[336] The general shareholder fiduciary duties theory by Anabtawi and Stout has been further developed by Zanoni, who pays special attention to empty voting and different positions of empty voters as exercisers of voting power.[337]

A somewhat similar kind of approach, at least with regard to practical implications, has also been adopted by Cohen, who has proposed a private right of action that would enable shareholders, who have been harmed by negative voting, to sue negative voters for their loss.[338] In order to be successful, the plaintiff would need to prove that: 1) it possessed beneficial ownership of the stock at the moment of the vote; 2) the defendant was a negative voter; and 3) the defendant exercised his voting power in a way that harmed the plaintiff.[339]

## 5.3 Critique and new aspects

In essence, the question of regulating equity decoupling is a question of trade-offs. Allowing empty voting may facilitate for more efficient management monitoring and voting outcomes. On the other hand, empty voting may facilitate inefficient use of voting rights, extraction of private benefits of control and increased information costs. Thus, empty voting is a trade-off mainly between agency costs among shareholders and agency costs in shareholders–managers relation.

The same kind of trade-off can be viewed to exist in regulating hidden ownership schemes. For example, Chattopadhyaya has argued that hidden ownership encourages information acquisition

---

336 Anabtawi and Stout 2008, p. 1295.

337 Zanoni 2009, pp. 28–36.

338 Cohen 2008, pp. 253–257.

339 Ibid., p. 254.

and aggregation and mitigates managerial problems as well as the problem of strategic voting.[340] Alternatively, for example Schouten has made the point that hidden ownership may have detrimental effects on market efficiency, corporate governance and the protection of minority shareholders.[341] Thus, regulating hidden ownership is mainly a trade-off between the protection of minority shareholders and the mobility of corporate monitoring and control.[342]

Therefore, the questions of whether and how equity decoupling should be regulated depends on which arguments are emphasized the most and to which extent. In this sense assessing whether or not equity decoupling should be regulated or not (or to which extent), the focus should be on the lesser of the two evils, i.e. on the solution that provides the most efficient overall economic outcome. Neither market regulation in general, nor equity decoupling regulation in particular, is of particular value.

Legal literature has taken an unbalanced stance with regard to equity decoupling and it has emphasized its potential perils while disregarding its potential benefits. At the same time recent financial economics and law and economics literature have provided theoretical and empirical evidence in favor of allowing trading votes separately from shares, i.e. equity decoupling.[343] For instance with respect to empty voting Ringe has spelled out the point of view that perhaps reflects the most prevailing view in academia. According to Ringe, all structures of risk decoupling demonstrate vividly that the voter usually pursues objectives that are precisely not in the interest of the wider community of shareholders, but rather uses his risk-decoupled position deliberately for the purpose of achieving his own benefits and for disadvantaging other investors.[344]

---

[340] Chattopadhyaya 2011, p. 307 and p. 313.

[341] Schouten 2012, pp. 37–41.

[342] Ferrarini 2000, p. 4 and pp. 26–27.

[343] See e.g. Kalay and Pant 2009, Brav and Mathews 2011, Barry et al. 2013 and Esö et al. 2014.

[344] Ringe 2013a, p. 1065.

This argument is not compelling and disregards the potential increased social welfare relating to equity decoupling. For example a ban on negative voting[345] would be reasonable only if it is assumed that maximizing firm value also maximizes social welfare.[346] However, although this assumption is valid most of the time, there are exceptions to it as illustrated in this thesis. In any case, those arguing in favor of banning empty and negative voting should consider that such a measure would decrease effective voting power for well-informed voters and reduce efficient information gathering by strategic empty voters. Consequently, this would mean decreasing the efficiency of voting outcomes. The decrease in efficiency would especially affect proposals with a large expected value impact and proposals about which other voting shareholders may not have very precise information.[347]

If vote trading is possible for all investors and the economic and control rights ownership structures are transparent for every market participant, investors should under certain realistic conditions always have the incentive to engage in vote trading, which results in the most efficient overall economic outcome.[348] The result may not be privately optimal for all participants, but the result should be optimal in terms of social welfare. Therefore, if empty voting promotes participation of long-time committed shareholders holding significant stakes, this kind of behavior should be encouraged.[349] There is no need for curtailing empty voting, but rather a need to further reinforce the ongoing and perhaps inevitable marketization development in the creation of the market for corporate votes. Legislative regulatory policy should therefore preserve and further enforce the current role that shareholders play in corporate decision-making

---

[345] Suggested by among others Martin and Partnoy 2005, p. 813 and Hu and Black 2008, pp. 701–702.

[346] Barry et al. 2013, p. 1161.

[347] Brav and Mathews 2011, p. 302.

[348] Dombalagian 2009, p. 1271.

[349] Ibid., p. 1236. “If long-term institutional shareholders have an interest in long-term wealth maximization, they should be willing to incur short-term costs (e.g., the cost of acquiring additional voting power) to serve that interest. If this were the case, a market for borrowing public shares, as described herein, should develop over time as a means to harness shareholder power to improve corporate governance.”

and encourage significant shareholders to engage in voting activities providing the most socially beneficial outcomes.[350]

It is questionable whether empty voting can even be regulated in the presence of modern financial instruments.[351] As some commentators have argued, modifying the regulatory framework for derivatives and share-lending markets would be cumbersome and largely ineffective.[352] This is especially true if it is assumed that derivatives markets continue to grow making equity decoupling easier and divergence in economic and control rights more substantial.[353] Therefore, if there is no evidence to show more abusive empty voting than beneficial empty voting, why should a possible problem be tackled with broad *ex ante* rules?[354]

For effective harnessing of new elements of shareholder power, transparency is however needed. Ringe has discussed the use of transparency in curtailing empty voting. According to Ringe, a disclosure obligation would deter hedge funds and other savvy investors from entering into risk-decoupling structures. In this sense Ringe states that the private benefits that are pursued and the agency costs that are produced are only seen as an attractive business model for some market actors for the very reason that they can be pursued unnoticed on the market.[355] There are some weaknesses in this view. Firstly, the business model of empty voting is not based on acting under the veil of secrecy. The business model of empty voting is based on the specific use of control rights and in this sense disclosure would not be an effective remedy in the fight against the possible detrimental effects of empty voting. Secondly, hedge funds and other activist investors are not as sensitive with regard to their reputation as are banks and other similar

[350] Dombalagian 2009, p. 1237.

[351] See e.g. Kalay and Pant 2009, p. 1 and Christoffersen et al. 2007, p. 2927.

[352] Dombalagian 2009, p. 1263. See also Schouten 2012, p. 46, who discusses the inherent incompleteness of law and points out the likelihood for the emergence of new types of trading strategies and financial instruments that would not fall into the scope of the rules targeting equity decoupling.

[353] Barry et al. 2013, p. 1154.

[354] Schouten 2012, p. 93.

[355] Ringe 2013a, p. 1087.

financial institutions. Therefore, public outcry over morally questionable tactics would not be a powerful deterrent.[356] Dissenting from Ringe's view, it is likely that enhanced transparency would not deter hedge funds and other savvy investors from entering into risk-decoupling schemes.

However, transparency is not totally useless. Transparency makes investors aware of possible inefficient voting behavior and enables them to counter-act by adapting to it accordingly.[357] This is the key point as transparency still allows socially beneficial activities while discouraging activities that are detrimental to social welfare. Acknowledging and observing conflicts of interests and agency costs empowers monitors to act whether it is by voting or by empty voting. When incentives and their magnitudes are visible to all parties, the party with the most "skin in the game" should prevail. In free markets, this should also result in the most optimal outcome with respect to social welfare.[358] Therefore, transparency with respect to empty voting should increase voting efficiency.

Transparency is also the key issue of hidden ownership. There should be enough transparency to ensure investor confidence and efficient price formation. On the other hand, there should not be an overkill of transparency, since it introduces unnecessary costs and discourages investor activism important to market efficiency.[359] Due to the inevitable separation of economic and control rights, transparency should be extended to both economic and control rights. Where there is hidden ownership, empty voting usually also exists. In this sense, it is logical that transparency covers both sides of equity decoupling. Commentators arguing against disclosure

---

[356] Anabtawi and Stout 2008, p. 1304 and Clottens 2012, p. 463. On the opposite view, see Chattopadhyaya 2011, p. 330.

[357] Clottens 2012, p. 463 and Schouten 2012, p. 93.

[358] Transparency in this respect is also emphasized by Barry et al. 2013, p. 1104, who find that opaque derivatives markets can render financial markets unpredictable, unstable, and inefficient. The authors' model illustrates that in transparent markets, equity decoupling should only occur in those situations in which it is socially beneficial as is also suggested in this thesis.

[359] This delicate balance is emphasized also by Schouten 2012, pp. 44–45. See also Ferrarini 2000, p. 4 and pp. 26–27.

of economic-only positions[360] may have disregarded this aspect and provided too one-sided views. A sufficient amount of transparency with respect to both economic and vote holding should provide investors with the necessary information of incentives of different market participants and their courses of action.

> Consider the following simple example. Firm M has made a tender offer for the company K's shares. The merger would be beneficial for K but not for M. With respect to social welfare the economic effect of the merger would be neutral. K's shareholders decide whether to accept the offer or not. K has one shareholder, B, owning 50% of the company and numerous minority shareholders. Therefore, B effectively determines whether or not the offer is accepted or not. The decision-making process of B is relevant for the minority shareholders as it affects the value of their shares.
>
> In a base case scenario B would exercise his voting power in favor of accepting the offer. However, the circumstances change if B has an economic exposure to the share price performance of M. If B's exposure to his economic-only position in M is larger than B's exposure to shares of K, it is likely that B will not vote in favor of accepting the offer. Therefore, the economic-only position of B to the share price performance of M changes the anticipated behavior of B to the detriment of K's minority shareholders.

The above example may be theoretical, but the point is not. Significant economic-only exposures are currently often opaque and, as pointed out above, some commentators have argued against extending transparency to economic-only positions. However, these positions may have a tremendous impact on incentives of market participants. Therefore, they may also affect the behavior of those market participants. The behavior may be unexpected, if the incentives are not transparent. Hence, transparency with regard to significant economic-only positions would mitigate this problem.

Thus, with regard to both aspects of equity decoupling, market participants need information about each other's economic interests and control rights for reaching a socially efficient outcome. Market participants should be able to anticipate how control rights will be exercised.

---

[360] See for example Kettunen and Ringe 2012, who argue in favor of intentions based disclosure regime of cash-settled equity derivatives rather than all inclusive regime.

For this to be possible, market participants need to know who holds control rights and what those actors' economic interests are.[361]

Although the models and evidence discussed in this thesis mainly support allowing equity decoupling, it may still be possible, where market failure occurs, that socially inefficient actions may occur or that socially efficient actions are unfair on the private level. However, despite the possible adverse effects, ad hoc assessments and extension of fiduciary duties to shareholders who are non-controlling shareholders in cases of equity decoupling should be taken with a pinch of salt. Firstly, shareholder heterogeneity[362] does not allow the extension of fiduciary duties. Where managers are hired to operate a firm in the common interest of shareholders, shareholders are and should be concerned only about their private welfare. For each individual shareholder it is inherent to seek courses of action and outcomes that maximize their own private welfare. This is the key mechanism for maximizing social welfare in a free market environment.[363] If shareholders were required to consider also the welfare of their fellow shareholders, this would impair the whole efficiency of shareholder behavior and hinder maximization of social welfare.

> Take for instance the merger example discussed earlier in this thesis. The merger of firms K and M would benefit social welfare, but affect negatively on poorly diversified shareholders of M. This is because of uneven distribution of the gains. The merger decreases the market value of M, but increases the market value of K leaving the net social benefit positive. In such a case, the merger would be desirable from the society's point of view. However, decision-making is impaired and distorted, if the shareholders of M deciding on the merger would also be required to take into account the welfare effects for other shareholders. Under these kinds of circumstances, it would be desirable for each shareholder to pursue their own benefits. Maximization of social welfare should be the goal

[361] Barry et al. 2013, p. 1150.

[362] For shareholder heterogeneity, see e.g. Ihamuotila 1994, p. 9, who points out that shareholder homogeneity is not a realistic assumption, since large shareholders control companies according to their own preferences, which vary much.

[363] Jensen 2001, pp. 11–12. This is one of the cornerstones of classical and neoclassical economic theory. See Smith, 1776b, p. 190: "By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good."

> to pursue. Commentators promoting shareholder fiduciary duties have disregarded the key point that an action that may be value-destroying for one firm can still be beneficial for social welfare.

Furthermore, such an extension would most definitely create a plethora of lawsuits and therefore increase inefficient litigation and impose challenges on legal security. Shareholder fiduciary duties would also deter shareholder activism that is – because of modern ownership structures – very much needed as explained earlier in this thesis. The risk of litigation under fiduciary duties increases the costs of investor activism and, in more general terms, the cost of equity financing.[364]

All in all, fiduciary duties should properly rest with the board of directors and not be extended to cover non-controlling shareholders. As discussed earlier, transparency and further encouragement of shareholder activism is the proper way to deal with both sides of equity decoupling.

---

[364] Anabtawi and Stout 2008, pp. 1303–1308 discuss these possible harmful effects and do not consider them to be a significant problem undermining their proposal.

# 6 CONCLUSION

This thesis has provided a comprehensive analysis of equity decoupling as a phenomenon. The second chapter provided an illustration of the traditional view of a corporation, why it exists and what are shares. It was argued that voting rights are a necessary means of control, since contracts are inherently incomplete. Voting rights belong to shareholders, who as residual risk bearers are the best constituency to exercise voting rights, since shareholders incur most of the marginal costs and receive most of the marginal benefits for economic decision-making. Voting rights have traditionally been deemed to be inseparable from the economic rights of shares.

Then it was argued that the traditional picture has changed somewhat drastically. The change is due to a shift in the fundamental paradigm affecting the very core of securities and corporate law. As pointed out above, it has been a fundamental axiom that economic and control rights of shares are inseparable. However, due to modern financial instruments and other new and innovative tactics, economic and control rights are no longer inseparable. Therefore, it is now possible to trade these components of shares individually in accordance with investors' own preferences and risk bearing capabilities. The change has occurred outside the context of institutional corporate law, but at the same time the change has in practice had a significant impact on the very core of institutional corporate law.

Two drivers for the paradigm change were consequently distinguished. Firstly, marketization, complete markets and financial innovation stemming from marketization and complete markets theory have provided society with the means to trade almost anything and transfer the corresponding risks of tradable assets. Hence, marketization and complete markets have provided the supply of equity decoupling. Secondly, changes in investment theory, ownership structures and market for corporate control have created the demand for equity decoupling. These changes have led to the new kind of agency problem and undervaluation of control rights, since control rights are often not as valuable for well-diversified institutional investors following the modern portfolio theory.

Activist shareholders have emerged as gap-fillers under the new circumstances and have created the need for instruments and procedures allowing equity decoupling. Equity decoupling strategies enable these activist investors to use the shareholder governance power that is often

left unused by institutional investors by either leveraging their own voting power by purchasing only votes or by creating stealth economic positions by acquiring only economic ownership. In practice, these tactics have led to unusual voting tactics in corporate general meetings as well as market-surprising takeovers.

Finally, the potential benefits and detrimental effects of equity decoupling were discussed. Reflecting the points of the earlier discussion in this thesis, the already taken and suggested regulatory action was then presented. It seems apparent that hidden ownership side of equity decoupling has had a stronger regulatory response. Regulators have extended the scope of transparency rules by including also cash-settled derivative instruments that are used for building concealed economic positions. On the other hand, the issue of empty voting has gone mostly untouched by regulators with a few exceptions. In academia, a number of remedies targeting both hidden ownership and empty voting have been presented. However, in the light of the beneficial aspects of equity decoupling discussed in this thesis, it can be questioned if equity decoupling should be seen as a natural development and whether it should be left mostly unregulated. The development of equity decoupling appears to be more or less a natural progression, i.e. it is there for a reason. To this day academics and other commentators have not perhaps fully understood the drivers and consequences of decoupling strategies. Under most circumstances where free decoupling is allowed, the result is optimal for social welfare and, therefore, beneficial and efficient for society. Hence, instead of taking regulatory measures leading to more complexity and inefficiency, only adjustments to transparency of financial markets and further encouragement of investor activism should be considered as a regulatory response.