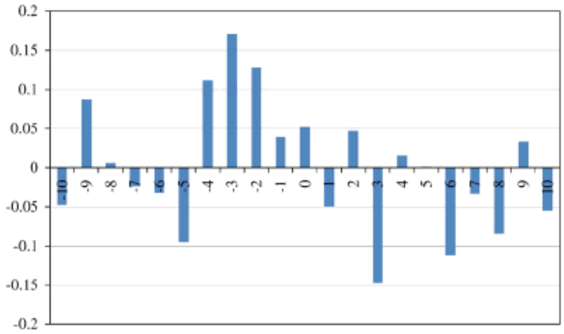
FIGURE 2: NET BUYING BY INSTITUTIONAL INVESTORS AROUND VOTING RECORD DATES



Source: Bethel et al. (2009)[121]

In terms of legal constraints, there are no direct constraints when purchasing shares in the spot market nor, as Delaware courts have recently confirmed, when purchasing shares through an off-exchange transaction.[122] There are significant *indirect* constraints, though. To name but a few: if the purchase results in more than 5% voting power, the shareholder may need to publicly disclose his position;[123] if the purchase results in more than 10% voting power, the shareholder becomes subject to short swing profit capture;[124] and if the vote buying results in more than 30% voting power, in certain jurisdictions such as European Union Member States the shareholder will run the risk of triggering a mandatory bid obligation. In light of these legal constraints and the cost constraints mentioned earlier, it is worthwhile exploring alternative arbitrage strategies such as proxy solicitation.

[121] *Id.* at 136. The figure reports the difference in percentages between trading activity on each day (relative to shares outstanding) and the average daily trading activity for the 20-day period surrounding the voting record date.

[122] *Kurz v. Holbrook*, *supra* note 22 at 69 (holding that "Delaware law does not restrict a soliciting party from buying shares … to bolster the solicitation's chance of success.") Aff'd, *Crown Emak Partners v. Kurz*, No. 64, 2010 at 22 (Del. Supr. Court April 21, 2010).

[123] Exchange Act Rule 13d-1(a), 17 C.F.R. § 240.13d-1 (2005).

[124] Exchange Act Rule 16a-2, 17 C.F.R. § 240.16a-2 (2005). Under this rule, company insiders (officers, directors or shareholders with a stake that exceeds 10%) are required to return any profits made from the purchase and sale of company stock if both transactions take place within a six-month period.

B. Proxy Solicitation

In theory, soliciting proxies from uninformed shareholders is an effective way of leveraging superior information. By soliciting sufficient proxies, the shareholder with superior information can ensure that the correct option is chosen by majority vote without having to purchase actual shares.[125] So if an overconfident management team proposes a merger that an informed shareholder knows will destroy value, he could solicit proxies to prevent the merger from being approved by a majority of the shareholders.

In practice, however, proxy solicitation appears to be an unattractive option to leverage superior information. Arguably the most important barrier is constituted by the free rider problem mentioned earlier. The shareholder with superior information will only internalize a fraction of the potential capital gains, while he will have to incur the full costs of soliciting proxies, costs that can be significant.[126] Related barriers include the prospect of an uphill battle against incumbent management which can deploy corporate funds to solicit proxies and has an informational advantage, the risk that institutional investors may vote with management because of conflicts of interest, the problem that existing shareholders may be skeptical about the challenger's credibility (which effectively causes a pro-incumbent bias), and so forth.[127] As a result, proxy contests are rare. A study of contested solicitations in US firms between 1996 and 2005 identified only 74 contests not involving the election of directors, i.e., contests in which shareholders opposed the board on matters such as mergers.[128] This suggests that proxy solicitation is of limited use as an arbitrage strategy to leverage superior information, at least under the present rules of the game.

[125] *See* Douglas R. Cole, *E-Proxies For Sale? Corporate Vote Buying in the Internet Age*, 76 Wash. L. Rev. 793, 808 (2001) (noting that proxy solicitation gives shareholders with superior information a method for distributing it to other shareholders).

[126] *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110, 114 (1965); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va. L. Rev. 675, 689 (2007). *See also* Bebchuk, *id*. at 697 (arguing for reimbursement of proxy challengers' expenses under certain conditions).

[127] *See generally* Bebchuk & Hart, *supra* note 17; Gilson & Schwarz, *supra* note 17; Bebchuk, *supra* note 126.

[128] Bebchuk, *supra* note 126 at 684. Other types of contests were also rare. *Id.* at 686.

C. Vote Buying

The third and final arbitrage strategy examined here is vote buying. The potential of vote buying as a strategy to leverage superior information was recognized early on. In his classic 1962 essay, Henry Manne observed that the market for votes serves the critical function of causing votes to move in the hands of those shareholders "who know how to use it most profitably."[129] In a similar vein, Robert Clark noted that vote buying "may be the cheapest or most feasible way for a person sincerely interested in shareholder welfare to achieve results that benefit the corporation as a whole."[130] What are the cost and legal constraints to this strategy?

The costs will largely depend on the consideration to be paid to the shareholder who agrees to vote as instructed. The consideration will be a function of the number of votes that need to be bought in order to become the pivotal voter or at least to significantly increase the probability that a majority of the shares is voted for the correct option. This, in turn, will depend on the number of shares initially held and other factors such as the likely turnout, the judgment of other shareholders on the question of which is the correct option, and the preference distribution. It appears that in absolute terms, the costs of buying votes, although not insignificant, need not be insurmountable either.[131] Whether it is worthwhile to incur the costs will depend on whether they are exceeded by the expected benefits, in the form of a capital gain on the shares

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[129] Henry Manne, *Some Theoretical Aspects of Share Voting*, 64 Col. L. Rev. 1427, 1444 (1962).

[130] Robert C. Clark, *Vote Buying and Corporate Law*, 29 Case W. Res. L. Rev. 776, 797 (1979). *See also* Thomas J. Andre, Jr., *A Preliminary Inquiry Into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. Cal. L. Rev. 533 (1990) (examining how a bidder might purchase votes as the first step toward acquiring the entire equity interest in its target and concluding that "assuming that [the bidder] increases share values, vote buying can lead to additional gains, the bulk of which are captured by the public shareholders"); Richard L. Hasen, *Vote Buying*, 88 Cal. L. Rev. 1323, 1349-1353 (2000) (acknowledging the potential of efficiency gains from facilitating corporate vote buying); Levmore, *supra* note 14 at 138 (noting that an ability to purchase voting rights "can provide a useful safety valve where defensive tactics go too far in blocking desirable takeovers"); Zvika Neeman & Gerhard O. Orosel, *On the Efficiency of Vote Buying When Voters Have Common Interests*, 26 Int'l Rev. L. & Econ. 536 (2006) (building a model to examine the conditions under which vote buying may promote efficiency in an environment where voters have identical preferences and producing results suggesting that vote buying may prove beneficial in the market for corporate control).

[131] Understandably, there is no empirical evidence on the cost of buying votes from other shareholders by instructing them how to vote, and much will depend on the specifics of the case. In addition to the consideration, the arbitrageur will have to incur the cost of finding one or more shareholders willing to sell their votes as well as transaction costs.

initially held, if the correct option is chosen (adjusted for the probability that the correct option will not be chosen). This suggests that vote buying will generally be worthwhile only for shareholders with a sizeable stake.

Turning to *legal* constraints, courts have long harbored suspicions toward vote buying because, as the Delaware Chancery Court put it in the landmark case of *Schreiber v. Carney*, "vote buying is so easily susceptible of abuse."[132] As in the debate on whether it is efficient that firms' capital structures reflect the principle of one share-one vote, the concern is that leveraged voting power enables shareholders to take self-serving actions to the detriment of other shareholders.[133] A shareholder may, for example, buy votes to secure shareholder approval of a transaction with a related party that has not been entered into at arm's length – an extension of the example of conflicted voting by a controlling shareholder offered in the previous section.

At the same time, courts have recognized that vote buying may be accomplished for laudable purposes, which is why vote buying is not always considered illegal per se.[134] Nevertheless, significant legal barriers remain. To begin, *Schreiber* implies that vote buying *will* be considered illegal per se if the vote buying agreement defrauds or disenfranchises the other shareholders.[135]

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[132] *Schreiber v. Carney,* 447 A.2d 17 (Del. Ch. 1982). In this section we focus on legal constraints imposed by case law, but the above legal constraints imposed by federal securities laws apply equally. *See supra* notes 123, 124 and accompanying text.

[133] *See* Mike Burkart & Samuel Lee, *One Share-One Vote: the Theory*, 12 Rev. Fin. 1, 3 (2008) (noting that "[l]everaging a blockholder's voting power … enables her to take self-serving actions, such as diverting corporate resources for less productive private purposes"); *In re IXC Commc's, Inc. S'holders Litig.*, 1999 WL 1009174, at 8 (Del. Ch. Oct. 27, 1999) (stating that "generally speaking, courts closely scrutinize vote-buying because a shareholder who divorces property interest from voting interest (…) fails to serve the 'community of interest' among all shareholders, since the 'bought' shareholder votes may not reflect rational, economic self-interest arguably common to all shareholders.")

In a recent decision, the District Court of the Southern District of New York has expressed the same concern in the context of bankruptcy, when shareholders are substituted for creditors when it comes to voting on key issues. The court found that DISH Network Corporation, a Chapter 11 debtor of communication company DBSD North America, "[d]id not purchase and vote its claim in order to gain financially by way of a distribution in this case. Rather … its purpose was as a strategic investor". Accordingly, the court concluded that DISH's votes, cast to reject the restructuring plan, should be disregarded per section 1126 (e) of the Bankruptcy Code. *In re DBSD North America, Inc.*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009). Aff'd, *In re DBSD North America, Inc.*, No. 09-CV-10156, Docket Item No. 55 (S.D.N.Y. Mar. 24, 2010).

[134] *Schreiber v. Carney*, *supra* note 132.

[135] *Id.* at 10. Notice that the court in Schreiber refers to voting agreements with "the object or purpose" to defraud or disenfranchise other shareholders. Later courts seem to have focused less on intent and more on actual result. *See e.g. Kurz v. Holbrook*, *supra* note 22 at 65 ("[v]ote buying is disenfranchising when it delivers the

Other shareholders will be considered disenfranchised when the bought votes deliver the swing votes.[136] This is problematic from an arbitrage perspective because the arbitrageur's very purpose will be to determine the outcome of the vote.

Even if the vote buying does not disenfranchise shareholders, *Schreiber* implies that the court will have to apply an intrinsic fairness test.[137] A recent decision of the Delaware Chancery Court suggests that the test boils down to the question whether the disproportionality between economic interest and voting interest resulting from the vote buying causes a misalignment between the vote buyer's interest and the general interest of the other shareholders, which is to maximize shareholder value.[138] This is encouraging from our perspective because the interest of the arbitrageur *will* be to maximize shareholder value.[139] Still, until courts have explicitly sanctioned vote buying with the purpose of increasing the probability that a majority of the shares is voted in favor of the correct option, the arbitrage strategy of vote buying entails significant litigation risk given the legal uncertainty and the interests at stake.[140]

Overall, the conclusion that emerges is that opportunities to leverage superior information through voting arbitrage are limited. This is problematic in a world where shareholders have limited information, bounded rationality and heterogeneous preferences.

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swing votes.")

[136] *Kurz v. Holbrook*, *supra* note 22 at 65.

[137] *But see* Kevin C. Cunningham, *Examination of Judicial Policy on Corporate Vote Buying in the Context of Modern Financial Instruments*, 64 N.Y.U. Ann. Surv. Am. L. 293, 315 (2008) (noting that "intrinsic fairness as an inquiry in many recent cases has faded to the point that it is not even mentioned.")

[138] *Kurz v. Holbrook*, *supra* note 22 at 72 (finding that Kurz had no reason to vote "other than in the manner he thinks would best maximize the value of EMAK as a corporation" and concluding that the voting of the relevant shares therefore is not a legal wrong).

[139] The Delaware Supreme Court approves of Vice-Chancellor Laster's general treatment of vote buying in *Kurz*, but seems to take a somewhat less nuanced approach in holding that in the case at hand there was no improper vote buying (merely) "because the economic interests and the voting interests of the shares remained aligned since both sets of interests were transferred" by the vote buying agreement. *Crown Emak Partners v. Kurz*, *supra* note 122 at 28.

[140] In the absence of legal barriers, a market for votes could emerge. The proposition that a market for corporate votes could yield significant benefits was made by Henry Manne in 1962. Manne, *supra* note 129. Today, the idea is still very much alive. *See* Levmore, *supra* note 14 at 137-139 and references *infra* note 146. A market for votes could be facilitated by new legal rules, for example rules ensuring that the vote seller's vote is cast in accordance with the vote buyer's preference, and, more generally, rules aimed at minimizing transaction costs.

IV. Policy Implications

This Part examines two phenomena that have recently captured the attention of the SEC and policymakers around the world: voting without a corresponding economic interest ('empty voting') and the major influence of proxy advisers such as ISS. By using the taxonomy of mechanisms of voting efficiency as a framework for analysis, we can get the costs and benefits of these phenomena into sharper focus. This, in turn, enables the formulation of various policy options aimed at mitigating the costs while fostering the benefits.

A. Empty Voting

In the previous section we assumed that votes are bought by agreeing with another shareholder that he or she will vote as instructed. But in modern financial markets, votes can effectively also be bought through a range of other techniques including borrowing shares (stock lending), reducing economic exposure through derivatives (hedging) and buying shares prior to the voting record date and selling them immediately afterwards (record date capture).[141] Vote buying has thus become relatively easy, and seems to be occurring more often.[142] To assess the impact of the new vote buying (or empty voting as it is referred to) on voting efficiency, it is again useful to look at the stock market. There, we find a cousin to empty voting: short selling. Both are strategies that can be used to leverage superior information. Both are facilitated by derivatives and securities lending. And both are commonly denounced by policymakers even if they carry the potential to enhance efficiency.

The potential of short selling to enhance efficiency lies in the fact that it can help to quickly incorporate new information into share prices. Empirical evidence suggests that short

[141] *See* Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. Ill. L. Rev. 775 (2005); Henry T. Hu & Bernard S. Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811 (2006).

[142] *Id.*

selling actually fulfills this role.[143] Policymakers have nevertheless long held a negative view of short selling.[144] Accordingly, they have responded to the recent financial crisis by imposing bans on short selling. The bans were largely driven by the concern that traders might seek to make a quick profit by selling short and driving the share price down either by increasing supply (and creating a negative feedback loop) or, less subtly, by spreading false stories. Theoretical as well as empirical studies of short-selling bans, however, suggest such bans slow down price discovery.[145] This suggests that we should be skeptical of limits on short selling.

By analogy, an analysis of empty voting should focus on its potential to enhance efficiency. Empty voting realizes this potential when it enables a shareholder with superior information to obtain greater voting power, thereby increasing the probability that a majority of the shares is voted in favor of the correct option. The new vote buying's potential to enhance efficiency is thus similar to that of conventional vote buying. This is recognized by scholars such as Susan Christoffersen et al., who examine stock lending activity and note that "since the dispersion of information can be a poor match to the dispersion of shareholdings, vote trading can improve the aggregation of this information."[146] Consistent with this hypothesis, they document increased lending activity around voting record dates, as illustrated in Figure 3.

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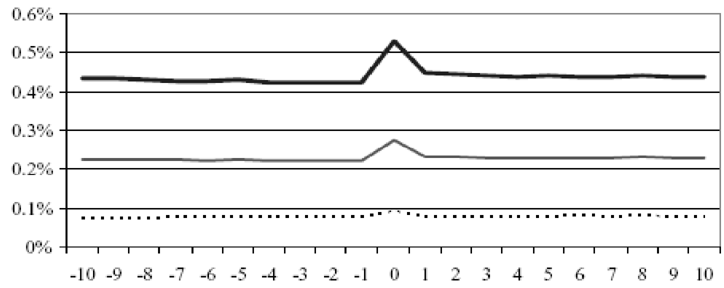
[143] *See e.g.* Ekkehart Boehmer, Charles M. Jones & Xiaoyan Zhang, *Which Shorts are Informed?*, 63 J. Fin. 491 (2008) (results are strongly consistent with the notion that short sellers possess important information and that their trades are important contributors to more efficient stock prices).

[144] *See* EDWARD CHANCELLOR, A SHORT HISTORY OF THE BEAR (London, David Tice & Co. 2001).

[145] *See* Douglas W. Diamond & Robert E. Verrecchia, *Constraints on Short-Selling and Asset Price Adjustment to Private Information*, 18 J. Fin. Econ. 227 (1987); Arturo Bris, William N. Goetzmann & Ning Zhu, *Efficiency and the Bear: Short Sales and Markets around the World*, J. Fin. (forthcoming); Allessandro Beber & Marco Pagano, *Short-Selling Bans around the World: Evidence from the 2007-09 Crisis* (2010). Available at http://ssrn.com/abstract=1502184.

[146] Susan E. K. Christoffersen, Christopher C. Geczy, David K. Musto & Adam V. Reed, *Vote Trading and Information Aggregation*, 62 J. Fin. 2897 (2007). *See also* Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. Davis L. Rev. 21, 44 (2006) (arguing that the new vote buying can be viewed as a way for the control rights associated with the votes to flow to the person with the most reliable information); Onnig H. Dombalagian, *Can Borrowing Shares Vindicate Shareholder Primacy?*, 42 U.C. Davis L. Rev. 1231, 1289 (2009) (arguing that facilitating empty voting by committed shareholders may alleviate collective shareholder action problems and that a market for borrowing public shares could improve shareholder decision-making).

FIGURE 3: LOAN MARKET VOLUME AROUND VOTING RECORD DATE



Source: Christoffersen et al. (2007)[147]

As with other arbitrage strategies, we can explore the limits of empty voting as an arbitrage strategy by identifying cost and legal constraints. The costs will largely depend on the consideration that needs to be paid to the lender of the shares (in the case of stock lending), the counterparty to the derivative transaction (in the case of hedging), and, in the case of record date capture, to purchase shares in the market. As a general matter, these costs do not seem prohibitive. Indeed, they may be lower than the cost of conventional vote buying.[148] Moreover, finding a counterparty who is willing to lend money or shares or to take the long side in a derivative transaction will probably be easier than finding a shareholder willing to accept voting instructions against a payment.

Moving to *legal* constraints, we have already seen that courts are suspicious of conventional vote buying because it is susceptible of abuse. This suspicion is also warranted with respect to the new vote buying. In the extreme case where a shareholder uses derivatives to build a net short position, his interests clearly conflict with those of other shareholders, as he will prefer an outcome (share price decrease) that is the opposite from that preferred by other

[147] *Id.* at 2910. The number of shares loaned by the author's data provider, as a percentage of shares outstanding, is on the vertical axis. The sample is 6,764 record dates of CSRP (Centre for Research in Equity Prices) stocks from 1998 to 1999 and broken into all shares in the CSRP (middle line), all shares in the Russel 3000 (top line) and those shares in the CSRP but not the Russel 3000 (bottom line). Consistent with the findings of the study by Bethel et al. discussed *supra* note 120 and accompanying text, Christoffersen et al. find that vote trading corresponds to opposition to management proposals. *Id.* at 2922. They find that vote trading grows as information asymmetry (as proxied by the bid-ask spread) increases, which is consistent with their hypothesis that the misdistribution of information across investors is an important incentive to rearrange votes across investors. *Id.* at 2915.

[148] *See supra* note 131 and accompanying text.

shareholders (share price increase).[149] The conflicted shareholder will, to use our terminology, vote *insincerely*.

Interestingly, the Delaware Chancery Court recently addressed the question of whether the concept of vote buying as developed by the courts is broad enough to encompass the new vote buying. The answer is yes. When these techniques prove deleterious to stockholder voting, the court "can and should provide a remedy."[150] In the case at hand, the court found that the voting buying was *not* a legal wrong, because the shareholder did not have any competing economic or personal interests that might have created an overall negative economic ownership.[151] So again, it appears that a shareholder with superior information who engages in vote buying – this time, the new vote buying – to ensure that the correct option is chosen might survive judicial scrutiny, but also faces a litigation risk.

Contrary to the courts, policymakers have been slow to recognize that empty voting need not be deleterious per se, resulting in additional legal constraints. While ownership disclosure rules have not yet been updated across the board, they have been in a number of jurisdictions and will soon be in others.[152] There are sound reasons to do so, both from a point of view of market efficiency and of corporate governance.[153] Indeed, the benefits of increased transparency

[149] *See* Martin & Partnoy, *supra* note 141 at 809 (noting that "[t]he assumption that arbitrageurs and other shareholders share the same incentives permits arbitrageurs to profit by encouraging or advancing suboptimal economic arrangements that destroy the value of shares.") *See also* Levmore, *supra* note 14 at 139 (pointing at the risk that shareholders sell their votes too cheaply in the absence of competing buyers).

[150] *Kurz v. Holbrook*, *supra* note 22 at 64. The same principle presumably applies in the context of bankruptcy, where the new vote buying enables empty creditor voting (*see* Henry Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Penn. L. Rev. 625, 728 (2008)). A creditor may, for example, hedge his financial exposure through credit default swaps. Using the same logic as the court uses in DBSD (*see supra* note 133), votes cast by empty creditors who vote insincerely risk being disregarded just like votes cast by empty voters who vote insincerely. *See* Patrick D. Fleming, *Credit Derivatives Can Create a Financial Incentive for Creditors to Destroy a Chapter 11 Debtor: Section 1126(e) and Section 105(a) Provide a Solution*, 17 Am. Bankr. Inst. L. Rev. 189 (2009).

[151] *Kurz v. Holbrook*, *supra* note 22 at 71. *See also id.* at 71, 72 (noting that "Kurz's only interest lies in how EMAK performs" and that "Kurz has no countervailing short interest; he is overwhelmingly long EMAK's stock.")

[152] *See* Michael C. Schouten & Mathias M. Siems, *The Evolution of Ownership Disclosure Rules Across Countries* (forthcoming, J. Corp. L. Stud. 2010). Centre for Business Research (CBR) of the University of Cambridge Working Paper 393. Available at http://ssrn.com/abstract=1434144.

[153] *See* Schouten, *supra* note 85.

may well outweigh the costs deriving from imposing legal constraints on empty voting as an arbitrage mechanism. In respect of further-reaching measures aimed at curbing abuse, however, the cost-benefit analysis is ambiguous.

Henry Hu and Bernard Black propose several measures that would have the effect of restricting not only the possibility to engage in vote buying for abusive purposes, but also the possibility to use vote buying as an arbitrage strategy.[154] This suggests that even though they acknowledge that the net efficiency of the new vote buying is uncertain, they tend to focus on the risk that votes are bought for abusive purposes.[155] It is far from clear though from Hu and Black's overview of real world examples that in those cases empty voting led to an inefficient outcome, and indeed they make no such claim. So until the contrary is proven, we must at least be open to the possibility that the new vote buying is used more often for benign purposes than for abusive purposes.

At this point, it is useful to revisit the analogy with short selling. The findings of a recent study on short selling and the news suggest that traders who sell short and then spread false news play a significant role.[156] Conceptually, this is equivalent to shareholders who engage in vote buying with the purpose of promoting a majority vote for the option that fails to maximize shareholder value. In both cases, the arbitrageur's behavior is not driven by the possession of superior information and consequently his acts will not reduce information asymmetry. But the findings of the study also suggest the importance of traders who, by collecting and analyzing publicly available data, detect that an issuer's share price exceeds its fundamental value, sell short and then truthfully spread their conclusions. This is the functional equivalent of sharehold-

[154] Hu & Black, *supra* note 150 at 697 (proposing, among others, to permit firms to modify their charters to limit voting rights based on a shareholder's economic ownership and that major shareholders be required to attest when voting that the voted shares do not exceed their economic ownership by a specified percentage).

[155] Henry T.C. Hu & Bernard Black, *Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 Eur. Fin. Manage. J. 663, 668 (2008) (noting that "[t]here are both pro- and anti-efficiency arguments specific to empty voting.")

[156] Merritt B. Fox, Lawrence R. Glosten & Paul Tetlock, *Short Selling and the News: A Preliminary Report on an Empirical Study* (2010). Columbia Law School Working Paper No. 364. Available at http://ssrn.com/abstract=1543855.

ers who engage in vote buying with the purpose of promoting a majority vote for the option that *does* maximize shareholder value. In both cases, the arbitrageur's behavior is driven by the possession of superior information, and his acts will reduce information asymmetry.

While research on short selling and the news is still in an early stage, the results so far offer no reason to assume that short sellers who spread false news are more prevalent than short sellers who spread true news.[157] If there is no reason to assume that there is more abusive short selling than beneficial short selling, why should we assume that there is more abusive vote buying than beneficial vote buying? It's not obvious why we should, especially since the usual suspects who engage in short selling, hedge funds, are one and the same as those who are usually suspected of engaging in the new vote buying.[158]

The S.E.C. has recently issued a draft release through which it seeks to obtain insight into how empty voting should be regulated.[159] The preceding analysis suggests that, because empty voting can be used for both beneficial and abusive purposes, it generally makes sense to battle abusive empty voting through narrow ex post rules rather than through broad ex ante prohibitions of empty voting. This observation completes the analogy with short selling. Finance scholars are near unanimous in their disapproval of short selling bans, citing the unintended consequence of disabling the salutary effect of short sales increasing information efficiency.[160] The new vote buying should also not be illegal per se. Rather, if it is established after the fact that a

[157] *Id.* at 57 (noting the current absence of evidence concerning the relative roles of false-news-spreading short selling versus true-news-spreading short selling).

[158] A recent theoretical study on empty voting by Alon Brav and Richmond Mathews also suggests that we should focus not only on abusive vote buying but also – and perhaps especially – on beneficial vote buying. Their model is heavily stylized, but the finding that trading between record and voting dates can improve efficiency despite the fact that traders sometimes end up selling short and then vote to decrease firm value is broadly consistent with the above evidence suggesting that short selling can improve efficiency despite the fact that apparently short sellers sometimes sell short and then spread false news to decrease firm value. Brav and Mathews correctly observe that there is "[a] trade off between increased information efficiency and the cost of possible manipulations via empty voting," and absent systematic evidence to the contrary there is no reason to believe that the costs of possible manipulations via empty voting exceed the benefits from increased information efficiency. Alon Brav & Richmond D. Mathews, *Empty Voting and the Efficiency of Corporate Governance*, 2 (2009). AFA 2009 San Francisco Meetings Paper. Available at http://ssrn.com/abstract=1108632.

[159] SECURITIES EXCHANGE COMMISSION, CONCEPT RELEASE ON THE U.S. PROXY SYSTEM 136, No. 2010-122 (July 14, 2010).

[160] *See* references *supra* note 145.

shareholder engaged in empty voting not to leverage superior information but to further his private interests by profiting from a majority decision that fails to maximize shareholder value, courts should intervene, just as regulators will intervene if it is established after the fact that a trader engaged in short selling not to leverage superior information but to further his private interests by profiting from the market's response to false news.[161]

To enable ex post scrutiny, transparency is key. To begin, a disclosure obligation discourages empty voting driven by insincere motives, by increasing the risk of detection. Moreover, disclosure enables the market and the firm to detect actual abuse and commence litigation if need be.[162] In securities markets, to enable detection of abusive short selling it suffices to require disclosure to the regulator only. This way, the profit potential from short selling is not unduly restricted and incentives to search for fundamental information are preserved. But notice that in principle a shareholder who engages in empty voting with sincere purposes needn't be reluctant to disclose his increased voting power to the market. On the contrary, if such shareholder holds a significant economic stake, public disclosure sends a credible signal to other shareholders that the shareholder has superior information and thus offers a means to further leverage that information. In this sense, disclosure of empty voting positions may increase voting efficiency in the same way as disclosure of short selling may increase market efficiency, even if it induces a risk of herding behavior.[163]

[161] *See also* Thompson & Edelman, *supra* note 14 at 166 (advocating judicial review of empty voting to safeguard the principle that voting requires a basic alignment with the collective interest); Kobayashi & Ribstein, *supra* note 147 at 45 (doubting the efficiency of broad substantive regulation of vote buying because vote buyers may have interests consistent with those of other shareholders).

[162] *See* Hu & Black, *supra* note 141 at 864; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1077 (2007); Thompson & Edelman, *supra* note 14 at 156; Schouten, *supra* note 85 at 175. *See also* EUROPEAN CORPORATE GOVERNANCE FORUM, STATEMENT ON EMPTY VOTING AND TRANSPARENCY OF SHAREHOLDER POSITIONS 2 (noting that transparency may spur appropriate behaviour).

[163] *See* Schouten, *supra* note 85 at 145; Emilios Avgouleas, *A New Framework for the Global Regulation of Short Sales*: *Why Prohibition is Inefficient and Disclosure Insufficient*, 16 Stan. J. L. Bus. & Fin. [58] (2010). Some regulators have explicitly cited this as a reason to require transparency of short sales. *See* FINANCIAL SERVICES AUTHORITY, EXTENSION OF THE SHORT SELLING DISCLOSURE OBLIGATION 9 (CP 09/15) (2009) (noting that "transparency of significant short positions and the identity of significant short sellers … provides insight into short sellers' price movement expectations and can improve pricing efficiency (if the information is correctly interpreted)"); COMMITTEE OF EUROPEAN SECURITIES REGULATORS, MODEL FOR A PAN-EUROPEAN SHORT

B. Proxy Advisers

Proxy advisers play an increasingly prominent role in corporate governance. Earlier in the paper, ISS's recommendation to vote in favor of the acquisition of ABN Amro by Fortis was mentioned as a possible explanation for why Fortis shareholders approved the deal. ISS's recommendation is also seen as the explanatory factor for why Hewlett-Packard shareholders approved the controversial acquisition of Compaq in 2002.[164] But instead of relying on anecdotal evidence, we can rely on a growing body of systematic evidence revealing ISS's influence on voting outcomes. A study using a sample of over 40,000 director elections, for example, finds that directors receiving a negative ISS recommendation received 19% fewer votes.[165] This suggests a significant influence.

How do proxy advisers affect voting efficiency? Or, more precisely, how do proxy advisers affect the operation of the various mechanisms of voting efficiency? To answer this question, we first need to take a closer look at the impact of proxy advisers on *individual* voting behavior.

While empirical evidence is scarce, one study has found that mutual funds have tended to vote in line with ISS recommendations across the board during the five recent proxy seasons.[166] Although this finding suggests that mutual funds follow ISS's recommendation instead of their independent judgment – which, as we have seen, could affect voting efficiency –, it does not provide conclusive evidence that they do. Because ISS typically consults with mutual funds

SELLING DISCLOSURE REGIME 12 (March 2010) (noting the same beneficial effect as well as the risk that disclosure leads to an increase of short selling due to herding).

[164] *BusinessWeek*, March 18, 2002 at 62.

[165] Jie Cai, Jacqueline L. Garner & Ralph A. Walkling, *Electing Directors*, 5 J. Fin. 2389, 2401 (2009). *See also* Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Influence of Proxy Advisors*, 49 (2008) (estimating the overall marginal (i.e., controlling for the underlying factors that investors would take into account anyway) impact of an ISS withhold recommendation at 14.37%). NYU Law and Economics Research Paper No. 08-22. Available at http://ssrn.com/abstract=1127282.

[166] James F. Cotter, Alan R. Palmiter & Randall S. Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 90 (2009). Vanderbilt Law and Economics Research Paper No. 09-20. Available at http://ssrn.com/abstract=1477564.

prior to issuing its recommendations, it cannot be excluded that it tailors its recommendations to track mutual funds' voting preferences.[167]

Even if ISS recommendations merely track mutual fund preferences, however, they may still compromise voter independence, for two reasons. First, mutual fund managers consulted by ISS are unlikely to be unanimous in their beliefs. ISS's recommendation would thus necessarily deviate from at least some fund managers' beliefs. Some of these managers may be inclined to change their beliefs once ISS has issued its recommendation, assuming the recommendation is based on superior information, or simply to avoid criticism.[168]

Second, shareholders who are not subscribed to ISS's advisory services may also learn of ISS's recommendation prior to deciding on how to vote. Especially when shareholders votes are contentious, such as in proxy contests or takeovers, ISS's recommendations typically receive much attention from the financial press. When shareholders learn of the recommendation, again, they may be inclined to base their voting decision on ISS's recommendation.[169] In each case, shareholders would ignore their own beliefs.

Notice that a trade off emerges between independent voting and informed voting, for while ISS's recommendations may reduce voter independence they may also raise average competence, just as recommendations of other types of opinion leaders may do. Some evidence suggesting that ISS recommendations raise average competence is provided by a recent study that documents significant abnormal returns around ISS recommendations in proxy contests.[170] To explain these returns, the authors test the hypothesis that ISS recommendations are informative about the value that a dissident team would bring to a firm if victorious, and find that they

[167] *Id.* at 3, 108.

[168] *See* Cotter et al. *supra* note 166 at T-6 (noting that mutual funds, "knowing they must disclose their actual votes may tend to herd, on the theory that only voting outliers can be subject to criticism.")

[169] In fact, they are very likely to do so given the incentives to engage in epistemic free-riding. *See supra* note 88 and accompanying text.

[170] Cindy R. Alexander, Mark A. Chen, Duane J. Seppi & Chester S. Spatt, *The Role of Advisory Services in Proxy Voting*, 18 (2009) (finding that recommendations for dissidents are associated with positive abnormal returns of 3.76%). NBER Working Paper No. w15143. Available at http://ssrn.com/abstract=1434658.

are.[171] Apparently, the market perceives ISS as being extraordinarily competent. If this is correct, ISS recommendations can promote informed voting.

Whether it can be inferred from the market's response that ISS is indeed extraordinarily competent is questionable, though. Investors may not accurately perceive the information content of a recommendation.[172] A somewhat similar problem exists with respect to the judgments of credit rating agencies. Investors' responses to downgrades can be quite dramatic, as evidenced by the sharp declines in share prices following the rating agencies' downgrades of debt issued by Southern European countries such as Greece this spring.[173] This raises concern as to whether the market's response is proportionate to the information content of such a downgrading. A concern that is fuelled by remarks of David Beers, head of sovereign ratings of Standard & Poor's, a major credit rating agency, who was recently quoted as saying that "people's perceptions are that a downgrade from AAA means that minutes later you default, but in fact it means only a slight increase in default risk."[174]

Skepticism is also warranted when we turn our attention from ISS's proxy advise to its corporate governance ratings, which may indirectly influence voting behavior on, for example, proposed by-law amendments. The main thrust of criticism is that ISS' rating methodology fails to account for firm specific characteristics, i.e. that one size does not fit all.[175] Indeed, empirical

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[171] *Id.* at 25-30. *See also* Alon Brav, Wei Jang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance and Firm Performance*, 4 J. Fin. 1729, 1744 (2008) (offering favorable ISS recommendations as a possible explanation for the high success rate of activist hedge funds).

[172] Choi et al., *supra* note 165 at 167 (finding that proxy advisers use different factors in making their recommendations and noting that to the extent investors are not aware of the factors, "investors may not accurately perceive the information content [of a recommendation].")

[173] *See* Jack Ewing & Jack Healy, Cuts to Debt Rating Stir Anxiety in Europe, New York Times, April 28, 2010.

[174] Judging the Judges, THE ECONOMIST, June 26, 2010, at 13. This goes back to the earlier observation that market prices may deviate from fundamental values; *see supra* notes 31-34 and accompanying text.

[175] *See* Paul Rose, *The Corporate Governance Industry*, 32 J. Corp. L. Vol. 887, 917 (2007) (noting that "the imposition of governance metrics … compels a rigid set of acceptable practices in a context where flexibility should be a goal"); Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. Penn. L. Rev. 1263 (2009) (arguing that the methodology fails to take into account the governance implications of differences in ownership structure). *See also* Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 Colum. L. Rev. 1803 (2008) (explaining

evidence suggests that governance ratings have failed to adequately predict risks associated with governance structures – just as credit rating agencies have failed to adequately predict risks associated with financial structures.[176]

The trade off between the various mechanisms of voting efficiency may also indirectly involve conflicted voting. There is concern that ISS's consulting services to issuers may compromise its objectivity in rating their governance structures or in issuing proxy advise with respect to these issuers.[177] As to the rating of governance structures, the concern is mitigated by the recent launch of ISS's "Governance Risk Indicators", which are both transparent and absolute.[178] But there remains widespread unease about potential agency problems.[179]

The preceding analysis has three implications for policymakers such as the S.E.C., which in its recent concept release also addresses the question of whether and how to regulate proxy advisors.[180] First, to promote informed voting, policymakers could require increased transparency of proxy advisers' methodologies, just as they are requiring increased transparency of credit rating agencies' methodologies.[181] Second, to promote independent voting, policymakers

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the differences between commercial- and academic corporate governance indices).

[176] Robert Daines, Ian D. Gow & David F. Larcker, *Rating the Ratings: How Good are Commercial Governance Ratings?* (2009). Stanford Law and Economics Olin Working Paper No. 360. Available at http://ssrn.com/abstract=1152093.

[177] *See* Rose, *supra* note 175 at 906.

[178] The indicators are used to measure "the degree to which a company's governance structures may meet, or fall short of, best practices in a particular market." RiskMetrics, RiskMetrics Group to Launch Governance Risk Indicators on March 17, Press release dated March 10, 2010.

[179] *See* Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 Stan. J. Law, Bus. & Fin. 384 (2009).

[180] SECURITIES EXCHANGE COMMISSION, *supra* note 159 at 103. *See also* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS 30, February 24, 2010 (calling upon authorities to ensure a competitive market for proxy advisory services and monitor the management of conflicts of interest by advisors); COMMITTEE OF EUROPEAN SECURITIES REGULATORS (CESR), PUBLIC STATEMENT OF THE MARKETS PARTICIPANTS CONSULTATIVE PANEL 2, July 10, 2010 (announcing that proxy advisors will be the subject of a work stream on corporate governance); FINANCIAL REPORTING COUNCIL, THE UK STEWARDSHIP CODE (2010) (requiring institutional investors to disclose how they make use of proxy advisory services).

[181] *See* Belinfanti, *supra* note 179 at 434. For the regulation of credit rating agencies, *see* §932 of the Dodd-Frank Act, *supra* note 6 (requiring credit rating agencies to disclose information that can be used by investors and other users of credit ratings to better understand credit ratings); EC REGULATION ON CREDIT RATING AGENCIES, ¶ 25 and art. 6 (No 1060/2009) (requiring credit rating agencies to disclose information to the public on the methodologies, models and key rating assumptions to enable users to perform their own due diligence).

may wish to encourage institutional investors to make an independent judgment rather than exercising their voting rights solely on the basis of proxy advise, just as they have cautioned investors against overly relying on credit rating agencies.[182] Third and finally, to prevent conflicted voting, policymakers could consider to restrict the ability of proxy advisers to provide consulting services to issuers, just as they have restricted the ability of auditors to provide consulting services to issuers.[183] A less far-reaching option would be to require proxy advisers to take strict measures to avoid conflicts of interest, which measures could be similar to the ones credit rating agencies are required to take pursuant to the recent Dodd-Frank Act.[184]

Taking these measures is critical in light of pending reforms. Consider the reform in the area of executive compensation, on which proxy advisers have strict policies. Not only do shareholders in US firms now have broader powers with respect to executive compensation, the issue will also be qualified as a non-routine matter meaning brokers may vote only when instructed.[185] Since retail investors are least likely to instruct their brokers, the vote of institutional investors is likely to increase in relative weight. And given that institutional investors are the ones retaining proxy advise, it is ever more important that they vote on an informed and independent basis.[186] Lest some portfolio firms lose talent to rival firms because they are unable to offer competitive pay, the fear expressed by Countrywide's former CEO at the beginning of this paper.

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[182] The SEC has made a cautious move in this direction. S*ee* Belinfanti, *supra* note 179 at 437, n237. *See also* Principle 1 of the UK's Code on the Responsibilities of Institutional Investors (2009) (requiring institutional investors to disclose how they make use of proxy advise); EC REGULATION ON CREDIT RATING AGENCIES, ¶ 10 (stating that "[t]he users of credit ratings should not rely blindly on credit ratings but should take utmost care to perform own analysis.")

[183] *See* Millstein Center for Corporate Governance and Performance, Voting Integrity: Practices for Investors and the Global Proxy Advisory Industry, 18 (2009) (proposing a ban on a vote advisor performing consulting work for any company on which it provides voting recommendations or ratings). *See also* Financial Reporting Council, Consultation on A Stewardship Code For Institutional Investors (2010) (asking whether voting services agencies should be encouraged to commit to the spirit of the UK's Code on the Responsibilities of Institutional Investors). For the regulation of auditors, *see* §201 of the Sarbanes-Oxley-Act (amending section 10-A of the Securities Exchange Act of 1934 (U.S.C. 78j-1)).

[184] Dodd-Frank Act, *supra* note 6, §932.

[185] *Id.*, §957.

[186] *See also* Eric Hilfers, Say on Pay with Teeth: Important New Provision in Senate Finance Reform Bill (April 8, 2010) (warning that the proposed reforms will increase the influence of ISS). Available at http://www.boardmember.com.

Conclusion

This paper has drawn an analogy between stock trading and corporate voting and used insights on market efficiency to study voting efficiency. The result is a taxonomy of mechanisms of voting efficiency, including informed voting, rational voting, independent voting and sincere voting. The paper has also explored the limits of voting arbitrage through share trading, proxy solicitation and vote buying. This has provided a framework for analysis of two issues that are currently being studied by the SEC and policymakers around the world: empty voting and the major influence of proxy advisers. The analysis has shown why policymakers should refrain from addressing empty voting through further reaching measures than disclosure, except on an ex post basis in individual cases of abuse. In addition, the analysis has shown that policymakers should consider specific measures relating to proxy advisers in order to enhance voting efficiency. These measures should be aimed at promoting informed voting and independent voting, and at preventing conflicted voting.

The framework also provides a roadmap for future empirical research by generating a number of testable hypotheses. Among these are: (1) sample size neglect causes shareholders of firms with strong track records of prior acquisitions to approve proposed acquisitions even if the prior acquisitions are not fully representative of management's ability to make the proposed acquisition a success; (2) optimism causes shareholders of firms to approve proposed acquisitions that purport to exploit opportunities arising in a new era, and to appoint directors who claim they will exploit such opportunities; (3) shareholders make attribution errors in director elections; (4) the presence of an opinion leader results in convergence of shareholder votes around the explicit or implicit recommendation of the opinion leader; (5) the greater the dispersion of share ownership, the greater the incentive to engage in epistemic free-riding and thus the greater the relative impact of an opinion leader; and (6) absent conflicted voting, the more significant the cost and legal constraints to voting arbitrage, the greater the risk that a majority of the shares in a firm with dispersed ownership will be voted for the incorrect, i.e. value decreasing, option.

To conclude, our understanding of voting efficiency may perhaps never equal our understanding of market efficiency given the unmatched wealth of data that the stock market churns out every minute. But the importance of voting efficiency for the efficient allocation of resources in the economy compels us to try to improve our current limited understanding. Here, the taxonomy of mechanisms of voting efficiency should prove a useful analytical tool.

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