Empty Voting Position Statement

Introduction

Empty voting refers to the separation or decoupling of the economic interest in shares from the right to vote those shares[1]; in other words, "votes have been emptied of a corresponding economic interest"[2]. Empty voting is a phenomenon CCGG strongly opposes on principle. While there is little empirical data on the extent of empty voting in Canada[3], in recent years after the prominent Telus/Mason Capital proxy contest that ended in 2012, the issue has received increasing attention in Canada and for good reason. Empty voting challenges a fundamental assumption underlying much of corporate law and theories of corporate governance, namely, that the right to vote stems from the unique economic relationship shareholders have with the corporation (i.e., the economic interests of the corporation as reflected in its share price are the same as the economic interests of shareholders). To put it colloquially, "As the fortunes of the corporation go, so go the fortunes of the shareholders". For this reason, one assumes that shareholders will always vote in what they perceive to be the best interests of the corporation.[4]

Because of the development of practices such as securities lending and the use of derivatives and other financial innovations, however, these traditional assumptions may be under threat. Empty voters may have no economic interest in the voted shares and in extreme versions may even have a negative interest in that they will benefit if the share price falls, putting them in direct conflict with the interests of the corporation and most other shareholders.

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[1] It is important to note that this discussion does not apply to dual class share structures where different voting rights are created in a corporation's articles and publicly disclosed. In dual class share structures voting rights are decoupled from a corresponding economic interest, but CCGG's views on dual class share structures and the principles that should apply to them are set out already in our *Dual Class Share Policy*, published in September 2013.
[2] Henry T.C. Hu, *Financial Innovations and Governance Mechanisms: The Evolution of Decoupling and Transparency*, The Business Lawyer; Vol. 70 (Spring 2015), p 356. The term "empty voting" is also used to describe situations where votes substantially exceed economic ownership.
[3] The prevalence of empty voting is harder to discern in part because of weaknesses of our current proxy voting infrastructure which make it difficult to know whether votes have been accurately transmitted and calculated, which in turn makes it more challenging to assess the extent of empty voting. The increased transparency that would result if the CSA's proposed Proxy Meeting Vote Reconciliation Protocols, released in March 2016, are adopted, may provide more information that could help to track cases of empty voting.
[4] Under Canadian corporate law, shareholders are under no fiduciary obligation to act in the best interests of the corporation or other shareholders. It is assumed, however, that because of their economic interest or 'skin in the game', shareholders will vote in the best interests of the corporation and hence other shareholders (provided that there are no conflicts of interest with other shareholders).

Under corporate law and corporate governance theory, shareholders have various rights and obligations that stem from the special economic relationship with the corporations to which they provide capital, including the right to elect directors and thereby hold directors (and through them management) to account, the right to receive dividends and the right to approve fundamental corporate transactions. Shareholders also have certain obligations, such as insider reporting and early warning reporting disclosure obligations, that follow from this economic relationship.

Empty voting, whether by outside investors such as hedge funds or by insider shareholders as a result of equity monetization, presents shareholders with serious issues that go to the heart of shareholder democracy[5] and CCGG rejects the practice categorically. Several tenets of the Canadian Coalition for Good Governance (CCGG), such as our commitment to majority voting[6], are undermined by empty voting. However, with the exception of a provision under the Canadian Securities Administrators' insider reporting regime[7] and new rules under the early warning regime[8] that touch on empty voting, there have been no Canadian regulatory or legislative responses to the issues presented by empty voting.

In this publication, we set out CCGG's current thinking on empty voting and its implications for institutional shareholders and suggest an approach for securities regulators to take, at a minimum, with respect to an area that CCGG believes requires a prompt and considered response.

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[5] Some argue that empty voting is not necessarily harmful to the interests of shareholders. For example, if more voting power is concentrated in the hands of informed and concerned shareholders then their votes are more likely to be beneficial to shareholder value than disinterested shareholders. See Susan E.K. Christoffersen, Christopher C. Geczy, David K. Musto, and Adam V. Reed, *Vote Trading and Information Aggregation*, Journal of Finance, Vol.62, 2007, pp 2897-2929. However, this assumes that the empty voter has a positive economic interest in the shares rather than no interest or a negative economic interest.

[6] The right to elect directors who in the shareholders' opinion will serve in the best interests of the corporation is weakened by the ability of shareholders with no interest in the economic state of the corporation to have a say in board composition: "The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock…or they may vote to replace incumbent board members." Blasius Industries, Inc. v. Atlas Corp, 564 A.2d 651 (De. Ch. 1988) at 659. Empty voting also raises particular concerns in the context of the director nomination process where, in CCGG's view, shareholders should have a right to influence the director nomination process provided certain conditions are met (see Shareholder Involvement in the Director Nomination Process: Enhanced Engagement and Proxy Access (2015)). CCGG believes that empty voters should not be eligible to nominate directors.

[7] *Insider Reporting Requirements and Exemptions* NI 55-104 and Companion Policy 55-104CP – insiders must disclose if they have hedged their interests in the corporation or entered into a derivative agreement or any other agreement, arrangement, or understanding that "has the effect of altering, directly or indirectly, the reporting insider's economic exposure to the reporting issuer". Note that under CCGG's Executive Compensation Principles *(2013*) directors and officers should not hedge or monetize the securities of the corporation of which they are insiders.

[8] CSA Notice of Amendment to Early Warning System

Recommendation

In CCGG's view, the law should be changed to make empty voting illegal. Recognizing that this goal is far from being a practical reality, CCGG believes that the most appropriate action for securities regulators to take in the interim at this time would be to publicly state that they will use their discretion to act in the 'public interest' to restrict empty voting or empty voters where it is warranted in the particular circumstances and also to provide guidance as to the sorts of situations that will prompt the exercise of their discretion. Regulators also should indicate that they will intervene as amicus curiae in appropriate court cases to express their views. Together with existing and proposed disclosure rules, these actions would constitute progress towards the mandate of securities regulators which, under Ontario's Securities Act for example, requires the Ontario Securities Commission to provide protection to market participants from "unfair, improper or fraudulent practices" (which, in CCGG's view, includes empty voting) and "to foster fair and efficient capital markets". With respect to securities lending, securities regulators should provide explicit guidance that borrowing securities for the purpose of voting is unacceptable. The results of this approach should be monitored and revisited by securities regulators at a later date.

Background and the Need for Regulatory Reform

There are generally three types of situations that can result in empty voting:

- Share lending, where the borrower typically is entitled to vote the shares, along with the right to receive dividends, but the lender retains the underlying economic interest
- Hedging or the use of certain derivative transactions that leave the person holding the votes neutral as to the effect of the vote on the share price or even benefiting from a decline in share price
- Record date capture, whereby a person purchases shares before the record date in order to be able to vote the shares but sells them before the date of the meeting to which the vote pertains and hence is not subject to the consequences of the vote outcome.[9]The first two types of transactions have become fixtures of modern capital markets, can be

[9] In July 2017, such a potential "empty voting" situation arose when Fairfax Financial Holdings Ltd. sold its significant holding in Tembec Inc. on the record date set by Tembec for voting on a proposed offer by Rayonier Advanced Materials to purchase Tembec's shares. Prior to the announcement of the Transaction, Fairfax indicated to Tembec that Fairfax was supportive of Tembec proceeding but Fairfax did not agree to hold or vote the shares in any manner. Other significant shareholders opposed to the Rayonier offer complained that Fairfax should not be allowed to cast "empty votes' on the offer, as Fairfax was technically permitted to do since it held the Tembec shares on the record date, and filed complaints on that basis with both the Ontario Securities Commission and Quebec's Autorité des marches financiers. In the end, no empty voting took place because Fairfax announced that it had no intention of voting on the offer once it had sold the Tembec shares. Fairfax advised CCGG that "Fairfax was never approached by the OSC and never has considered voting any share it has sold, including the Tembec shares. Fairfax firmly believes that only shares that are owned should be voted."

> beneficial to the functioning of those markets or even integral, for example for purposes of liquidity, and thus should not be prohibited. Such strategies, however, can potentially undermine corporate and securities laws which are based on an understanding that voting and economic interests coincide. In CCGG's view it is incumbent upon regulators to be able to address the negative effects of financial innovation that do threaten fundamental notions of fairness underlying the functioning of our capital markets.[10] Although such situations may be rare, regulators should be prepared to act when they do occur.

Regulators have been charged with this task in Canada. In its 2012 decision relating to Mason Capital's challenge to Telus' proposed plan of arrangement, the British Columbia Court of Appeal made the following statement: "To the extent that cases of "empty voting" are subverting the goals of shareholder democracy, the remedy must lie in legislative and regulatory change"[11].

The Telus case was unusual in that Mason Capital's economic interests did not vary depending on whether Telus' share price went up or down, but rather its economic interest was based on the arbitrage opportunity presented by there continuing to be a spread between the voting and non-voting classes of shares. If the arrangement proposed by Telus was approved, then it was anticipated that the share price of both voting and non-voting shares would go up, benefiting both classes of shareholders but a neutral event for Mason Capital, which had hedged its ownership of both voting and non-voting shares so that its economic interest in both classes of shares was negligible. If the arrangement was not approved, however, then both classes of shareholders would lose the benefit of the expected share price appreciation, but the historical spread between the price of the voting and non-voting shares would be restored and that result would be positive for Mason Capital. While the circumstances in the Telus case were highly unusual, [12] this case provides an example of a shareholder of record with a 19% voting interest that was financially motivated to vote against the interests of the rest of the shareholders and thus raises a cause for concern which, as indicated by the British Columbia Court of Appeal, points to the need for a regulatory response.

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[10]As stated by then SEC Chair Mary Schapiro in 2011 when the SEC was "considering whether [SEC rules] should be changed in light of modern investment strategies and innovative financial products": it is "important to modernize [securities] rules"[10] Mary L. Schapiro., *Remarks at the Transatlantic Corporate Governance Dialogue* (Dec. 15, 2011), available at http:..www.sec.gov/news/speech/2011/spch121511mls.htm

[11] Telus Corporation vs. Mason Capital Management LLC, 2012 BCCA 403 at 81.

[12] Interestingly, expert opinion was divided on whether Telus constituted a case of true empty voting, with Henry Hu acting as expert witness for Telus to argue that it was a case of empty voting and Bernard Black, with whom Hu has co-written several articles on empty voting, acting for Mason and saying the opposite.

Another publicly reported case of empty voting in Canada, *In the Matter of Sears Canada Inc.*[13] involved the use of derivatives that enabled Scotiabank to engage in empty voting in its support of Sears Holdings' offer to buy out the minority shares in its subsidiary, Sears Canada. The Sears Canada independent directors and some shareholders opposed the deal. Pershing Square Capital, one of the hedge funds opposed to the buyout, had entered into equity swaps in Sears Canada shares with Scotiabank and wanted Scotiabank to unwind the swaps so that Pershing could vote against the transaction, which required majority of the minority approval by Sears Canada's shareholders. Scotiabank refused to unwind the swaps (even though Pershing argued that refusal to unwind did not comply with swap market conventions) and voted in favour of the buyout in accordance with a support agreement it had entered into with Sears Holdings. The buyout was ultimately successful but securities regulators denied Scotiabank the right to vote its shares on public interest grounds because the support agreement constituted a collateral benefit.

The situation at CGI Group Inc. is also noteworthy. In 2008, the co-founders and co-chairs of CGI Group Inc. reportedly sold approximately $130 million of CGI shares but retained all of their voting rights associated with the sold shares[14], as part of a transaction which they said was entered into for estate planning purposes. The executives reportedly entered into a 25-year agreement with National Bank of Canada to monetize approximately 11 million CGI shares, but the voting rights associated with the stock remained with them during the 25-year term of the agreement. Thus, CGI was an example of empty voting by insiders rather than on the part of outside shareholders such as a hedge fund.[15]

[13] In the Matter of Sears Canada Inc., July 2006

[14] CGI co-founders cash in, but keep control, Globe and Mail, May 8, 2008

[15] In what appears to be another case of empty voting, in 2015 press releases Minera IRL Limited indicated that its board had commenced an investigation into voting irregularities at the Extraordinary General Meeting (EGM), with the chair stating that "I have received evidence of a potential violation of Ontario securities laws as a result of which a substantial portion of the votes cast by proxy, significant enough in number to alter the outcome of the matters to be decided at the EGM, were cast on behalf of persons who do not have a corresponding economic interest in the future of the Company". The situation was resolved when the proxy in question was revoked. *Minera IRL Limited reports on Extraordinary General Meeting of Shareholders* (November 27, 2015)and *MInera IRL Board Concludes Investigation in Anticipation of EGM Resumption* (December 12, 2015).

Prominent cases in other countries illustrate the myriad ways empty voting can occur, which would seem to be limited only by a failure of creativity on the part of market participants. One of the better-known U.S. cases, Perry-Mylan[16], took place in 2004 and involved empty voting implemented by hedging a share ownership position with over-the-counter equity derivatives in the form of short equity swaps. Hedge fund Perry Corporation owned seven million shares of King Pharmaceuticals when Mylan Labs agreed to buy King in a stock-for-stock merger at a significant premium over King's trading price, which would have resulted in a large profit for Perry. However, Mylan's shares dropped on the announcement of the merger, which required the approval of Mylan's shareholders. Perry then bought 9.9% of the shares of Mylan so that Perry could vote in favour of the merger, while at the same time fully hedging its economic exposure to Mylan by means of the equity swaps. When Perry's position in King was included, its overall economic interest in Mylan was negative given that the more Mylan overpaid for King, the better the result for Perry. Carl Icahn, Mylan's second largest shareholder, tried to prevent the merger by suing Mylan and Perry. The lawsuit was not resolved because Mylan ultimately withdrew from the merger for reasons unrelated to voting.

In another prominent U.S. case, empty voting was rumoured to have occurred in connection with Hewlett Packard's 2002 acquisition of Compaq. The merger announcement led to a sharp drop in HP's price and to a proxy contest by Walter Hewlett opposing the merger. It was believed that some holders of Compaq shares had engaged in empty voting of HP shares to support the merger and that the empty voting might have affected the outcome of what was a very close vote.[17]In the U.K., the merger between British P&O Princess Cruises plc and American Carnival Corporation raised significant concerns about the consequences of borrowers exercising the votes attached to their borrowed shares. P&O Princess shareholders had to decide whether to accept the restructuring and it emerged that many shares were borrowed by activist shareholders and that the borrowers might have voted against the wishes of the majority of investors.[18]

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[16] Discussed in Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 Bus. Law, 1011, 1024 (2006)
[17] Andrew Ross Sorkin, *Nothing Ventured, Everything Gained*, N.Y. Times, Dec 2, 2004
[18] Hedge Funds and Risk Decoupling: The Empty Voting Problem in the European Union, Wolf-Georg Ringe, 2012, Seattle University Law Review, at 1042

Possible Regulatory Initiatives

Cases such as those described above have prompted numerous regulatory reviews[19] and academic articles[20] globally but to date concrete responses[21] seem to be limited to statements such as that found in the voluntary Stock Borrowing and Lending Code of Guidance, a best practice code for securities lending, which now states: "There is a consensus...in the market that securities should not be borrowed solely for the purpose of exercising the voting rights at, for example, an AGM."[22] As stated by the SEC, "significant decoupling of voting rights from economic interests could potentially undermine investor confidence in the public capital markets"[23] and, as stated by the British Columbia Court of Appeal, "To the extent that cases of "empty voting" are subverting the goals of shareholder democracy, the remedy must lie in legislative and regulatory change", and accordingly CCGG believes that an appropriate Canadian regulatory response is needed. One of the challenges for regulators in attempting to craft rules for financially innovative products and transactions is that their level of sophistication and complexity can make them more difficult to regulate than more traditional financial products and transactions.[24] Better disclosure, however, would be a good place to start. As stated by the SEC in its 2010 Concept Release on the proxy system where it considered the issue of empty voting:

> "regardless of whether empty voting is deemed to be "good" or "bad," there is a strong argument for ensuring that there is transparency about the use of empty voting. If a voter acquires shares with a view to influencing or controlling the outcome of a vote but takes steps to reduce the risk of economic loss or even achieve a negative economic interest, disclosure of the empty voter's status and intentions could be important information to other shareholders."[25]

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[19] In the U.K., Lord Paul Myners considered the problem in his 2004-2007 reports on share voting, see e.g. Review of the Impediments to Voting U.K. Shares: An Update on Progress Three Years On (2007) at 9

[20] See, for example, Securities Lending, Empty Voting and Corporate Governance, Paul Ali, Ian Ramsay and Benjamin B. Saunders, Research Working Paper Series No. 023/2014, supported by the Australian Centre for International Finance and Regulation.

[21] There have been many proposals suggested by bodies appointed by various regulators or by academics but we are not aware of any of these proposals being put into practice anywhere in the world to date. See, for example, Mazard & Marccus Partners, Transparency Directive Assessment Report – Prepared for the European Commission Internal Market and Services DG, Final Report 124 (2009) at p 132 which advocates the adoption of a ban on empty voting altogether, given the principles at stake.

[22] Published by the Securities Lending and Repo Committee of the Bank of England, 2009

[23] SEC Concept Release on the U.S. Proxy System, 2010 p 139

[24] It is fair to assume that empty voting will only increase as the derivatives market (currently estimated at over U.S. $700 trillion last year – or about ten times the GDP of the world) continues to grow and new products are created. See Financial Derivatives Time Bomb

[25] SEC Concept Release on U.S. Proxy System , "Empty Voting" and Related "Decoupling" Issues, pp 137-150

Under the current Canadian securities disclosure regime, the only requirements to disclose situations of empty voting or that may lead to empty voting are under the existing insider reporting regime and new rules under the early warning system which recently came into effect. The insider reporting provisions require that an insider entering into hedging or derivative transactions which reduce the exposure of the insider to changes in the issuer's share price or performance must file an insider report on the basis that the insider is changing the insider's economic exposure to the reporting issuer.[26]

The new rules under the early warning regime will clarify reporting obligations with respect to borrowed securities to provide greater transparency about the potential use of borrowed securities to engage in empty voting. Borrowed securities do not have to be included for purposes of determining the early warning threshold trigger for certain securities lending arrangements, provided that the borrowed securities are disposed of within three business days and that the borrower does not thereafter vote or intend to vote the borrowed securities. Thus, the new rules provide an exemption for borrowers in the context of short selling, which would not normally give rise to empty voting concerns, but should trigger disclosure requirements in cases where borrowing securities may give rise to empty voting. In addition, the new rules provide that any alteration in the economic interest related to a financial instrument involving a security where disclosure is required must also be disclosed, so that the same kind of disclosure as is required for insiders under insider reporting requirements now is required for those reporting under the early warning regime. This new disclosure that arises when the requirements are triggered should go some distance to providing information that will reveal and hence neutralize the opportunities for empty voting.[27]

With respect to the treatment of derivatives, shares underlying cash-settled derivatives such as total return swaps will not be included in determining whether a shareholder has crossed the 10% threshold. However, the new rules contain guidance informing investors that they will have to include within the early warning threshold calculation securities held by an equity swap or similar derivative counterparty if the investors are able, formally or informally, to obtain those securities from the counterparty or to direct the counterparty with respect to the voting of those securities. Such arrangements present another example of the challenges of potential hidden ownership related to financial innovation with which regulators are confronted. Again, the new disclosure should help to decrease opportunities for empty voting to remain beneath the radar screen.

The benefits to the capital markets of this type of disclosure would seem to be uncontroversial.

[26] See *Insider Reporting Requirements and Exemptions* NI 55-104 and Companion Policy 55-104CP

[27] See Form 62-103FI Required Disclosure under the Early Warning Requirements: acquirors must describe the material terms of any agreement, arrangement or understanding they are party to that (i) has the effect of altering the acquiror's economic exposure to the relevant securities or (ii) is related to voting, loans or the giving or withholding of proxies with respect to the relevant securities .

Whether regulators should go beyond disclosure requirements is more contentious. In those extreme situations of empty voting where the shareholder has a negative economic exposure and where it can be shown that a shareholder's interests are negatively correlated to the share price and to other shareholders' interests, however, there is an argument that regulators should consider limiting the voting rights of that shareholder.[28] It is one thing to vote where the outcome is neutral for an investor but another thing altogether if the investor's interests directly conflict with other shareholders so that the investor's gain is the other shareholders' loss. Negative economic exposure provides an incentive to destroy shareholder value for other shareholders. However, the practical challenges of limiting voting rights even in the most egregious circumstances are not easily overcome.

Similarly, there are practical considerations which suggest that proposals to require borrowed shares to be recalled by the lender prior to a shareholder meeting would be unworkable, because the sheer volume of meetings and the extent of proxy voting make it impractical to recall shares for every meeting (including those where only ordinary business is carried out). There also are theoretical challenges, given that there is no regulatory requirement in Canada that shareholders must vote their shares and therefore on a policy basis it is difficult to defend a requirement to recall shares in order to vote them.

Some observers have proposed that securities regulators and legislators could deal with record date capture by permitting the record date for determining when shareholders are entitled to vote to be different from the record date for the notice of meeting. By moving the former closer to the meeting date, itself, they argue there would be less opportunity to buy shares for the vote and then dispose of them before the consequences of the vote are felt.[29] However, practical considerations suggest that to shorten the time frame would be unworkable, given the current challenges in properly transmitting and calculating proxy votes under existing time frames.

[28] This position is shared by Hu who doesn't "contemplate blanket substantive limitations on the voting rights of all empty voters and focuses on limiting the voting rights in the extreme case of empty voters with negative economic exposure." Ibid, Footnote 2, page 364
[29] Ibid, *Hedge Funds and Risk Decoupling: The Empty Voting Problem in the European Union*, at 1053

Summary

In conclusion, CCGG is fundamentally opposed to empty voting on principle. While the prevalence of empty voting in Canada may not be known, and may in fact be rare, the fact that it has occurred and can occur in the future threatens some of the fundamental premises on which the capital markets run and on which corporate and securities laws are founded. Certain corporate governance principles which CCGG advocates, such as majority voting, can be rendered meaningless in the face of empty voting. Thus, the occurrence of even a small number of situations such as those described in this paper means that it is time for regulators to act now to direct further attention to this issue until such time as the law is changed to make empty voting illegal across the board. Until the law is changed, regulators should attempt to address specific empty voting issues, for example, such as endeavouring to ensure that the votes typically attaching to borrowed shares are in fact exercised by the person with the economic interest in those shares.

CCGG believes that empty voting is an appropriate matter for securities regulatory intervention now because the phenomenon raises public policy issues with respect to public companies. We encourage securities regulators, at a minimum, to issue a notice or policy expressly articulating their intention and willingness to intervene in empty voting situations in appropriate circumstances by exercising their existing discretion to act in the public interest under section 127 of Ontario's Securities Act and under similar provisions in other securities legislation across Canada. To this end, we encourage legislators to expand securities regulators' authority under securities legislation to include the power to make orders to take away voting rights in connection with a specific shareholder meeting or transaction where the circumstances warrant. CCGG believes that these regulatory tools would be a first step towards addressing the issue of empty voting with the ultimate goal on the part of regulators being to make the practice illegal.

Public interest would be further served by securities regulators providing guidance to the market, to the extent possible, as to the sorts of circumstances that would lead them to act to exercise that discretion, recognizing that, as with most discretion, the guidance will not be prescriptive but rely on a case by case analysis. CCGG would welcome, for example, an explicit statement to the effect that 'borrowing shares for the purpose of voting those shares is not in the public interest". Regulators also should indicate that they will intervene as amicus curiae in appropriate court cases to express their views.