A Call to Arms on Empty Voting!

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The proxy battle over the TELUS proposal to eliminate its dual class share structure earlier this year underlines the need for regulatory action on empty voting.

What is Empty Voting?

Empty voting occurs when a holder of the voting right attached to a share has reduced or eliminated its economic interest in that share.

Why is it Wrong?

Shareholders are accorded a special role in corporate governance because they are the source of risk capital for companies. Through their voting rights, shareholders elect directors, appoint the external auditors and approve certain matters of fundamental importance.

Our system of governance generally accepts as valid a decision made by a majority of shareholders acting in their own self-interest. That is not to say that shareholders will not disagree regarding the relative merits of voting one way or another. And shareholders are not homogenous – they have differing tax positions and may have other interests which the outcome of the vote may affect, leading them to vote differently. But it is a fundamental assumption underlying our system of corporate governance that shareholders are entitled to make certain decisions because they have a real economic interest in the outcome.

While a divergence between voting rights and economic interest occurs in companies which use multiple voting share or restricted voting share structures, at least when investors buy shares of such companies they do so knowing what they are getting into.

But where empty voting really becomes a concern is where the arrangement results in or reflects a negative economic incentive. That is, where the holder of the voting right would realize economic consequences from the decision that are the reverse of those that would be realized by other shareholders.

When does it arise?

There are a variety of ways in which decoupling of voting rights and economic interest in a share may occur, but the principal circumstances are:
1. Selling Shares after the Record Date for Voting – It takes time to determine who is entitled to vote at the meeting. As a result, the record date is always set on a date significantly before the meeting date. A shareholder who sells shares between the record date and the meeting date generally will have a right to vote those shares even though the shareholder is no longer exposed to the economic consequences of their decision.

2. Share Borrowing and Lending – When an investor borrows shares immediately prior to a record date, the right to vote the loaned shares usually moves from the lender to the borrower. If the borrower does not sell or return the borrowed shares until after the record date, the borrower may be able to vote the borrowed shares despite not having an economic interest in them.

3. Derivatives – A shareholder can enter into a derivative or swap transaction to limit its economic exposure to the shares it holds in order to exercise voting rights without commensurate economic exposure.

Why hasn’t something been done before now?

Although empty voting has long been recognized as a concern, to date almost nothing has been done to address it. The Canadian Securities Administrators’ Notice and Request for Comment dated December 18, 2008 on proposed NI 55-104 Insider Reporting Requirements and Exemptions stated that the CSA was aware of and reviewing issues on empty voting. On July 14, 2010 the U.S. Securities and Exchange Commission issued a Concept Release on the U.S. Proxy System requesting comments on potential regulatory initiatives to improve proxy voting in the U.S., including initiatives to address empty voting. More recently, one of the key initiatives in the Ontario Securities Commission’s Statement of Priorities for 2012-13 is to improve the proxy voting system by conducting an empirical analysis to review concerns raised about its accountability, transparency and efficiency and facilitate discussions amongst market participants to improve the system.

One reason that nothing has been done to address empty voting is that some degree of empty voting is an unavoidable consequence of the need under our proxy voting system to set a record date for voting that precedes the meeting date. There are also practical difficulties in establishing enforceable rules to protect the integrity of the vote. Another reason is the desire to avoid regulations that might impede the benefits to market liquidity of share lending arrangements and derivative transactions. But a key reason is the lack of empirical evidence as to the extent of the problem.

What happened at TELUS?

On February 21, 2012, TELUS Corporation announced that it was proposing to eliminate its dual class share structure by way of a court-approved plan of arrangement (the Proposal) to be voted on at TELUS’ next shareholder meeting. Under the terms of the Proposal, each non-voting share would be converted into a common share on a one-for-one basis if approved by two-thirds of the votes cast by the holders of common shares and two-thirds of the votes cast by the holders of non-voting shares, each voting separately as a class.

The Proposal was well-received as it would:

- enhance the liquidity and marketability of TELUS’ shares by having one large class of shares and would permit TELUS’ common shares to be listed on the New York Stock Exchange; and
- enhance TELUS’ corporate governance practices by resulting in an equity capital structure that would conform to the “one share – one vote” principle endorsed by shareholders and governance advocates.

Proxy advisory firms Institutional Shareholder Services Inc. and Glass, Lewis & Co., LLC each
recommended that holders of TELUS’ common shares and non-voting shares vote in favour of the Proposal.

The Proposal was opposed by Mason Capital Management LLC, an opportunistic New York hedge fund that had amassed a significant voting position in TELUS’ common shares shortly following the announcement of the Proposal funded largely by short sales of TELUS non-voting shares. In its dissident circular, Mason stated:

“As of April 20, 2012, Mason had ownership or control over (i) 33,182,029 Voting Shares, representing approximately 18.97% of the outstanding Voting Shares, and (ii) 607,300 Non-voting Shares, representing approximately 0.4% of the outstanding Non-voting Shares.

In addition, as of April 20, 2012, Mason had obligations under securities lending arrangements to return to lenders an aggregate of 11,950,529 Voting Shares and 21,422,400 Non-voting Shares in connection with prior short sales made by Mason of Voting Shares and Non-voting Shares.”

TELUS’ non-voting shares historically traded at a discount to the common shares. After the Proposal was announced, in the expectation that the transaction would be approved the trading price of both classes of shares rose, but the trading price of the non-voting shares rose more significantly to approximate the trading price of the common shares. As Mason had sold short almost as many TELUS shares as it held, it had capped virtually any loss it might incur should the Proposal be approved. But because of the number of non-voting shares it sold short, if the trading price of the non-voting shares returned to its historic discount relative to the trading price of the common shares, the gain on Mason’s non-voting share short position would exceed any loss on its offsetting common share position.

It was not evident to a reader of Mason’s dissident proxy circular that the economic consequences to Mason from defeating the Proposal were opposite to those that would be realized by ordinary shareholders. Canadian securities regulators were invited to review the sufficiency of Mason’s disclosure in light of its obligation under securities laws to briefly describe any material interest, direct or indirect, by way of beneficial ownership of securities or otherwise, in the matters to be considered at the meeting. They declined to do so.

TELUS ultimately withdrew the Proposal rather than see it defeated at the meeting, noting that if Mason Capital’s shares were factored out, “TELUS’ proposal was on track to be overwhelmingly approved by both classes of shareholders, with 92.4 per cent of voted shares in favour of the proposal.”

TELUS was a precedent-setting transaction as it provided for the first time in Canada clear evidence of empty voting and, as a result, a unique opportunity for Canadian securities regulators to express a view on the issue – which to date they have declined to do.

**Incentives to Engage in Empty Voting**

There is a cost to creating and maintaining an empty voting strategy. In light of those costs as well as the risks of pursuing that strategy, empty voting concerns are more likely to arise where there is an opportunity to engage in economic arbitrage, such that the holder of the voting right has an opportunity over the short term to realize economic consequences from the decision that are the reverse of those that would be realized by other shareholders. In most shareholder voting situations, the subject matter of the vote does not lend itself to an economic arbitrage opportunity. The most likely scenario for an economic arbitrage opportunity is an M&A transaction. Not surprisingly, it is in the M&A context that
empty voting has been highlighted as an issue in the past. In particular, economic arbitrage opportunities may exist where a target company needs to obtain shareholder approval for a transaction and either (1) the target faces a simultaneous takeover bid from another party (for example, those who support the takeover bid may use empty voting to vote against the other transaction) or (2) the acquirer also requires shareholder approval under stock exchange listing requirements due to the number of shares to be issued by the acquirer in the transaction (for example, by providing an opportunity for shareholders of a target to engage in empty voting of the acquirer’s shares to ensure approval of transaction that is favourable to target shareholders). Such opportunities are rare, although since 2009, when the TSX began requiring shareholder approval for acquisitions by listed issuers resulting in greater than 25% dilution of the listed issuer’s shareholders, there is a greater likelihood that a Canadian acquirer may need to obtain shareholder approval for an acquisition that is dilutive to shareholders. If the number of public M&A transactions increases, and if U.S. hedge funds continue to look for opportunities in Canada to engage in strategic gamesmanship, concerns about empty voting will also increase.

Conclusion

TELUS’ encounter with empty voting was a setback, but is not a defeat. The Proposal was a transaction that was internal to TELUS’ governance and capable of being revisited in the future. In fact, the company has announced that it will proceed with a new proposal at a later date at the same exchange ratio. The situation will be very different when shareholders face the permanent loss of a value-maximizing opportunity because of strategic trading strategies implemented by a competing bidder, hedge fund or other party. Canada has had a wake-up call to a major flaw in the regulation of its public markets and securities regulators need to respond promptly and decisively.

1 See, for example, (1) Multi-Fineline Electronix (2006, U.S. & Singapore) in which Multi-Fineline Electronix (M-Flex) sought approval by a majority of its minority shareholders to acquire another company, even though an independent committee of the M-Flex board recommended that minority shareholders vote against approval, and a hedge fund with an unhedged long position in the target obtained an empty vote position in M-Flex to make sure M-Flex minority shareholder approval was obtained in order to profit on the sale of its interest in the target (2) Henderson Land Development Co. (2005, Hong Kong) in which Henderson Land offered to take its subsidiary private at a large premium to the market price but needed approval by 90% of the holders of the ‘free floating’ shares and hedge funds were suspected of having borrowed shares of the subsidiary prior to the record date, sold them short when the trading price was high in anticipation of approval and voted the borrowed shares against the going private transaction, thereby defeating it and profiting from closing their short position when the trading price fell and (3) Mylan Laboratories (2004, U.S.) in which Mylan Laboratories sought approval by its shareholders to acquire another company in a stock-for-stock merger and a hedge fund with an unhedged long position in the target obtained an empty vote position in Mylan Laboratories with a view to helping obtain a favourable vote by Mylan Laboratories shareholders in order to profit on the sale of its interest in the target.
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1. **Share Borrowing and Lending** – When an investor borrows shares immediately prior to a record date, the right to vote the loaned shares usually moves from the lender to the borrower. If the borrower does not sell or return the borrowed shares until after the record date, the right to vote the loaned shares usually moves from the borrower to the lender. If the borrower sells the shares before the record date, the right to vote the loaned shares is retained by the borrower.

2. **Selling Shares after the Record Date for Voting** – It takes time to determine who is entitled to vote the shares. Therefore, even if the record date is long past, a vote may still be taking place. In such cases, a person may vote shares that they do not own.

3. **Mylan Laboratories (2004, U.S.)** – In this case, Mylan Laboratories sought approval by its shareholders of a takeover proposal. At the same time, another party was pursuing a simultaneous takeover bid for the same company. Mylan Laboratories shareholders were suspected of having borrowed shares of the subsidiary prior to the record date, sold them short and obtained an empty voting position in Mylan Laboratories with a view to possible dilution of the company. However, by the time the trading price was high in an approval vote, and voted the borrowed shares against the proposal.

4. **Henderson Land Development Co.** – A shareholder of Henderson Land Development Co. was found to have obtained an empty voting position in order to profit on the sale of its interest in the target.

5. **TELUS** – TELUS' proposal to eliminate its dual class structure was opposed by Mason Capital Management LLC, an opportunistic New York hedge fund that had amassed a significant voting position in TELUS' common shares shortly following the announcement of the Proposal funded largely by short sales of TELUS non-voting shares. In its dissident circular, Mason stated:

   "If shareholders of a target to engage in empty voting of the acquirer's shares to ensure approval of the Proposal rather than an alternative, the risks of pursuing that strategy, empty voting concerns are more likely to arise where there is an unhedged long position in the target obtained an empty voting position in Mylan Laboratories with a view to possible dilution of the company."