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Securities lending as a barrier to (or an instrument for) shareholder activism and the role of intermediaries as lending agents

WP 2022-15

Louise Van Marcke

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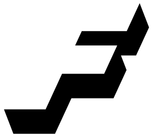

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Abstract

This paper discusses the corporate governance implications of securities lending transactions in the European Union, in particular with regard to the exercise of voting rights by activist shareholders. When shares are on loan, both sides of the lending equation (i.e. that of the lender and the borrower) affect the exercise of voting rights: lenders must recall lent out shares in a timely manner if they do not want to lose the voting rights attached to them, and borrowers may employ stock borrowing practices to increase their voting power and manipulate voting outcomes. By analysing legal doctrine, consulting with practitioners and examining recent securities lending cases (such as Mediobanca/Generali), this paper highlights the ongoing risks that stock lending poses to corporate governance. Techniques such as negative risk-decoupling, record date capture and empty voting are analysed from the perspective of stock lending. It is found that securities lending can be as much a barrier to activism as it can be used to the advantage of activists. As a conclusion, some recommendations and guidelines for future regulation are included.

The author welcomes your comments at louise.vanmarcke@ugent.be

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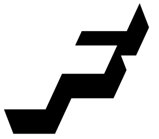

Securities lending as a barrier to (or an instrument for) shareholder activism and the role of intermediaries as lending agents [1]

Louise Van Marcke[2][3]

WORKING PAPER FINANCIAL LAW INSTITUTE, GHENT UNIVERSITY

Abstract

This paper discusses the corporate governance implications of securities lending transactions in the European Union, in particular with regard to the exercise of voting rights by activist shareholders. When shares are on loan, both sides of the lending equation (i.e. that of the lender and the borrower) affect the exercise of voting rights: lenders must recall lent out shares in a timely manner if they do not want to lose the voting rights attached to them, and borrowers may employ stock borrowing practices to increase their voting power and manipulate voting outcomes. By analysing legal doctrine, consulting with practitioners and examining recent securities lending cases (such as Mediobanca/Generali), this paper highlights the ongoing risks that stock lending poses to corporate governance. Techniques such as negative risk-decoupling, record date capture and empty voting are analysed from the perspective of stock lending. It is found that securities lending can be as much a barrier to activism as it can be used to the advantage of activists. As a conclusion, some recommendations and guidelines for future regulation are included.

Key words: securities lending, shareholder activism, voting rights, intermediaries, negative vote-decoupling

JEL Classification: Business and Securities Law **K22**, General Financial Markets: Government Policy and Regulation **G18**, Pension Funds; Non-bank Financial Institutions; Financial Instruments; Institutional Investors **G230**

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[1] Forthcoming in A. VAN HOE and T. VOS (eds.), *Shareholder Activism in Belgium: Boon or curse for sustainable value creation?*, Brussel, Larcier Intersentia, 2023. No part of this working paper may be reproduced without appropriate reference.

[2] Ph.D. candidate, Financial Law Institute, Ghent University.

[3] The practical approach of this paper was made possible by highly valuable discussions with practitioners, for which my utmost gratitude goes to Andrew Dyson and Adrian Dale (International Securities Lending Association), James Cunningham (Bank of New York Mellon) and Marije Verhelst (Euroclear Bank). All interpretations, conclusions and errors are my own. I furthermore wish to thank em. prof. dr. Eddy Wymeersch and prof. dr. Hans De Wulf for their valuable feedback to my working paper.

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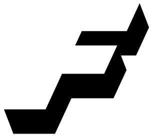

1. *Introduction*

1. **Chains of Intermediaries.** In today's markets, one of the requirements for admission to most trading venues is that shares are traded electronically rather than on paper and are therefore held in book-entry form (i.e. dematerialised or immobilised[4]) on securities accounts. The relationship between listed companies and their shareholders is also generally characterised by the presence of intermediaries (such as (custodian) banks, brokers, central securities depositaries ('CSD's') etc.) who offer a wide range of services related to holding their clients' securities in book-entry form.[5] In most cases, shares are therefore held in an intermediated way (referred to as 'indirect holding'), although (often impractical) exceptions apply.[6]

The phenomenon of a complex network of securities accounts (with corresponding cash accounts for the purpose of settlement of transactions and, for example, dividend payouts) held in different layers is commonly referred to as a 'chain of intermediaries'. In a typical chain, an upper-tier intermediary (usually, the CSD) holds the total amount of issued securities directly from the issuer on behalf of other institutions (CSD-participants), who in turn hold securities for others and so on. Intermediaries in the holding chain can hold securities for their own account but can also, and will more generally, hold securities in their own name but *on behalf* of other natural or legal persons, i.e. their clients. For efficiency reasons, the upstream

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[4] Dematerialization refers to the fact that financial instruments exist (have been issued) *ab initio* as book entry records, while immobilization assumes the securities being deposited for safekeeping with a CSD, who then books them onto securities accounts. The book-entry form has become mandatory in the EU/EEA: European issuers that issue transferable securities which are admitted to trading or traded on trading venues must issue such securities in book-entry form, from 1 January 2023 for new securities, and from 1 January 2025 for all existing securities. See art. 3 j. 76 Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012, *Oj.L.* 28 August 2014, ep. 257, 1-72 ("CSDR").

[5] See annex 1, Section B (1) Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance, *Oj.L.* 12 June 2014, ep.173,349-496 ("MiFID II") and Annex, Section A (for core services of central securities depositories) CSDR. For an interesting overview of the roles of different intermediaries in the chain, see EUROPEAN POST-TRADE FORUM, "EPTF Report Annex 3: Detailed analysis of the European Post Trade Landscape", 15 May 2017, 26-30 (3.1.3).

[6] "It is debatable whether subscribers of publicly traded securities have a choice as many stock exchanges today make the holding of securities on an intermediated system a condition of listing.", M. OOI, "Re-enfranchising the investor of intermediated securities", *Journal of Private International Law* 2020, Vol.16(1), 69, 86. "Equity investors in European companies often have no practical alternative to being part of a custody chain because of the way that trading, clearing and settlement is organized", E. FERRAN, "Shareholder Engagement and Custody Chains", University of Cambridge Faculty of Law Research Paper No. 1/2022, 6 January 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4001702 , p. 9 (accessed 21.09.2022).
For example, in the UK, shares in listed companies can be held through CREST by 'direct membership' (so that the investor appears vis-à-vis the issuer as the registered company member), but this holding way is quite bothersome since only few brokers in the UK offer it, and those that do charge very high fees for it. Consequently, its popularity has declined. See LAW COMMISSION, "Intermediated securities: who owns your shares? A Scoping Paper", 11 November 2020, https://www.lawcom.gov.uk/project/intermediated-securities/ , p. 29 (accessed 21.09.2022).

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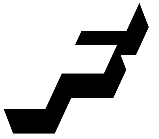

accounts intermediaries hold with a higher-tier intermediary on behalf of their combined clients will often pool the clients' securities in one and the same account. These accounts are then referred to as 'omnibus accounts' (as opposed to individually segregated client accounts).[7]

At the intersection of chains of intermediaries and corporate law, several issues and questions arise (some of which have been addressed elsewhere[8]) that are the subject of a growing body of literature.[9] One of these issues, explored in this paper, are shareholders engaging in 'securities financing transactions'. According to DONALD, at least in the US, "the anonymity, complexity, and uncertainty created by the indirect holding system is aggravated by share lending and the related practice of short selling"[10]. The relationship between securities financing transactions and corporate governance has been much less explored in the EU.

2. **Securities Financing Transactions.** While shares[11] may be held on a securities account until their owner decides to dispose of them, some transactions may be engaged in during the time the shares are held in the investor's portfolio. The underlying idea is that the portfolio may be used to realise an additional source of income by allowing shares to be 'used' by market actors in need. This kind of efficient resource management on the market takes the form of securities financing transactions (SFT's)[12], which include inter alia securities lending agreements and repurchase transactions ('repos')[13]. This paper focuses on the first of these

[7] See L. GULLIFER, *Goode and Gullifer on Legal Problems of Credit and Security*, Oxford, Sweet & Maxwell, 2017, p. 243; P. DE GIOIA-CARABELLESE and M. HAENTJENS, *European Banking and Financial Law*, New York, Routledge, 2020, p. 176.

[8] One of the most insightful recent papers on this topic that summarizes several problems to a great extent, is E. FERRAN, "Shareholder Engagement and Custody Chains", University of Cambridge Faculty of Law Research Paper No. 1/2022, 6 January 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4001702 , 30 p. (accessed 21.09.2022). See also E. MICHELER, "Transfer of Intermediated Securities and Legal Certainty" in T. KEIJSER (ed.), *Transnational Securities Law*, Oxford, Oxford University Press, 2014, p. 117–43; VAN DER ELST, C. and LAFARRE, A., "Blockchain and Smart Contracting for the Shareholder Community", *EBOR* 2019, 111–37.

[9] The author's doctoral research is focusing on a comparative legal analysis of the corporate law problems caused by chains of intermediaries in the holding of shares in listed companies and their possible solutions.

[10] D.C. DONALD, "Heart of Darkness: The Problem at the Core of the U.S. Proxy System and its Solution", *Virginia Law & Business Review* 2011, Vol. 6(1), 41, 77.

[11] This paper is mainly concerned with shares of publicly listed companies. Any reference to 'securities', should be interpreted as referring to shares only (thus excluding other kinds of securities).

[12] For a definition, see art. 3 (11) of REGULATION (EU) 2015/2365 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012, *Oj. L.* 23 December 2015, ep. 337, 1-34 ("SFTR").

[13] In a repurchase agreement, the investor (in need of cash (short-term capital)) sells its securities to another investor (buyer) and buys them back after a short period of time (often, the following day) at a slightly higher purchase price. As explained by HAENTJENS, "the main difference between the two types of standardised financial collateral transactions is that in securities lending transactions it is the transferee of securities, that is the borrower, who initiates the transaction as she is in need of securities, whilst in repos, it is the transferor of the securities, that is the seller, who initiates the transaction as she is in need of cash. This difference is reflected in the fee: in securities lending transactions, it is paid by the transferee of securities, that is the borrower, whilst in repos, it is paid by the transferor of the securities, that is the seller", M. HAENTJENS, *Financial Collateral: Law and Practice*, Oxford, Oxford University Press, 2020, p. 115. "The main differences are that: securities lending does not necessarily involve cash

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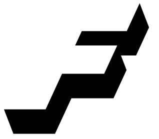

transactions, i.e. stock (share) lending. The general ideas and conclusions of this paper may, however, also be applied to repo's: while the initiating party, the intent and/or the maturity of a repo may be different, both transactions have the same outcome in terms of transfer of title and can therefore have the same consequences for corporate governance and the exercise of voting rights.

There are many reasons why shareholders would engage in stock lending transactions, including the facilitation of the settlement process (in the case of automated lending programs[14]) which leads to reduced trading costs, the facilitation of the market pricing mechanism (by allowing for short selling to correct overvaluations[15]), enhanced liquidity and efficiency in the market (due to effective resource management) and – on an individual level, often the most important reason – increased revenue by having an additional source of income stemming from lending fees.[16]

3. To illustrate the significance of today's[17] securities lending markets, the International Securities Lending Association (hereafter: 'ISLA'[18]) asserted that "the size of the global

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(it can be security against security); is generally driven by the demand to borrow specific securities (rather than cash); and tends to be transacted on an open basis", see EUROPEAN POST-TRADE FORUM, "ETPF Report: Annex 3", 15 May 2017, https://ec.europa.eu/info/sites/default/files/170515-eptf-report-annex-3_en.pdf , p. 184–89 (accessed 21.09.2022).

[14] As a CSD, Euroclear operates an automated lending programme that many intermediaries (including Bank of New York Mellon) use. The programme essentially detects settlement fails due to a shortage in securities supply, and automatically provides securities from a large lending pool to allow the settlement of the transaction to proceed. Once lenders and borrowers join the pool, Euroclear can use it automatically to cover settlement positions. The main difference between this type of securities lending and 'negotiated securities lending' is that the loans are concluded for a much shorter period and securities are usually returned at the end of the trading day, or 1 or 2 days later. For shares, recalls and other corporate governance problems are therefore much less likely to occur. In automated lending programs, borrowers pay a significantly higher fixed lending fee than in negotiated securities lending transactions. "Euroclear's (…) automated securities lending and borrowing programme (…) targets borrowing demand to avoid settlement fails and counterparty claims", see EUROCLEAR, "Securities Lending and Borrowing", https://www.euroclear.com/services/en/securities-lending-and-borrowing.html#:~:text=An%20automated%20fail%2Dcuring%20solution,confidential%2C%20secure%20and%20flexible%20solution (accessed 21.09.2022).

[15] See below, fn. 87.

[16] For a more elaborate discussion, see G. RAAIJMAKERS, "Securities Lending and Corporate Governance", Maastricht University Faculty of Law Working Paper, 2006, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=928312 , p. 5 (2.2 Reasons for securities lending) (accessed 21.09.2022). See also the preamble of INTERNATIONAL CORPORATE GOVERNANCE NETWORK, "ICGN Guidance on Securities Lending", 2016, https://www.icgn.org/sites/default/files/2021-06/ICGN068_Guidance_On_Securities_Lending_24pp_AUG16-v3_0.pdf, 5 (accessed 21.09.2022).

[17] From a historical perspective, according to RINGE "the volume of 'borrowed' securities rose sharply in global markets in the years just before the financial crisis (…). In the years following 2008, however, we saw a significant decrease in such transactions. (…) More recently, the industry appears to have revived", see W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 36–37.

[18] The ISLA is the leading non-profit industry association that represents the interests of participants in the securities lending and financing market in Europe, the Middle East and Africa. The ISLA has developed the "Global Master Securities Lending Agreement" which functions as the widely-used, global standard master agreement in securities lending.

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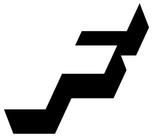

securities lending industry (securities available for loan) [was] estimated to be in the region of €24 trillion as at the end of 2020. Over 90% of this supply is attributable to lendable assets of beneficial owners, in the form of Pension Plans, Insurance Companies, Mutual and Retail Funds, Sovereign Entities and Government offices, Foundations and Endowments, and Corporations (both LLC and LLP)".[19] More recent figures estimate the size of the global securities borrowing market at €32.4 trillion.[20] In terms of loaned securities, roughly half of today's market are government bonds but there is also a big equity component – according to the European Post-Trade Forum, over 50% of securities on loan are equities (shares).[21]

4. **Goal of This Paper.** Activist shareholders can engage in stock lending transactions both on the side of the lender, as well as on the side of the borrower. It should be clarified that aggressive and 'offensive' activists, such as hedge funds, are more likely to be on the 'borrowing' side and large institutional investors (i.e. traditional activists making use of defensive activist techniques) on the 'lending' side.[22]

The starting point of this paper is that lending agreements affect the activists' ability to exercise voting rights (as a lender), and (the expansion of) the activists' voting power (as a borrower). While more ink has flowed on activists as share borrowers (e.g., in their capacity as short-sellers) and empty voting practices, especially in the US, less attention has been paid to the angle of shareholders as stock lenders. This paper aims to make a contribution in both respects.

The first part of this paper discusses stock lending from the perspective of stock lenders (i.e. transferors of securities) and the corporate governance implications of lending transactions, especially with regards to voting rights. In particular, this paper analyses the (in)ability for institutional shareholders, such as activists, to exercise voting rights when large share portfolios appear to be out on loan in the run-up to the annual general meeting. By analysing the implications of lending practices in company law (including, inter alia, the exercise of voting rights as a shareholder (lender) and the right to 'recall' loaned shares), this paper shed light on the potential risks posed by securities lending practices for activist shareholders who

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[19] ISLA, "Institutional Investors & Securities Lending", December 2020, https://www.islaemea.org/institutional-investors-and-securities-lending/ (accessed 21.09.2022).

[20] ISLA, "Securities Lending Market Report" (16th edition), March 2022, https://www.islaemea.org/assets/smart-pdfs/isla-securities-lending-market-report-march-2022/files/downloads/2516_21_June_ISLA_Market_Report_-_March_2022_final.pdf , p. 6–7 (accessed 21.09.2022).

[21] EUROPEAN POST-TRADE FORUM, "ETPF Report: Annex 3", 15 May 2017, https://ec.europa.eu/info/sites/default/files/170515-eptf-report-annex-3_en.pdf , 9. 195 (accessed 21.09.2022).

[22] This common distinction between activists was also highlighted in e.g. A. BRAV, W. JIANG and R. LI, "Governance by Persuasion: Hedge Fund Activism and Market-based Shareholder Influence", European Corporate Governance Institute – Finance Working Paper No. 797/2021, 10 December 2021, https://ssrn.com/abstract=3955116 , 9–10 (accessed 21.09.2022).

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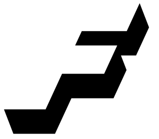

cannot afford to 'lose' voting rights when launching an activist intervention in a target company. On the other hand, the second part of this paper explores the position of activists as stock borrowers and explains the phenomena of 'vote decoupling' and empty voting. This way, it is examined whether activists can increase their voting power by deliberately borrowing shares in the run-up to the general meeting, and the risks such practices may cause with respect to corporate governance.

2. *Securities Lending Agreements and the Role of Intermediaries*

5. A securities lending agreement is generally defined as a transaction where an investor (the lender) lends securities to a borrower (often with cash or securities being provided as collateral[23]), with the borrower returning to the seller equivalent securities and a fee at the date of maturity (and the seller subsequently returning the provided collateral). Essentially, the lender is sacrificing liquidity in a security for a given period of time, in return for a (at times, quite substantial[24]) lending fee.

The term 'loan' however, does not accurately reflect what is happening from a legal perspective. In fact, the lender transfers the ownership of its securities fully and unconditionally to another party (the borrower), against the obligation for the borrower to return equivalent securities.[25] Importantly, from the moment the securities have been

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[23] As a principle, the value of the provided collateral will be greater than that of the lent securities. After all, when securities are lent, the lender runs a counterparty risk, i.e., the risk that the borrower cannot return the shares at the end of the loan, in which case the collateral provided by the borrower will be sold and from those proceeds the securities can be bought back in the market. See R. AGGARWAL, P.A.C. SAFFI and J. STURGESS, "The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market", *The Journal of Finance* 2015, Vol.70(5), 2309, 2314. Collateral can also be delivered by a pledge, so that the borrower retains ownership of the pledged assets. According to the ISLA, in the European model almost 100% of all loaned securities are collateralised by non-cash assets, while the North-American model primarily relies on cash collateral.

[24] For a study estimating securities lending revenue in exchange traded funds (ETF's) and index mutual funds (IMFs), see J. BLOCHER and R.E. WHALEY, "Passive Investing: The Role of Securities Lending", working paper 6 November 2014, https://acfr.aut.ac.nz/__data/assets/pdf_file/0010/29917/WhaleyPassive-Investing.pdf , 40 p. (accessed 21.09.2022).

[25] G. RAAIJMAKERS, "Securities Lending and Corporate Governance", Maastricht University Faculty of Law Working Paper, 2006, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=928312 , p. 4 (accessed 21.09.2022); M.C. FAULKNER, *An Introduction to Securities Lending* (4th edition), London, Spitalfields Advisors Limited, 2007, p. 15–22; W. RINGE, "Hedge Funds and Risk Decoupling: The Empty Voting Problem in the European Union", *Seattle University Law review* 2013, Vol.36, 1027, 1039; P. ALI, I. RAMSAY and B. SAUNDERS, "Securities lending, empty voting and corporate governance", *Law and Financial Markets Review* 2014, Vol.8(4), 326, 327; D. MARAIS, "Decoupling Voting Rights from Economic Interest: The Case of Empty and Negative Voting", *Trinity College Law review* 2015, Vol.18, 180, 186; R. AGGARWAL, P.A.C. SAFFI and J. STURGESS, "The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market", *The Journal of Finance* 2015, Vol.70(5), 2309, 2313–314; W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 36; EUROPEAN POST-TRADE FORUM, "ETPF Report: Annex 3", 15 May 2017, https://ec.europa.eu/info/sites/default/files/170515-eptf-report-annex-3_en.pdf , p. 193 (accessed 21.09.2022); J. BENJAMIN and L. GULLIFER, Stewardship and Collateral: The Advantages and Disadvantages of the No Look Through System, in L. GULLIFER and J. PAYNE (eds.), *Intermediation and Beyond*, Oxford, Hart Publishing, 2018, 218; M. HAENTJENS, *Financial Collateral: Law and Practice*, Oxford, Oxford University Press, 2020, p. 114–15.

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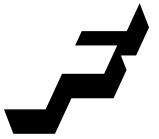

transferred to the borrower, the latter obtains ownership thereof, accompanied by all the rights and entitlements attached to those securities. Correctly put, the lender remains the owner of the securities only in an economic sense, since "the lender and not the borrower is [ultimately] exposed to any change in the value of the securities"[26]. For this particular reason, the practice of short selling[27] is at times criticised because the original owner (lender) may end up with less valuable shares and, by lending out its shares, may have contributed to its own worsened position (as discussed below, fn. 89-92). This situation illustrates that from a short selling perspective, stock lending often comes down to a 'bet' by long-term investors who believe their shares have long-term intrinsic value that will remain unaffected by short selling – in return for a lending fee to offset that risk.

6. In terms of contract drafting, two agreements govern the lending relationship. In practice, the overwhelming majority of cross-border securities lending agreements (concluded between the lender (or his agent), and the borrower (or his agent)) are drafted on the basis of the ISLA's Global Master Securities Lending Agreement (hereafter: 'GMSLA').[28] Alternatively, securities lending transactions may take the form of *ad hoc* lending agreements: these are customised, tailor-made agreements that are not standardised within the industry. The lending agreements of Euroclear, for example, are drawn up solely on an *ad hoc* basis for both the negotiated securities lending programme and the automated securities lending programme (a policy-based, historical choice that has been adhered to for the time being).[29] Even though great value emanates from the GMSLA, in principle securities lending agreements may be freely drafted by the parties involved and, in reality, may vary in terms of the extent to which the lender's shareholder rights are protected. Here, the bargaining power of the lender (or its agent) inevitably plays a major role.

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[26] P. ALI, I. RAMSAY and B. SAUNDERS, "Securities lending, empty voting and corporate governance", *Law and Financial Markets Review* 2014, Vol.8(4), 326, 327.
[27] Short-selling ('to go short') speculates on a possible drop in the share price. The short seller borrows a certain number of securities and sells them at the market price (X). Once the share price has dropped, the seller buys the securities back at the lower price (X - 20), in order to return them to the lender. The difference between the higher sale price (X) and the lower purchase price (X - 20) constitutes the net profit (20).
[28] The GMSLA was originally published in 2000. The current version is that of 2010, with minor amendments made in 2012. For the full text, see ISLA, "Global Master Securities Lending Agreement", 2010, https://www.fixedincome.global/uploaded_files/privacy_sercurity/GlobalMasterSecuritiesLendingAgreement(GMSLA).pdf (accessed 21.09.2022). One of the main reasons for the success of the GMSLA is the fact that the ISLA maintains the GMSLA from a legal enforceability perspective. Since the lending arrangement is a collateralised transaction, the ISLA collects enforceability opinions from counsel in over 60 jurisdictions on an annual basis, to ensure that, in an event of default on the part of the borrower, the received collateral can effectively be used to net out the position. See ISLA, "GMSLA Netting Opinions", https://www.islaemea.org/gmsla-title-transfer/gmsla-netting-opinions/ (accessed 21.09.2022).
[29] Although it should be noted that both of Euroclear's lending programmes are mainly oriented towards fixed income securities such as bonds.

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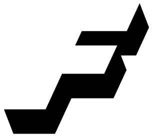

The second agreement governing the lending relationship is the 'securities lending authorization agreement' concluded between the lender and his agent; often his direct intermediary. These non-standardised agreements set the terms on which the intermediary, as a lending agent, will lend securities from its clients.

7. Investors may manage their lending activities themselves, but more commonly intermediaries are placed in between lenders and borrowers as 'lending agents' (be it an intermediary with which an existing custody relationship exists, or a specialist third-party agent), "to whom lenders[30] delegate lending power"[31] by means of the securities lending authorization agreement. Although relatively little attention is paid to it in the literature, intermediaries play an important role in securities lending transactions. Securities lending is mainly offered by intermediaries to clients as an ancillary service, allowing them to earn a return on the portfolio that can offset the cost they charge for their services (at least to some extent, since revenue from securities lending will be shared between the intermediary and the investor[32]). Working with intermediaries for lending purposes generates a number of advantages: for example, the portfolios of several smaller investors can be pooled and both lenders and borrowers can benefit from the intermediary's established customer base and, accordingly, can be matched more efficiently.[33] For this reason, omnibus accounts prove to be

[30] Both lenders and borrowers can make use of intermediaries as agents, so that additional layers of intermediaries become involved in lending transactions, J. BENJAMIN and L. GULLIFER, Stewardship and Collateral: The Advantages and Disadvantages of the No Look Through System, in L. GULLIFER and J. PAYNE (eds.), *Intermediation and Beyond*, Oxford, Hart Publishing, 2018, p. 217. For example, most securities are borrowed by prime brokers on behalf of underlying clients, such as hedge funds.

[31] S. HIRST and A.Z. ROBERTSON, "Hidden Agendas in Shareholder Voting", Boston Univ. School of Law Research Paper, August 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3833304 , p. 9 (accessed 21.09.2022).

[32] Revenue not only consists of the borrowing fee. In addition, "the lender earns a spread by investing the collateral in low-risk short-term securities", see R. AGGARWAL, P.A.C. SAFFI and J. STURGESS, "The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market", *The Journal of Finance* 2015, Vol.70(5), 2309, 2314. While intermediaries, acting as lending agents, can receive a part of lending revenue, the European Union prohibits fund managers from profiting from securities lending. To this extent, ESMA has clarified that "all the revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS". See ESMA, "Guidelines for competent authorities and UCITS management companies", 18 December 2012, https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf , p. 7 (Guideline 29) (accessed 21.09.2022). Fund managers can only deduce from the gross revenue stemming from securities lending a fee, payable to the securities lending agent, that is considered a 'normal' compensation for the agent's services. Nevertheless, in recent years, questions have arisen as to whether asset managers actually follow this rule and pass on all income derived from securities lending to their clients (institutional investors), or rather pocket revenue they are not entitled to. See S. RIDING, "Fund groups challenged over securities lending practices", *Financial Times* 11 May 2019, and the report drawn up by consumer group BetterFinance, BETTERFINANCE, "Efficient Portfolio Management Techniques: Attribution of Profits Derived from Securities Lending by UCITS and Exchange-traded Funds", 13 May 2019, https://betterfinance.eu/wp-content/uploads/BETTER-FINANCE-Research-Paper-Securities-Lending-11062019.pdf , 24 p. (accessed 21.09.2022).

[33] M.C. FAULKNER, *An Introduction to Securities Lending* (4th edition), London, Spitalfields Advisors Limited, 2007, p. 23; M. HAENTJENS, *Financial Collateral: Law and Practice*, Oxford, Oxford University Press, 2020, p. 119–20.

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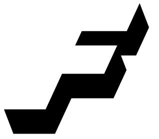

very effective. Omnibus accounts also allow for the reallocation of loans (as discussed below, fn. 52-53).

8. Lending authorization agreements are often part of an existing custody arrangement with the intermediary.[34] The authorization agreement will allow the intermediary, when the opportunity presents itself, to lend the client's securities without prior authorization and within the limitations that have been set by the client in advance.[35] At the client's discretion, the authorization agreement thus specifies certain parameters or criteria between which the agent is allowed to engage in securities lending (e.g., an exclusion of certain borrowers, a limitation of only lending particular types of assets to particular borrowers, restrictions in terms of accepted collateral, the maturity (term or open term) of the transactions etc.).

Over time, some concerns have risen on the awareness of the investor that (some of) its shares have been lent and the consequences for voting entitlements, especially in the US and the UK.[36] Similar concerns have arisen in the EU[37], although these are generally older and, as became

[34] Discussed more deeply in J. BENJAMIN and L. GULLIFER, Stewardship and Collateral: The Advantages and Disadvantages of the No Look Through System, in L. GULLIFER and J. PAYNE (eds.), *Intermediation and Beyond*, Oxford, Hart Publishing, 2018, p. 217–18.

[35] Also referred to as a 'general authority' from clients to use their shares for lending purposes, see SHAREHOLDER VOTING WORKING GROUP, "Shareholder Proxy Voting: Discussion Paper on Potential Progress in Transparency", July 2015, https://uk.practicallaw.thomsonreuters.com/9-616-7485?transitionType=Default&contextData=(sc.Default)&firstPage=true , p. 35 (accessed 21.09.2022).

[36] "Typically, large institutional investors will either have the custodian bank handle the securities lending or will put the business out to bid to a third-party specialist. As a result, the personnel in the institutional investor with responsibility for voting the shares may not even be aware that the shares are out on loan", M. KAHAN and E.B. ROCK, "The Hanging Chads of Corporate Voting", *The Georgetown Law Journal* 2008, Vol. 96, 1227, 1256; In 2009, the International Corporate Governance Network spoke of a 'loss of control' depending on the breadth of the lending agent's mandate, see ICGN, Response to the Panel on Securities Lending and Investor Protection Concerns, File No. 4-590, 24 September 2009, https://www.sec.gov/comments/4-590/4590-10.pdf , p. 5 (accessed 21.09.2022); "Investment managers often do not know that stock they are managing has been lent out, if being lent out by custodians", SHAREHOLDER VOTING WORKING GROUP, "Shareholder Proxy Voting: Discussion Paper on Potential Progress in Transparency", July 2015, https://uk.practicallaw.thomsonreuters.com/9-616-7485?transitionType=Default&contextData=(sc.Default)&firstPage=true , p. 64 (accessed 21.09.2022); "Broker-dealers do not always inform their customers about the fact of specific share loans, or their effect on vote entitlements", A. SHEEHAN and J. C. COATES, "Proxy Plumbing Recommendation", Harvard Law School Corporate Governance Forum, 10 September 2019, https://corpgov.law.harvard.edu/2019/09/10/proxy-plumbing-recommendation/#53b , (annex) (accessed 21.09.2022). See also P. MYNERS, "Review of the impediments to voting UK shares", Report by Paul Myners to the Shareholder Voting Working Group, January 2004, p. 20; G. RAAIJMAKERS, "Securities Lending and Corporate Governance", Maastricht University Faculty of Law Working Paper, 2006, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=928312 , p. 8 (accessed 21.09.2022).

[37] "In some cases, the lender does not know that securities are being borrowed from his securities account. He is only informed after the event. (…) It also occurs that securities lending is based on specific agreements, whereby the lender is aware of the actual lending", THE EXPERT GROUP ON CROSS BORDER VOTING IN EUROPE, "Cross-border Voting in Europe: Final Report", August 2002 https://repository.wodc.nl/bitstream/handle/20.500.12832/1326/on2002-6-full-text_tcm28-67161.pdf?sequence=2&isAllowed=y , p. 47 (accessed 21.09.2022); "Where a custody lending agent manages the lending, the investor has to await activity reports from the custodian. Where no activity report has been established or reached, (…) [and] an investor wants to vote his shares between two activity reports, he might discover at that moment that his shares are lent and that he therefore is prevented from doing so. An additional problem arises where the investor has outsourced also the voting process: here the voting agency may not even be informed about

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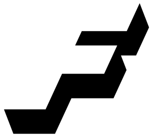

clear from discussions with practitioners[38], are not reflected by current market practices. In any case, a securities lending authorization agreement that forms part of a wider custody relationship with an intermediary, who acts as a lending agent on the basis of a general mandate and only informs the investor (its client) retrospectively, in principle places the investor at greater risk of not knowing if and/or when shares have been lent and how this affects the exercise of its voting rights. For example in the UK, it was argued "the involvement of two other parties [i.e. intermediaries] in the chain increases the risk of missed votes and indeed this is compounded by the fact that the beneficial owner may not know whether the securities are out on loan."[39] Timely awareness about the number of shares that have been lent out is nevertheless a crucial first step would the investor be willing to recall the loaned shares for voting purposes.

3. *The Effect of Securities Lending Agreements on the Exercise of Shareholders' Voting Rights*

3.1 The Entitlement to Vote

9. As explained above, fn. 25-26, a lending transaction fundamentally alters ownership status, at least from a legal perspective.[40] The transfer of title to the shares is accompanied by a transfer of shareholder rights (except for the right to dividends[41]), including voting rights. The legal position is therefore, as a principle, that the borrower becomes entitled to vote. In some jurisdictions, like the UK, the borrower will even appear on the register as the registered

the stock lending where the information does indeed reach the investor", P. SANTELLA, E. BAFFI, C. DRAGO and D. LATTUCA, "Legal Obstacles to Institutional Investor Activism in the EU and in the US", *European Business Law Review* 2012, Vol. 23(2), 257, 287. It has been noted by the European Commission that "it happens that stock held for the account of investors can in some instances be lent without informing investors". This statement in itself, however, need not necessarily express an underlying problem, as it merely reflects standard market practices where, indeed, investors are not notified by their agent until after shares have been lent and there is no prior authorization of loans. EUROPEAN COMMISSION, "Fostering an Appropriate Regime for Shareholders' Rights: Third consultation document of the Services of the Directorate General Internal Market and Services", 30 April 2007, https://www.treasurers.org/ACTmedia/consultation3_en.pdf , p. 4 (accessed 21.09.2022).

[38] See above, fn. 3.

[39] SHAREHOLDER VOTING WORKING GROUP, "Shareholder Proxy Voting: Discussion Paper on Potential Progress in Transparency", July 2015, https://uk.practicallaw.thomsonreuters.com/9-616-7485?transitionType=Default&contextData=(sc.Default)&firstPage=true , p. 36 (accessed 21.09.2022).

[40] Above, at fn. 26, it was argued that the lender remains the owner in an economic sense since he ultimately bears the investment risk related to the shares (that will, eventually, have to be returned to him).

[41] It is generally contractually provided "the dividend and other distributions in respect of the shares must be paid or forwarded by the borrower to the lender" since the lender remains the owner of the shares from an 'economic' perspective. See G. RAAIJMAKERS, "Securities Lending and Corporate Governance", Maastricht University Faculty of Law Working Paper, 2006, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=928312 , p. 4 and 7–8 (accessed 21.09.2022). See also ISLA, Guidance Notes to the Global Master Securities Lending Agreement (2010 Version), 18 April 2010, https://www.islaemea.org/wp-content/uploads/2019/03/GMSLA_2010_Guidance_Notes_Freshfields.pdf , p. 7 (Principle 2.5) (accessed 21.09.2022).

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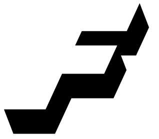

holder.[42] Moreover, the lender in principle has no say in how voting rights are exercised by the borrower. This principle is also part of the GMSLA ("where any voting rights fall to be exercised in relation to any Loaned Securities or Collateral, [no] Borrower (…), shall have any obligation to arrange for voting rights of that kind to be exercised in accordance with the instructions of the other Party in relation to the Securities borrowed by it (…), unless otherwise agreed between the Parties"[43]).

In theory, the parties to a lending agreement are therefore free to stipulate a right of instruction on the part of the lender, vis-à-vis the borrower.[44] It is extremely doubtful, however, to what extent such a clause would be enforceable on the market and would lead to the desired result in practice. Since the borrower becomes the legal owner of the shares on loan, he is free to sell them on the market to any third purchasing party (and it is for this purpose that some borrowers, such as short sellers, borrow shares in the first place). The anonymity surrounding stock exchange trading prevents the buyer and seller from being linked to each other for the purpose of passing on voting instructions. The increasing volatility of share ownership in listed companies only exacerbates this.[45] Requiring a third-party purchaser to vote according to the (original) lender's instructions or requiring him to execute a proxy to the (original) lender's benefit, is downright impracticable (if not impossible) in today's market.[46]

It has been argued in the US that intermediaries often do not provide enough transparency about the person entitled to vote on shares on loan, resulting in a risk of 'overvoting' (because both the lender and the borrower exercise the voting right attached to the shares).[47]

3.2 The Right To Recall Shares on Loan

10. The most common way to address the voting issue is the inclusion of a 'recall clause' in the securities lending agreement that allows the investor to instruct the borrower to return

[42] SHAREHOLDER VOTING WORKING GROUP, "Shareholder Proxy Voting: Discussion Paper on Potential Progress in Transparency", July 2015, https://uk.practicallaw.thomsonreuters.com/9-616-7485?transitionType=Default&contextData=(sc.Default)&firstPage=true , p. 35 (accessed 21.09.2022).
[43] Art. 6.6 GMSLA.
[44] THE EXPERT GROUP ON CROSS BORDER VOTING IN EUROPE, "Cross-border Voting in Europe: Final Report", August 2002 https://repository.wodc.nl/bitstream/handle/20.500.12832/1326/on2002-6-full-text_tcm28-67161.pdf?sequence=2&isAllowed=y , p. 47 (accessed 21.09.2022); G. RAAIJMAKERS, "Securities Lending and Corporate Governance", Maastricht University Faculty of Law Working Paper, 2006, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=928312 , p. 8 (accessed 21.09.2022)
[45] C. CLOTTENS, *Proportionaliteit van stemrecht en risico in kapitaalvennootschappen*, Antwerpen, Biblo, 2012, p. 401.
[46] M. KAHAN and E.B. ROCK, "The Hanging Chads of Corporate Voting", *The Georgetown Law Journal* 2008, Vol. 96, 1227, 1257.
[47] *Ibid*, 1258–263; A. SHEEHAN and J. C. COATES, "Proxy Plumbing Recommendation", Harvard Law School Forum on Corporate Governance, 10 September 2019, https://corpgov.law.harvard.edu/2019/09/10/proxy-plumbing-recommendation/#47b , (last par.) (accessed 21.09.2022).

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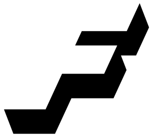

equivalent securities for voting purposes. Par. 8.1 of the GMSLA contains a clause stating that "subject to (…) the terms of the relevant Loan, [the] Lender shall be entitled to terminate a Loan and to call for the delivery of all or any Equivalent Securities at any time by giving notice on any Business Day of not less than the standard settlement time for such Equivalent Securities on the exchange or in the clearing organization through which the Loaned Securities were originally delivered". In practice, most stock loan agreements are 'open term', that is, with no set maturity date, so the loan will continue until one of the two parties decides to terminate it and the securities are returned. Open term agreements include a right of recall that can accommodate, for example, a lender's voting wishes. If, on the other hand, the maturity period is 'fixed' (i.e. a 'term' agreement), the shares on loan are only returned at the end of the term without a right to recall on the part of the lender. In a term contract, "the lender is not obliged to accept the earlier return of the securities; nor does the borrower need to return the securities early if the lender requests it".[48] While borrowers may prefer term agreements (in order to gain certainty about how long they can hold the shares), these come at the price of higher lending fees for the benefit of the lender. It must also be noted that for some programmes, such as Euroclear's automatic lending programme, term agreements are not an option since in any case, reimbursement of the shares takes place in the short to very short term (usually one day, or the next day).

11. Before entering in securities lending agreements, it is considered good practice for lenders to develop and communicate some kind of 'voting policy' that makes the exercise of the right to recall more predictable (to avoid confusion, this is actually a kind of 'recall policy', and it has nothing to do with voting instructions as discussed above, fn. 44-46).[49] These policies may range from (i) not voting (and thus recalling) the shares at all, (ii) only voting (and thus recalling) the shares for important matters (possibly with an indicative, but not exhaustive, list of subjects to be voted on), (iii) voting (and thus recalling) all shares at every voting opportunity.[50] It is also advised the lender maintains at least one share of a portfolio company

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[48] M.C. FAULKNER, *An Introduction to Securities Lending* (4th edition), London, Spitalfields Advisors Limited, 2007, p. 36. See also T. ADRIAN, B. BEGALLE, A. COPELAND and A. MARTIN, "Repo and Securities Lending", National Bureau of Economic Research Working Paper 18549, 2012, http://www.nber.org/papers/w18549 , p. 4 (accessed 21.09.2022); M. HAENTJENS, *Financial Collateral: Law and Practice*, Oxford, Oxford University Press, 2020, p. 115.

[49] See, for example, the 'best practice recommendations' set out by the Global Alliance of Securities Lending Associations ("GASLA"), a collaboration of leading global securities lending industry associations, GASLA, "Voting Practices and Shareholder Engagement", November 2021, https://www.paslaonline.com/downloads/esgresources/GASLA-Voting-Guide-202111-FINAL.pdf , p. 7 (accessed 21.09.2022).

[50] Based on M.C. FAULKNER, *An Introduction to Securities Lending* (4th edition), London, Spitalfields Advisors Limited, 2007, p. 49.

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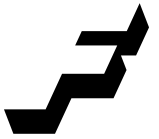

as a 'buffer' (i.e. *not* on loan) to ensure that he is directly – as a shareholder for voting purposes – and timely informed by the company of information leading up to the AGM (such as the notice of the general meeting and/or the record date).[51]

12. An alternative to ending the loan agreement upon a recall, whereby the borrower would be forced to return the shares on loan, is the reallocation of the outstanding loan to another lender. This is common practice in the industry.[52] A reallocation, initiated by the intermediary (i.e. the lending agent) changes the loan position from one lender to another, without any effect on the outstanding loan vis-à-vis the borrower. "The outright ownership position is never impacted, as custody position must [remain in place] in order to execute the change on loan position."[53] This is another advantage for big custodian banks with large client portfolios held in omnibus accounts since it is unlikely all clients would want to recall their shares at the same time.

3.3 Obstacles For Shareholders to Recalling Shares on Loan in the US Compared to the EU

13. Overall, securities lending transactions are generally presented as a low-risk, revenue generating activity. Despite its obvious benefits (not only to shareholders, but also to the market as a whole), shareholders should approach stock lending with some precaution, not least because of the common presence of intermediaries acting as lending agents and the ambiguity, and, at times, uncertainty stock lending creates for voting entitlements. Some areas of concern with respect to voting rights are highlighted here.[54]

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[51] *Ibid*. Some intermediaries, like Euroclear, voluntarily inform their clients on the announcement of general meetings for outstanding loans (so that the lender is informed and can send a recall instruction if it wishes to exercise the voting rights), but this seems to be more of a favour to the benefit of the lender (i.e., a kind of market practice), rather than an enforceable right. For this reason, it is highly advisable to keep at least one share in the custody account, in order to receive company information directly from the issuer (instead of waiting for the intermediary to pass it along in a timely manner).

[52] A finding that became evident after discussions with practitioners, see fn. 3.

[53] SECURITIES MARKET PRACTICE GROUP, "Securities Lending/Borrowing Settlement Market Practice", October 2016, https://www.smpg.info/fileadmin/documents/3_Settlement%20and%20Reconciliation%20WG/A_Final%20Global%20Market%20Practices/SMPG_MP_SR_Securities_Lending_and_Borrowing.pdf , p. 4 (accessed 21.09.2022).

[54] Advocates of securities lending have argued that corporate governance complications arising from securities lending are a result of the investor's free choice to engage in such practices: "Investors who agree to lend their shares to their securities intermediaries cannot have their cake and eat it", see THE EXPERT GROUP ON CROSS BORDER VOTING IN EUROPE, "Cross-border Voting in Europe: Final Report", August 2002 https://repository.wodc.nl/bitstream/handle/20.500.12832/1326/on2002-6-full-text_tcm28-67161.pdf?sequence=2&isAllowed=y , p. 47 (accessed 21.09.2022).

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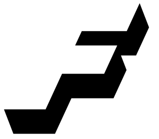

14. First, some institutional investors, by virtue of their fiduciary duties to their ultimate beneficiaries, will be pressured to reduce the costs of intermediation, for which stock lending fees are an obvious method.[55] In practice, the decision to recall shares on loan (and the expected benefits resulting from the exercise of voting rights) will always be weighed against the benefits resulting from an ongoing loan (i.e. the lending fee).

In addition, index funds (and their fund managers) are particularly exposed to governance risks when shares are being lent out. In practice, it has been observed that lending index fund portfolio shares often happens "without the option of retransferring for the general meeting".[56] The fee structure of fund managers also incentivises the decision not to recall the shares on loan for voting purposes, since the fund manager is sometimes remunerated by fees solely stemming from securities lending without any additional salary.[57]

15. Next, even when a securities lending agreement contains a recall clause – which is indeed almost always the case and considered good market practice[58] – it is argued by some that the actual exercise of the right to recall may not be as straightforward in practice as it is on paper and recalls are therefore met with a certain scepticism, even in the EU.[59] According to RINGE, in this respect three problems can arise.[60] Each of these should be nuanced, however, especially within the EU (when compared to the US).

First, exercising the recall clause does not necessarily mean that the lender will timely recover the shares, taking into account standard settlement cycles (T+2). It may also take some time for the borrower to have the securities available to redeliver them. Intermediaries generally counter this by pointing out that, while it is the lending agent's duty to inform its clients of the date at which the right to recall can be exercised at the latest, lenders bear the risk of failing to

[55] E. HU, J. MITTS and H. SYLVESTER, "The Index-Fund Dilemma: An Empirical Study of the Lending-Voting Tradeoff", The Center for Law and Economic Studies Columbia University School of Law, Working Paper No. 647, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3673531 , December 2020, p. 9 (accessed 21.09.2022).
[56] W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 50.
[57] *Ibid*, p. 47.
[58] "The ability for a lender to recall securities is a standard feature of industry securities lending contractual documentation", GLOBAL ALLIANCE OF SECURITIES LENDING ASSOCIATIONS, "Voting Practices and Shareholder Engagement", November 2021, https://www.paslaonline.com/downloads/esgresources/GASLA-Voting-Guide-202111-FINAL.pdf , p. 3 (accessed 21.09.2022).
[59] W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 45–47; J. BENJAMIN and L. GULLIFER, Stewardship and Collateral: The Advantages and Disadvantages of the No Look Through System, in L. GULLIFER and J. PAYNE (eds.), *Intermediation and Beyond*, Oxford, Hart Publishing, 2018, p. 230.
[60] Based on W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 45–47.

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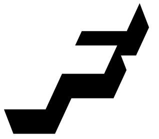

inform their agents of their wishes in this regard in good time.[61] Another sore point related to this timetable, especially in the US, is that recalling shares may conflict with the proxy voting timeline. In the US, the agendas of AGM's (i.e. the matters to be voted upon), which are part of companies' proxy statements, are generally not distributed to investors *before* the record date.[62] This is because there is currently no obligation for public companies to file proxy statements *before* the record date. This leaves lenders in the US at the real risk of not knowing if a recall for voting purposes is useful – a problem referred to as 'hidden agendas'.[63] A recent empirical analysis in the US found "for 88% of shareholder votes, investors are unable to find out what questions they will be voting on in time to decide whether they wish to vote on them"[64]. This sharply contradicts with most European jurisdictions, where the convocation of the annual general meeting generally includes the agenda (for example in Belgium, France and Germany[65]). It can be concluded, hence, that shares on loan from European listed companies would be recalled by investors in a more informed way, and in this respect EU national company laws are more suited to shareholders in their capacity of stock lenders.

Second, it is warned borrowers could be actively looking out for lending arrangements where the right to recall is *not* included (i.e. term agreements) [66], which has the potential of steering financial markets in a direction where the borrower is disadvantaged from a governance perspective. However, it should be noted that today, most lending agreements are still concluded on an open term basis, and there may be different reasons to opt for a term or open

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[61] According to the industry, these processes are nowadays highly automated and reduce any risks for lenders in this respect, provided that they exercise their right to recall in a timely manner.

[62] This is the result of the complex interplay between state corporate law rules (governing the record date) and federal securities laws (governing the filing of proxy statements). For a detailed explanation of how both timelines overlap in practice, see S. HIRST and A.Z. ROBERTSON, "Hidden Agendas in Shareholder Voting", Boston Univ. School of Law Research Paper, August 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3833304 , p. 10–13 (accessed 21.09.2022).

[63] C. CLOTTENS, "Empty Voting: A European Perspective", *ECFR* 2012, n°4, 477-478; S. HIRST and A.Z. ROBERTSON, "Hidden Agendas in Shareholder Voting", Boston Univ. School of Law Research Paper, August 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3833304 , 52p. See also the 'securities lending surprise' in relation to agenda-setting after the record date as described in M. KAHAN and E.B. ROCK, "The Hanging Chads of Corporate Voting", *The Georgetown Law Journal* 2008, Vol. 96, 1227, 1257.

[64] S. HIRST and A.Z. ROBERTSON, "Hidden Agendas in Shareholder Voting", Boston Univ. School of Law Research Paper, August 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3833304 , p. 2 (accessed 21.09.2022).

[65] Respectively, art. 7:129, §2 Wetboek Vennootschappen en Verenigingen (Belgium); Art. R225-66 Code de Commerce (France); §121(3) Aktien Gesetz (Germany). Also in the UK, Sec. 311(2) Companies Act 2006 stipulates the notice of a general meeting must state the general nature of the business to be dealt with at the meeting, and in practice, notices will accurately set out the actual resolutions to be considered at the AGM, accompanied by explanations, see L. KOSMIN QC and C. ROBERTS, *Company Meetings and Resolutions: Law, Practice, and Procedure* (third edition), Oxford, Oxford University press, 2020, p. 21.

[66] W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 45.

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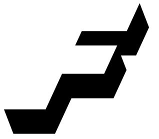

term contract on both sides (as discussed above, fn.48). What is more, lenders remain free to exclude term agreements from the authorization agreement with their lending agent.

Lastly, it has been suggested that actual exercise of the right to recall would damage the lender's reputation towards the borrower, which could impede future lending transactions and resultant fees.[67] While this may be true to some extent (from the borrowers' point of view, lenders may indeed differ in attractiveness depending on the limits they set in the authorization agreement with their lending agent), the impact may be mitigated by the mere fact that securities lending remains an ancillary service to investors. Over the years, borrowers have furthermore become aware of the increasing trend in shareholder engagement and activism and consequent recalls for these purposes – it could even be argued the borrower's image would be damaged to a much greater extent by a failure to return recalled shares in a timely manner. In practice, both in the US and in the EU, share recalls have become standard market practice and large intermediaries holding omnibus accounts prove useful in this respect, for example by providing reallocation of outstanding loans to other lenders (as discussed above, fn.52-53).

It is true, however, that most shares are only recalled in exceptional circumstances when voting stakes are particularly high.[68] In absolute terms, therefore, it is not surprising that in practice the recall rate of all outstanding lent shares remains relatively low.[69]

3.4 Empirical Findings And Input From The Industry

16. Recent empirical research has also revealed a number of sore points on the voting activity of investors that engage in securities lending. According to a study from 2022 analysing the securities lending and voting data for actively managed mutual funds in the US

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[67] "Funds' recall of securities might also reduce their potential securities lending income in the future because borrowers tend to borrow from lenders with a lower likelihood of recalling stocks", see J. XIE, "Are passive investors also passive voters? Evidence from securities lending by mutual funds", 28 February 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3754346, p. 16 (accessed 21.09.2022); RINGE speaks of a reputation as an "unreliable business partner", W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 46–47.

[68] W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 45. A finding confirmed by G. RAAIJMAKERS, "Securities Lending and Corporate Governance", Maastricht University Faculty of Law Working Paper, 2006, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=928312 , p. 11 (accessed 21.09.2022); P. SANTELLA, E. BAFFI, C. DRAGO and D. LATTUCA, "Legal Obstacles to Institutional Investor Activism in the EU and in the US", *European Business Law Review* 2012, Vol. 23(2), 257, 260; D. MARAIS, "Decoupling Voting Rights from Economic Interest: The Case of Empty and Negative Voting", *Trinity College Law review* 2015, Vol.18, 180, 188.

[69] W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 47. To the best of the author's knowledge, there is no recent data publicly available on the exact number of recalls.

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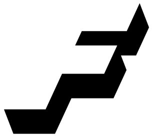

from 2005 to 2011, active mutual funds are more inclined to forego lending fees and recall their shares for voting purposes when their ownership stake in the stock is larger and thus, the potential to gain greater benefit from governance improvements increases.[70] This finding is in line with traditional free-riding theory about shareholder participation.[71] Adding to the free-riding problem, it has been argued that while the benefits of shareholder intervention are shared between all shareholders, the lending fee is foregone only by the intervening shareholder which in itself incentivises lending over voting.[72]

A slightly older study from 2015, using lending and voting data from 2007 to 2009 (on aggregate blockholders, mutual funds, banks and insurance companies, pensions and endowments, and long-term investors), furthermore found that recall is associated with more voting support for shareholder proposals and less for management proposals (e.g., those related to corporate control and compensation).[73] This finding confirms that shares on loan are recalled mainly in cases that are critical to activist shareholders, e.g., because the voting outcome may have a positive impact on the stock price that is greater than the lending fee (earned if the shares were not recalled). On the other hand, this study also shows that in the period prior to the record date, the lending supply is significantly lower.[74] A recent study from 2022, using securities lending data from 2014 to 2020, has also found that "the number of shares available to lend falls sharply a week or two before record dates before jumping back up the

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[70] J. XIE, "Are passive investors also passive voters? Evidence from securities lending by mutual funds", 28 February 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3754346, 53 p. (accessed 21.09.2022).
[71] Traditionally, it has been held that the willingness of a shareholder to intervene in a company increases with the holding stake, see A. SHLEIFER and R.W. VISHNY, "Large shareholders and corporate control", *Journal of Political Economy* 1986, Vol.94, 461–488. There is nevertheless a debate as to whether shareholding size is a determinant of shareholder engagement. MCCAHERY, SAUTNER and STARKS, for example, hypothesised in their research that "larger investors are more likely to have larger holdings in their portfolio firms, and larger holdings provide stronger engagement incentives because they allow an investor to keep a larger share of the benefits if engagement is successful." However, their qualitative (survey) research could not confirm this hypothesis and the size of an institutional investor was therefore not retained by the authors as a determinant for shareholder engagement. See J.A. MCCAHERY, Z. SAUTNER and L.T. STARKS, "Behind the Scenes: The Corporate Governance Preferences of Institutional Investors", *The Journal of Finance* 2016, Vol. 71(6), 2905–932. More generally, activists are probably the best example of actors who, with often a very small stake in a company, are nevertheless enormously involved and (have the potential to) bring about major changes in portfolio companies.
[72] E. HU, J. MITTS and H. SYLVESTER, "The Index-Fund Dilemma: An Empirical Study of the Lending-Voting Tradeoff", The Center for Law and Economic Studies Columbia University School of Law, Working Paper No. 647, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3673531 , December 2020, p. 4 (accessed 21.09.2022); J. MITTS, "The Price of Your Vote: Proxy Choice and Securities Lending", 11 October 2021, The CLS Blue Sky Blog, https://clsbluesky.law.columbia.edu/2021/10/11/the-price-of-your-vote-proxy-choice-and-securities-lending/ (accessed 21.09.2022).
[73] R. AGGARWAL, P.A.C. SAFFI and J. STURGESS, "The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market", *The Journal of Finance* 2015, Vol.70(5), 2309, 2309–346.
[74] *Ibid.*

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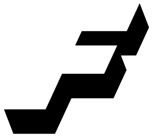

day after the record date".[75] The ISLA, too has confirmed that a lot of shares are increasingly being recalled in the period leading up to the record date.

Based on these findings, it thus seems justified to conclude that investors – regardless of any agreements with lending agents – nowadays have sufficient control over the outstanding number of shares on loan and seem to be (more) aware of the loss of voting rights that such lending causes, and – at least in the EU – are able to make informed decisions on the 'dilemma' between maintaining the loan, or voting (and thus recalling shares for that purpose).

4. *Activists as Stock Borrowers: Stock Lending as an Instrument for Activism*

17. On the other side of the lending equation are borrowers, i.e. those institutions that wish to acquire shares *temporarily* with the view to returning them in a later stage – a practice viewed as cheaper, quicker and less risky than the alternative of buying and re-selling shares. Several reasons may explain borrowers' interest in the stock lending supply, including settlement facilitation (for example, in automatic lending programs), short-selling and risk-decoupling (i.e. separating or decoupling the economic exposure of shares from formal legal ownership and subsequent voting rights). Risk-decoupling related to stock lending will generally take the 'negative' form: the shareholder "seeks to keep their entitlement to all formal shareholder rights (…), but attempts to exclude (or to limit) bearing the economic consequences"[76].

Since the (first) settlement motive is self-evident and does not present any corporate governance problems in practice, this section of the paper focuses on the latter two techniques. Borrowers are often hedge funds looking to reduce their economic risk associated with their equity portfolio[77] (as also recently confirmed by M. Lipton with regard to the US markets[78]), although borrowers may also include other types of shareholders[79]. In any case, it cannot be

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[75] S. HIRST and A.Z. ROBERTSON, "Hidden Agendas in Shareholder Voting", Boston Univ. School of Law Research Paper, August 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3833304 , p. 16–21 (accessed 21.09.2022).
[76] As opposed to 'positive risk-decoupling', where there is a greater economic exposure than the formal shareholder position, a strategy often used in takeover attempts but not discussed here, see W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 27.
[77] W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 23.
[78] In a recent update of the Wachtell Lipton memorandum on shareholder activism techniques, one of the attack devices of (hedge fund) activists is mentioned as "using stock loans, options, derivatives and other devices to accumulate positions secretly, announce surprisingly large, leveraged economic stakes or increase voting power beyond the activist's economic equity investment", see M. LIPTON, "Wachtell Lipton on Dealing with Activist Hedge Funds and Other Activist Investors", The CLS Blue Sky Blog, 7 September 2022, https://clsbluesky.law.columbia.edu/2022/09/07/wachtell-lipton-on-dealing-with-activist-hedge-funds-and-other-activist-investors-3/ (accessed 21.09.2022).
[79] C. CLOTTENS, "Empty Voting: A European Perspective", *ECFR* 2012, n°4, 446, 452.

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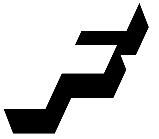

denied that it is often activist shareholders from whom borrowing demand comes to the lending market, and that it is often long-term shareholders (sometimes passive) who make part of their portfolio available to meet this demand. The existence and frequent use of the stock lending market, and the shift in voting entitlements that accompanies it, thus raises a number of corporate governance risks that require closer consideration.

18. The borrowing side (as well as some of the concepts used in this section) can be summarised by the following scheme.

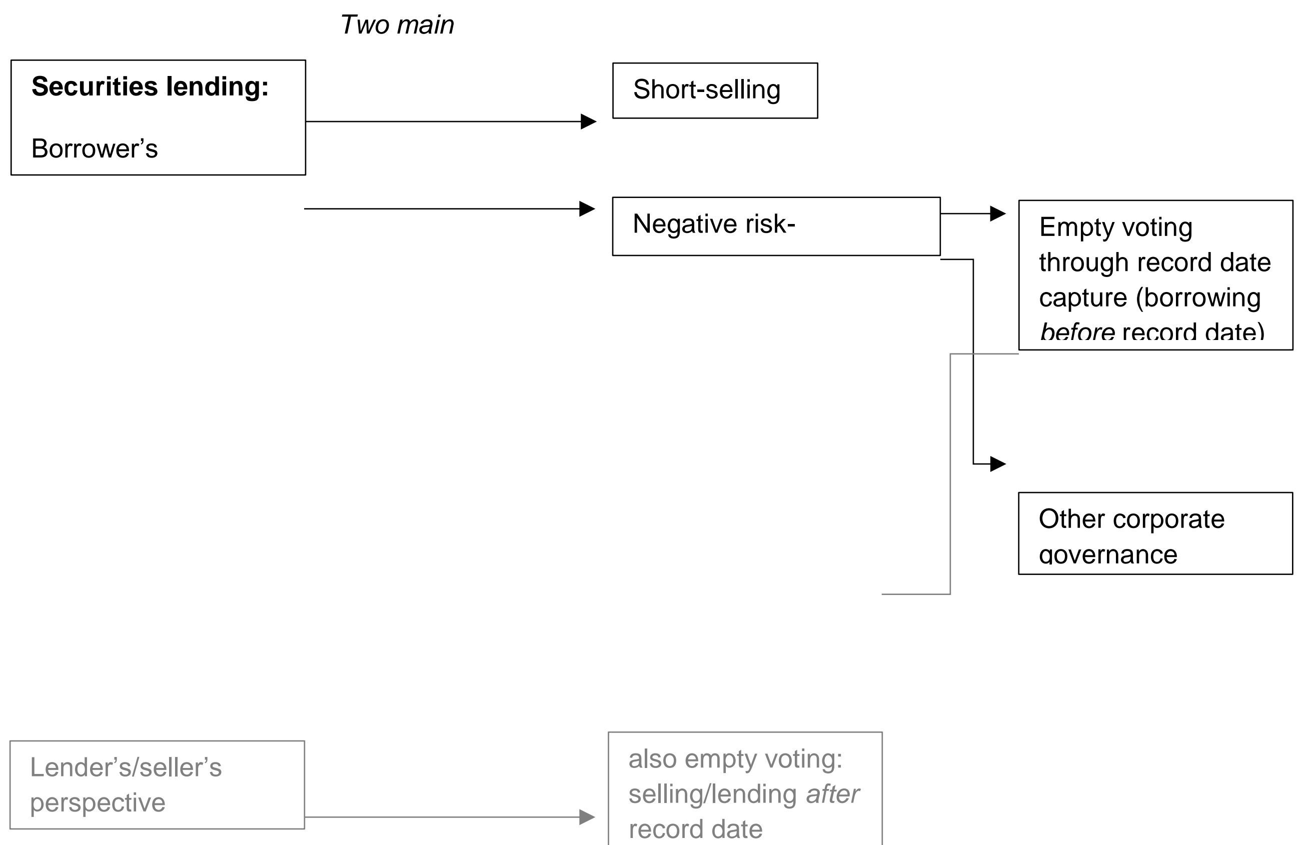

Figure 1. Strategies of activists as stock borrowers (author's creation).

'Negative risk-decoupling', 'empty voting' and 'record date capture' (see *supra*, 4.2-4.3) are concepts that have been established in the US and that have been widely researched and

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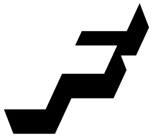

described in US literature.[80] One of the reasons for this is without a doubt the large time span between the record date (i.e. the date (and sometimes more specifically, the moment in time) at which it is established who are the eligible shareholders for the purposes of attendance to and voting at the general meeting) and the date of the general meeting (this timespan usually being between 30 and 60 days[81]). In the US, this creates a significant risk that economic ownership and voting power of shares will have become disconnected by the time of the general meeting.[82] For several reasons, however, it is worth contemplating the potential of these phenomena in European jurisdictions. Before doing so, another common strategy among activist borrowers, i.e. that of short-selling, will be examined.

4.1 Short-Selling and Negative Voting

19. Short selling is one of the primary purposes of securities lending transactions.[83] As discussed before (see *infra*, fn. 26), in neutral terms short selling can be defined as "the financial technique of "1) borrowing shares of a company owned by a long investor (…), 2) selling those shares in the market, and 3) repaying later the share loan by buying back the shares in the market"[84].[85] Short activism has the goal of profiting from a downward movement of the share price, by returning to the lender shares that the investor has bought back in the market at a lower price than he had first sold them.

Even though short-activism has a predominantly negative connotation (in part, due to its frequent use during the 2008-2009 global financial crisis which had the potential of

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[80] For prominent treatment of these issues, see H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", Southern California Law Review 2006, Vol.79, 811–908; A. BRAV and R.D. MATHEWS, "Empty Voting and the Efficiency of Corporate Governance", *Journal of Financial Economic* 2011, n°99, 289–307; S. CHRISTOFFERSEN, C.C. GECZY, D.K. MUSTO, and A.V. REED, "Vote Trading and Information Aggregation", The Journal of Finance 2007, Vol. 62 (2), 2897–929; M. KAHAN and E.B. ROCK, "The Hanging Chads of Corporate Voting", The Georgetown Law Journal 2008, Vol. 96, 1227, 1227–281.

[81] According to DGCL §213(a), the record date shall not be more than 60 nor less than 10 days before the date of the general meeting, but some exchanges like the NYSE recommend "that a minimum of 30 days be allowed between the record and meeting dates so as to give ample time for the solicitation of proxies", see Rule 401.03 NYSE Listed Company Manual.

[82] See R.F. BALOTTI, J.A. FINKELSTEIN, *Delaware Law of Corporations and Business Organizations* (4th edition), s.l., Wolters Kluwer, 2022-1 Supplement (§ 7.8 Voting).

[83] S. HIRST and A.Z. ROBERTSON, "Hidden Agendas in Shareholder Voting", Boston Univ. School of Law Research Paper, August 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3833304 , p. 7 (accessed 21.09.2022).

[84] C. BLOCK, "Muddy Waters Capital LLC's observations on the parliamentary mission report on activism submitted by the Finance, General Economy Control Commission of the French Parliament ("Assemblée Nationale") on October 2, 2019", 3 December 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3499127 , p. 4 (accessed 21.09.2022).

[85] 'Naked' or 'uncovered' short selling involves selling shares (short) that were *not* rightfully borrowed at the time of the short sale and has now been prohibited in the EU, see art. 12 ('Restrictions on uncovered short sales in shares') Regulation (Eu) No 236/2012 of the European Parliament and of The Council of 14 March 2012 on short selling and certain aspects of credit default swaps, *Oj.L.* 24 March 2012, ep. 86, 1-24.

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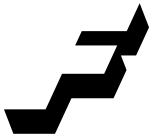

aggravating the downward spiral in stock prices[86]), the phenomenon in itself need not necessarily be viewed unfavourably in all cases. This is especially true in a situation where a company's share price is overvalued (i.e. deviates significantly from the company's fundamental value) and is in need of a downward correction to the benefit of all stakeholders.[87] Short sellers equally contribute to more information about companies in the market and short selling is even a technique to protect investors from risk (for example by holding part of a predominantly 'long' portfolio 'short').[88]

20. Short-selling bears the risk, on the other hand, of becoming problematic when shares are borrowed *before* the record date, voting rights are exercised with the aim to effectively reduce the company's value, and the shares are subsequently shorted (i.e. sold on the market and bought back at a reduced price once the share price has dropped, to return them to the lender). This phenomenon is labeled as 'negative voting', referring to the negative interest (opposite to that of long investors) of the shareholder exercising the voting right.[89] An example of such negative voting was described by BLACK and HU in 2006, when a couple of hedge funds borrowed Henderson Investment shares before the record date and voted against a buy-out at the general meeting. This way, they effectively blocked the buy-out, contrary to the expectations of the other shareholders and the market. Anticipating on the share price drop the outcome of the general meeting would cause, they then sold the shares short and profited from the share price drop caused by the buy-out they defeated themselves.[90]

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[86] See consideration (1) Regulation (Eu) No 236/2012 of the European Parliament and of The Council of 14 March 2012 on short selling and certain aspects of credit default swaps, *Oj.L.* 24 March 2012, ep. 86, 1-24.

[87] In his study on the agency costs of overvalued equity, JENSEN recommends that companies consult with short-sellers on a frequent basis on potential overvaluations, admitting that "establishing such practices would require abandoning the generally held belief that short sellers are evil and damaging to the firm", see M.C. JENSEN, "Agency Costs of Overvalued Equity", *Financial Management* 2005, Vol. 34(1), 5, 16. According to some short sellers, such as Muddy Waters, bankrupt companies often point the finger to short sellers as the cause of their declining stock price, when in fact such declines are primarily due to the loss of long-term investors' confidence in the company and the sale of their holdings for this reason, see C. BLOCK, "Muddy Waters Capital LLC's observations on the parliamentary mission report on activism submitted by the Finance, General Economy Control Commission of the French Parliament ("Assemblée Nationale") on October 2, 2019", 3 December 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3499127 , p. 9 (accessed 21.09.2022).

[88] C. BLOCK, "Muddy Waters Capital LLC's observations on the parliamentary mission report on activism submitted by the Finance, General Economy Control Commission of the French Parliament ("Assemblée Nationale") on October 2, 2019", 3 December 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3499127 , p. 7–8 (accessed 21.09.2022).

[89] J. COHEN, "Negative Voting: Why It Destroys Shareholder Value and a Proposal to Prevent It", *Harvard Journal on Legislation* 2008, Vol.45, 237, 245; D. MARAIS, "Decoupling Voting Rights from Economic Interest: The Case of Empty and Negative Voting", *Trinity College Law* Review 2015, Vol. 18, 180, 188.

[90] H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", *Southern California Law Review* 2006, Vol.79, 811, 834–835.

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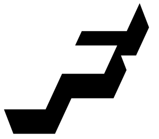

According to CLOTTENS, "negative voting (…) presents by far the greatest potential for inefficiency and welfare destruction"[91], a view shared by ESMA in its latest 2012 feedback statement in response to a call for evidence on empty voting in the EU[92]. Unfortunately, it remains difficult, and often impossible, for lenders to assess borrowers' intentions (other than based on the borrower's historical voting behaviour) before lending out their shares to them. For this reason, the lending decision remains a weighing of interests and is estimated by lenders according to their 'belief' in the long-term value of the shares.

4.2 Negative Risk-decoupling

21. A second, common strategy to engage in stock lending as a borrower is negative risk-decoupling, i.e. making the formal shareholder position greater than the underlying economic exposure. Negative risk-decoupling can be brought about by different financial techniques (such as the use of derivatives)[93], but for reasons of relevance only the risk-decoupling that is the result of borrowing shares is analysed here.

A. Formal Shareholder for Governance purposes (Other Than Voting Entitlement)

22. One of the reasons to borrow shares for the purpose of negative risk-decoupling is to meet minimum participation thresholds (in the company's capital) for bringing certain claims as a shareholder. These include thresholds for corporate internal remedies (e.g., the right to put items on the agenda of the general meeting and to table draft resolutions[94] or the right to call a general meeting[95]) and thresholds for remedies that require judicial intervention (e.g., bringing liability claims against directors[96]). Some of these remedies are especially relevant to

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[91] C. CLOTTENS, "Empty Voting: A European Perspective", *ECFR* 2012, n°4, 446, 451–452.
[92] "ESMA tends to agree (…) that the most risky practice related to empty voting is when an investor borrows shares (…) in order to vote in a way that is perceived to be against the long-term interest of the company and which may be with the objective of pursuing a personal gain from the trading position built up (often taking advantage from the share's price falling)", ESMA, "Feedback Statement: Call for Evidence on Empty Voting", 29 June 2012, https://www.esma.europa.eu/system/files_force/library/2015/11/2012-415.pdf , 6–7 (accessed 21.09.2022).
[93] For a discussion, see W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 28–36; H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", *Southern California Law Review* 2006, Vol.79, 811–908.
[94] See art. 6 SRD I (EU) and art. 7:130 WVV (for the Belgian Public Limited Company (NV), requiring shareholders who together hold at least 3% of the capital of a listed company).
[95] Art. 7:126 WVV (for the Belgian Public Limited Company (NV), including an obligation for the board of directors to convene the general meeting and set its agenda within three weeks when shareholders representing one-tenth of the capital request it, with at least the agenda items proposed by the shareholders concerned.)
[96] See for the Belgian Public Limited Company (NV) art. 7:156 WVV (the *actio mandati* or *vennootschapsvordering* – requiring a simple majority at the general meeting) or art. 7:157 WVV (the 'minority shareholders' claim' – *minderheidsvordering* – requiring, on the day the general meeting decides on the discharge to be granted to the

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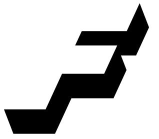

minority shareholders – including activists who, more often than not, hold relatively small stakes in target companies.

The possibility of exercising information rights as a shareholder seems a less relevant motive for stock borrowing, since in the EU, no thresholds have been set for these (e.g. the right to ask questions on the general meeting is vested in "any" shareholder, regardless of the size of their holding[97]).

An illustration of stake-building through stock lending for the purpose of meeting thresholds as a shareholder is the *Lindner* case, decided before the German Federal Supreme Court in 2009.[98] In this case, a shareholder (initially holding about 62% of the share capital) borrowed shares from his fellow shareholders to acquire a holding of 95% of the company's capital, which was the threshold for initiation of a squeeze-out procedure in accordance with §327a *Aktiengesetz*. Although the squeeze-out was challenged by some minority shareholders, it was ultimately upheld by the *Bundesgerichtshof*.[99]

23. Admittedly, stakes in a target company can also be expanded by borrowing shares for the purpose of informal, 'behind-the-scenes' engagements with members of the board or management.[100] As a shareholder expands his voting power through borrowed shares, he increases his bargaining power. In practice, the threat of casting a public, negative vote at the general meeting has proved an effective pressure tool to push through significant changes in target companies (even before the general meeting).[101]

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directors, shareholders to hold securities representing at least 1% of the votes attached to all the securities existing on that day, or hold on the same day securities representing a portion of the capital worth at least EUR 1 250 000).

[97] See art. 9 SRD I and art. 7:139 WVV (for Belgium).

[98] Bundesgerichtshof, judgment of 16 March 2009 (II ZR 302/06), Entscheidungen des Bundesgerichtshofes in Zivilsachen 180, 154.

[99] See also E. CULINOVIĆ-HERC, A. ZUBOVIĆ, "Tackling Empty Voting in the EU: The Shareholders' Rights Directive and the Revised Transparency Directive", *Croatian Yearbook of European Law and Policy* 2015, Vol.11(1), 133, 141; W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 39.

[100] J.A. MCCAHERY, Z. SAUTNER and L.T. STARKS, "Behind the Scenes: The Corporate Governance Preferences of Institutional Investors", The Journal of Finance 2016, Vol. 71(6), 2905–932. This bargaining power is also recognised by W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 38–39.

[101] L. VAN MARCKE, "Shareholder engagement (SRD II) : zin en onzin : aandeelhoudersbetrokkenheid als regelgevend antwoord op bekommernissen van short-termism", *TRV/RPS* 2021, n°8, 829, 841.

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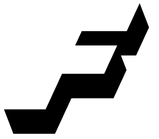

B. Formal Shareholder to Exercise Voting Rights: 'Empty Voting'

24. As indicated by HU and BLACK, "omit the short sale, and share borrowing becomes an easy route to empty voting"[102]. 'Empty voting' refers to the most extreme form of negative risk-decoupling, i.e. that of *full* depletion of risk – in such a case, the shareholder is completely 'emptied', so to speak, from any economic consequences related to the shares while retaining the voting rights.[103] Borrowers may find themselves in (or actively steer themselves towards) a situation of empty voting when they borrow shares shortly *before* the record date, so that they become the shareholder entitled to exercise the voting rights (by holding title to the shares on the decisive record date). After the record date, the borrowed shares can be returned to the lender without affecting the voting entitlement at the AGM in any way.[104] A similar, yet slightly riskier position can be brought about by buying (instead of borrowing) the shares before the record date, and subsequently selling them shortly after.[105] This strategy is also referred to as 'record date capturing'.[106]: on the record date, the shareholder 'seizes' the voting rights of shares he will dispose of prior to the meeting (by returning them to the lender, resp. selling them on the market), allowing him to vote at the general meeting without any economic exposure (i.e. empty voting).

25. It should be noted, however, that record date capture does not necessarily have to be accompanied by empty voting at the general meeting. Should the shareholder still hold a block

[102] H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", *Southern California Law Review* 2006, Vol.79, 811, 833.
[103] E. ĆULINOVIĆ-HERC, A. ZUBOVIĆ, "Tackling Empty Voting in the EU: The Shareholders' Rights Directive and the Revised Transparency Directive", *Croatian Yearbook of European Law and Policy* 2015, Vol.11(1), 133, 135; D. MARAIS, "Decoupling Voting Rights from Economic Interest: The Case of Empty and Negative Voting", *Trinity College Law Review* 2015, Vol. 18, 180, 183; W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 27–28. Empty voting can also have another, less common meaning: for example (according to the author, an analogy with empty voting by hedge funds), it can refer to the voting behaviour of mutual funds (or their management) that are formally entitled to exercising voting rights of portfolio shares, but that do not themselves hold the underlying beneficial ownership (which lies with the underlying investors of the fund). For such 'mutual fund empty voting' which essentially amounts to the broader principal-agent problem of institutional investors, see J.E. FISCH, "Mutual Fund Stewardship and the Empty Voting Problem", *Brooklyn Journal of Corporate, Financial & Commercial Law* 2021, Vol.16(1), 71–96.
[104] "Between the record date and actual voting date, securities may be sold or lent, but the right to exercise the attached voting rights is retained by the seller or lender", N. RACHMAN and M. VERNAAS, "Corporate Actions in the Intermediated System: Bridging the Gap between Issuer and Investor", in T. KEIJSER (ed.), *Transnational Securities Law*, Oxford, Oxford University Press, 2013, p. 153.
[105] H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", *Southern California Law Review* 2006, Vol.79, 811, 835.
[106] E. ĆULINOVIĆ-HERC, A. ZUBOVIĆ, "Tackling Empty Voting in the EU: The Shareholders' Rights Directive and the Revised Transparency Directive", *Croatian Yearbook of European Law and Policy* 2015, Vol.11(1), 133, 136; W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 52–58; D. MARAIS, "Decoupling Voting Rights from Economic Interest: The Case of Empty and Negative Voting", *Trinity College Law* Review 2015, Vol. 18, 180, 189–90; H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", *Southern California Law Review* 2006, Vol.79, 811, 832–35.

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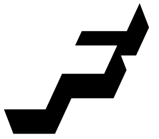

of his own shares, on top of which he has increased his voting power through record date capture, he will be voting at the general meeting in a negative risk-decoupled way, but not completely 'empty'.[107] For example, both in the *Mediobanca* and *Laxey/British Land* cases (discussed below, fn. 117-128), the borrower already held shares in the company *prior* to increasing its voting power through a stock lending transaction. Since there was still some economic exposure in both cases, albeit less than the formal voting position, the vote cannot be considered 'empty' but merely reflects a situation of negative risk-decoupling in combination with a record capture strategy.[108]

26. A situation of empty voting may, on the other hand, also occur in a more incidental and unintentional way as a logical and inevitable consequence of the record date system. This is the case where a shareholder sells or lends out its shares *after* the record date (i.e. in the period between the record date and the general meeting) (see **Figure 1**). The prevailing view in the literature[109], among market authorities (such as ESMA[110]) and practitioners[111] is that such cases of empty voting are inevitable, but much less harmful. Many cases of empty voting take this (less harmful) form. For this reason, prohibiting empty voting would not be desirable.[112]

27. In spite of the development of some arguments to defend empty voting (e.g., that it has the potential to overcome shareholder passivity on the lending side[113]), the overall consensus by scholars is that empty voting is, more often than not, a harmful practice. The main reason

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[107] Despite the confusion in this regard in some literature (with a different use of the term 'empty voting'), see for example J.M. BARRY, J.W. HATFIELD and C.D. KOMINERS, "On Derivatives Markets and Social Welfare: a Theory of Empty Voting and Hidden Ownership", *Virginia Law Review* 2013, Vol. 99(6), 1103, 1127.

[108] Admittedly, some of the confusion comes from different definitions adopted in literature. HU and BLACK define empty voters as "persons whose voting rights substantially *exceed* their net economic ownership", thus referring to full *or* partial decoupling. In the author's view, it seems more advisable to make a clear distinction between empty voting as (according to RINGE) "complete risk depletion" (i.e., full decoupling from economic interests) and other negative risk-decoupling situations that reflect *reduced* risk. This approach is also taken by E. ĆULINOVIĆ-HERC, A. ZUBOVIĆ, "Tackling Empty Voting in the EU: The Shareholders' Rights Directive and the Revised Transparency Directive", Croatian Yearbook of European Law and Policy 2015, Vol.11(1), 133, 135; W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 27–28. See for their definition also H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", *Southern California Law Review* 2006, Vol.79, 811, 825.

[109] E.g., W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 52.

[110] ESMA, "Feedback Statement: Call for Evidence on Empty Voting", 29 June 2012, https://www.esma.europa.eu/system/files_force/library/2015/11/2012-415.pdf ,p. 9 (accessed on 21.09.2022).

[111] Cf. interviews with practitioners, fn. 3.

[112] Whereas the borrower would normally become entitled to exercise the voting rights of the borrowed shares, in this case the voting rights remain with the lender (who was, after all, the voting shareholder on the record date and remains untouched by subsequent transfers of the shares). As explained above, at fn. 44-46, voting instructions are not a viable solution here.

[113] D. MARAIS, "Decoupling Voting Rights from Economic Interest: The Case of Empty and Negative Voting", *Trinity College Law Review* 2015, Vol. 18, 180, 190-191. For other potential benefits of risk-decoupling, see J.M. BARRY, J.W. HATFIELD and C.D. KOMINERS, "On Derivatives Markets and Social Welfare: a Theory of Empty Voting and Hidden Ownership", *Virginia Law Review* 2013, Vol. 99(6), 1103, 1124–129.

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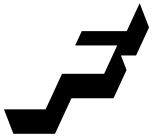

for this is that the exercise of voting rights without any underlying economic exposure may prove harmful to other shareholders and stakeholders. Indeed, the shareholder passivity argument presupposes that voting rights are exercised in a manner that benefits all shareholders as a group, which is not necessarily the case.[114] Empty voting further touches on a fundamental concept inherent to company law that voting power is principally attributed on the basis of financial risk taking, and for this reason also raises reluctance from a 'moral' point of view. Many industry groups and codes of conduct in securities lending have explicitly stated that shares should not be borrowed for the sole purpose of exercising voting rights.[115] The UK has even banned this practice (see below, fn. 148). Interviews with practitioners equally revealed that such borrowing intentions are strongly frowned upon. The GMSLA even includes a representation and warranty on the part of the borrower that "it is not entering into a Loan for the primary purpose of obtaining or exercising voting rights in respect of the Loaned Securities" (art. 14, (e) GMSLA). Still, in terms of enforceability it should be stressed these are "only (…) best-endeavor obligation[s], and one should not be overly optimistic about the result"[116] To date, there is no European legislation that prohibits such practices.

In practice it does happen that shares are borrowed with the main or sole aim of increasing the shareholder's voting power at the AGM and deliberately engaging in empty voting. This is demonstrated by a very recent case in the EU, which received a lot of media attention but has (to the author's best knowledge) not yet been discussed in the context of securities lending and resulting corporate governance concerns.

4.3 Empty Voting and Record Date Capture in Practice

A. Mediobanca/Generali

28. A recent case that caused a great deal of controversy was the increase of voting power of shareholder Mediobanca, a Milanese investment bank, in Assicurazioni Generali, a leading Italian insurance company (hereafter: "Generali"). On 23 september 2021, Mediobanca, who

[114] D. MARAIS, "Decoupling Voting Rights from Economic Interest: The Case of Empty and Negative Voting", *Trinity College Law* Review 2015, Vol. 18, 180, 192–193; W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 41–43.
[115] GASLA, "Voting Practices and Shareholder Engagement", November 2021, https://www.paslaonline.com/downloads/esgresources/GASLA-Voting-Guide-202111-FINAL.pdf , p. 7 (accessed 21.09.2022); INTERNATIONAL CORPORATE GOVERNANCE NETWORK, "ICGN Guidance on Securities Lending", 2016, https://www.icgn.org/sites/default/files/2021-06/ICGN068_Guidance_On_Securities_Lending_24pp_AUG16-v3_0.pdf , p. 16 ('Improper borrowing and lending practices') (accessed on 21.09.2022).
[116] G. RAAIJMAKERS, "Securities Lending and Corporate Governance", Maastricht University Faculty of Law Working Paper, 2006, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=928312 , p. 8 (accessed 21.09.2022).

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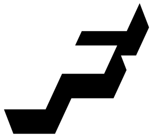

held just under 13% of Generali's capital, announced it had engaged in a securities lending transaction for 4.42% of Generali's shares, with the goal of increasing its voting power for the next general meeting. To this end, Mediobanca announced the transaction would have a duration of "approximately eight months, or, without prejudice to the foregoing, until at least the Annual General Meeting of Assicurazioni Generali called to reappoint the company's Board of Directors"[117]. Responding to rising criticism, Mediobanca published a second press release in April 2022 to defend its position, arguing "the aim of the (…) securities lending transaction is to protect its proprietary investment" and "it is fully legitimate to exercise at the Annual General Meeting of Assicurazioni Generali to be held shortly the voting rights in respect of the shares borrowed".[118] On 29 April 2022, Generali's AGM took place and it appeared Mediobanca had effectively increased its voting rights to a total of 17.2%, despite heavy criticism during the run-up to the AGM.[119]

The goal of the increase in voting power through stock lending was the re-election of Generali's CEO Philippe Donnet at the general meeting, "whose leadership was under challenge from a number of shareholders that opposed Donnet's re-election for a third term"[120]. The counterparty of the loan (i.e. the lender) was, amongst others, French Bank BNP Paribas. The loan agreement was covered by a strict confidentiality agreement, but later on, word came out in the Italian financial press that "the securities loan [had relieved] the French bank, and some transalpine institutions, of the embarrassment of having to vote for (or even worse, *against*) Philippe Donnet, a manager who began his career at Axa and for years at the head of a rival like Generali".[121] At the general meeting, Mediobanca ensured Donnet's re-election. In May 2022, Mediobanca's stake decreased below 13% after returning the borowed shares.[122]

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[117] MEDIOBANCA, "Press Release", 23 September 2021, https://www.mediobanca.com/en/media-relations/press-releases/press-release.html (accessed 21.09.2022).
[118] MEDIOBANCA, "Press Release", 11 April 2022, https://www.mediobanca.com/en/media-relations/press-releases/comunicato-stampa-11-aprile.html (accessed 21.09.2022).
[119] See S.S. BORRELLI and I. SMITH, "Insurer Generali faces new test as bitter battle for control nears climax", *Financial Times* 26 April 2022.
[120] SECURITIESFINANCETIMES, "Empty voting: back in the spotlight?", 5 July 2022, https://www.securitiesfinancetimes.com/specialistfeatures/specialistfeature.php?specialist_id=560&navigationaction=features&page=&newssection=features (accessed 21.09.2022).
[121] S. BENNEWITZ, "Mediobanca, assist francese. E' Bnp Paribas a prestare il 4,3% di Generali a Nagel", 29 September 2021, https://www.repubblica.it/economia/2021/09/29/news/generali-320019933/ (accessed 21.09.2022).
[122] REUTERS, "Mediobanca's stake in Generali drops back to just under 13% after AGM win", 18 May 2022, https://www.reuters.com/markets/europe/mediobancas-stake-generali-drops-back-just-under-13-after-agm-win-2022-05-18/#:~:text=MILAN%2C%20May%2018%20(Reuters),regulatory%20filing%20showed%20on%20Wednesday (accessed 21.09.2022).

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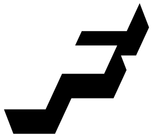

29. Mediobanca's actions as a borrower were heavily condemned by the industry, including the ISLA ("[it is] disappointing to recently see the open use of securities lending to gather votes ahead of a public AGM"[123]), emphasizing the reputational damage this type of activity may have on the securities lending industry. Institutional Shareholder Services added that Mediobanca's "questionable practice of borrowing shares . . . brings back memories of high-profile 'empty voting' cases from the 2000s"[124]. On the occasion, the industry reminded borrowers that bolstering voting power through securities lending violates many securities lending conduct rules (see above, fn. 115), but otherwise stood by helplessly in the absence of regulation (see below, and above, fn. 116).

30. From a legal perspective, a situation comparable to the *Mediobanca* case could also occur in Belgium. In European jurisdictions, it would generally be expected there is less opportunity for abusive record date capture than in the US since there is a shorter time span between the record date and the date of the general meeting (according to article 7(3) SRD I, not more than 30 days). Italian companies, such as Generali, face a comparatively 'late' record date of 7 trading days before the AGM (art. 83sexies(2) Italian Securities Act). While one would theoretically expect this to deter empty voting, the *Mediobanca* case exposes an ongoing risk of record day capture and subsequent empty voting. Since Belgium has installed an even longer time span between the record day and the AGM, namely 14 days (art. 7:134, §2 WVV), the same risk prevails and may be even greater than in Italy.[125]

What is more, both in the EU and the US, lenders generally lack insight into the identity, intentions and reputation of borrowers because lending occurs automatically within set parameters, meaning individual loans are not checked *ex ante* for manipulations.[126] Lenders may not become aware of voting manipulations until *after* the voting has taken place and are thus at risk of not recalling shares in manipulative situations.

B. Laxey Partners/British Land

31. As the ISS mentioned, record date capture situations have occurred before. The first notorious case is definitely the 2002 *Laxey Partners/British Land* case, in which the hedge fund

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[123] A. DYSON, "Reflections of the CEO", 26 May 2022, https://www.islaemea.org/blog/reflections-of-the-ceo-16/ (accessed 21.09.2022).
[124] See S.S. BORRELLI and I. SMITH, "Insurer Generali faces new test as bitter battle for control nears climax", *Financial Times* 26 April 2022.
[125] Although to the author's best knowledge, this has not yet materialised in a publicly available case in Belgium.
[126] D. MARAIS, "Decoupling Voting Rights from Economic Interest: The Case of Empty and Negative Voting", *Trinity College Law* Review 2015, Vol. 18, 180, 188.

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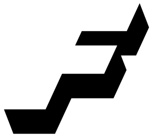

Laxey Partners (holding 1% in British Land) increased its voting power to nine times its economic exposure (i.e. to 9%) by borrowing almost 42 million shares.[127] In this way, Laxey Partners tried to put a hold on the re-election of the British Land chairman at the general meeting (though Laxey failed to do so). According to HU and BLACK, this case was "the first publicly reported instance" of record date capture.[128]

C. Other Empirical Findings Related To Activism: The Emergence of a Trend?

32. In addition to these incidents (and others, not discussed here[129]), the question can rightly be asked whether record date capture and empty voting are widespread phenomena, particularly in the EU. In sum, empirical studies that conclude record-date capture and empty voting are common occurrences, are relatively old and primarily US-focused.[130] By sharp contrast, practitioners in the EU (both those from the 2011 ESMA's call for evidence, as those from recent interviews) are convinced that both phenomena are less common in the EU – especially the more harmful practice of purposely borrowing shares to increase voting power and manipulate voting outcomes.[131] Recent, conclusive data demonstrating the occurrence of record date capture and/or empty voting in the EU is unfortunately lacking because these strategies often remain under the radar.

[127] H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", *Southern California Law Review* 2006, Vol.79, 811, 817; J.M. BARRY, J.W. HATFIELD and C.D. KOMINERS, "On Derivatives Markets and Social Welfare: a Theory of Empty Voting and Hidden Ownership", *Virginia Law Review* 2013, Vol. 99(6), 1103, 1127; W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 40.

[128] H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", *Southern California Law Review* 2006, Vol.79, 811, 817.

[129] For example, see *P&O Princess Cruises plc and Carnival Corporation* as discussed by W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 40; see *Henderson Land* as discussed by H.T.C. HU and B. BLACK, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership", *Southern California Law Review* 2006, Vol.79, 811, 834; see *Mylan Pharmaceuticals*, P. ALI, I. RAMSAY and B. SAUNDERS, "Securities lending, empty voting and corporate governance", *Law and Financial Markets Review* 2014, Vol.8(4), 326, 337 (fn. 8); S.M. HAAS, "SEC Resolves Empty Voting Action Involving King-Mylan Merger", Harvard Law School Forum on Corporate Governance, 19 August 2009, https://corpgov.law.harvard.edu/2009/08/19/sec-resolves-empty-voting-action-involving-king-mylan-merger/ (accessed 21.09.2022).

[130] For example, a study from CHRISTOFFERSEN et al. analyses US data from November 1998 until October 1999 and found that securities lending (borrowing) significantly increases around the record date, see S. CHRISTOFFERSEN, C.C. GECZY, D.K. MUSTO, and A.V. REED, "Vote Trading and Information Aggregation", *The Journal of Finance* 2007, Vol. 62 (2), 2897–929; T.C. HU and B.S. BLACK, "Equity and Debt Decoupling and Empty Voting II: Importance And Extentions", *University of Pennsylvania Law Review* 2008 Vol. 156(3), 625–739. For an overview of empirical evidence, see P. ALI, I. RAMSAY and B. SAUNDERS, "Securities lending, empty voting and corporate governance", *Law and Financial Markets Review* 2014, Vol.8(4), 326, 329; W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 70–74.

[131] ESMA, "Feedback Statement: Call for Evidence on Empty Voting", 29 June 2012, https://www.esma.europa.eu/system/files_force/library/2015/11/2012-415.pdf , p. 9 (accessed 21.09.2022).

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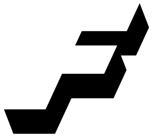

33. Even when it is difficult (in the absence of conclusive empirical evidence) to observe a shift towards fewer cases in the EU, such a conclusion would be consistent with the rise in shareholder engagement and shareholder activism over the last years. In effect, recalling shares for the purpose of exercising voting rights is now a widespread practice in securities lending markets. It can be assumed that 'active' shareholders will increasingly strive to exercise voting rights themselves, and, hence, recall their shares before the record date or make their shares unavailable around that period – especially with the *Mediobanca* case in mind. Where lenders may have been less vigilant in the past[132], they can be expected to be more so today. It is the author's prediction that, in line with growing shareholder activism which is now also increasingly sustainability- and ESG-focused, fewer and fewer securities will become available to lend around registration dates. Nevertheless, it is vital that the link between securities lending markets and voting rights continues to receive attention, and the ISLA's efforts in this area should be encouraged. After all, the *Mediobanca* story demonstrates a continuing risk to shareholders. Abuse is never far away. While for the time being, the *Mediobanca* case may not illustrate a 'trend' in the EU, it cannot be considered an isolated case either. Rather than a theoretical hypothesis, it is realistic to presume that such practices can *and will* occur in the future and raise significant ethical and corporate governance concerns within listed companies.

4.4 Regulatory Concerns

34. Over the past few years, securities lending transactions have increasingly been included in the (European) legislator's transparency framework – first more ambiguous, later more pronounced. For some time, art. 10 (b) of the Transparency Directive[133] has mandated a transparency notification of the acquisition or disposal of voting rights (in accordance with the thresholds of art. 9) when "voting rights [are] held (…) under an agreement (…) providing for the temporary transfer for consideration of voting rights". According to the European Commission as well as the industry, art. 9 and 10 (b) together implicitly included stock lending agreements and , hence, triggered a notification duty on the part of the lender and the

[132] Cf. The *Laxey Partners/British Land* case, where the lenders (long-term institutional investors) were totally in the dark on Laxey's borrowing and voting intentions and later on apologised to British Land.

[133] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, *Oj. L.* 31 December 2004, ep. 390, 38-57.

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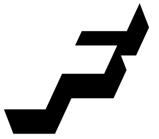

borrower.[134] Most European member states – like Germany[135], the UK[136] and Belgium[137] – adopted this approach in their implementation of the transparency directive. Some member states, like France, took a different view. In 2010, France explicitly installed a mandatory regime for shareholders temporarily holding shares amounting to 0.5% of the voting rights (which includes borrowers), to notify the issuing listed company and the French supervisor (AFM), with the sanction of losing the right to vote in the absence of such notification (art. L22-10-48 of the *Code de Commerce*[138]).

What is remarkable about the transparency regulatory framework is that a notification by a shareholder (even when that shareholder is a borrower) of its acquisition of a certain percentage of a listed company's voting rights (according to the thresholds of art. 9), says nothing about that shareholder's (borrower's) underlying economic exposure – which could effectively be decoupled, for example by means of securities lending.[139] The French system seems to differ from this in that the issuer itself must become informed that the borrower is holding the shares only 'temporarily', so that a situation of negative risk-decoupling may well be suspected by the market.

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[134] EUROPEAN COMMISSION, "COMMISSION STAFF WORKING DOCUMENT The review of the operation of Directive 2004/109/EC: emerging issues", COM(2010)243, 27 May 2010, https://www.europarl.europa.eu/registre/docs_autres_institutions/commission_europeenne/sec/2010/0611/COM_SEC(2010)0611_EN.pdf , p. 81 (accessed 21.09.2022) ; MAZARS, "Transparency Directive Assessment Report", https://www.mazars.be/content/download/40806/998379/version/3/file/Transparency_Directive_Assessment_Report.pdf , p. 123–25 (accessed 21.09.2022).

[135] See art. 21 and 25 a *Wertpapierhandelsgesetz*; E. CULINOVIĆ-HERC, A. ZUBOVIĆ, "Tackling Empty Voting in the EU: The Shareholders' Rights Directive and the Revised Transparency Directive", Croatian Yearbook of European Law and Policy 2015, Vol.11(1), 133, 154–155.

[136] This was not always the case. In the initial transposition of the Transparency Directive, the UK exempted lenders from the requirement to disclose stock lending transactions (DTR5.1.1R(5)), but this provision (together with DTR5.1.3R(6)) was deleted in 2015. See for the changed policy, https://www.fca.org.uk/publication/consultation/cp15-11.pdf , p. 21–23 (accessed 21.09.2022); see for the amendments, FCA, "Disclosure and Transparency Rules Sourcebook (Transparency Directive Amending Directive) Instrument 2015", 5 November 2015, https://www.handbook.fca.org.uk/instrument/2015/FCA_2015_54.pdf , p. 9–11 (accessed 21.09.2022).

[137] Belgium opted for a directive-compliant transposition. In the explanatory memorandum for the conversion of art. 10 (b) of the Transparency Directive, the legislator describes the case where the voting rights of shares are transferred, without the securities themselves being transferred. In such a case, both the transferor and the acquirer are under a notification obligation. If we may follow the intention of the European regulator, art. 10 (b) is not limited to such a situation only, but also covers stock lending agreements where both the shares, and the voting rights, are transferred to the acquirer. By analogy, it can then be concluded that, also in the case of stock lending agreements, Belgium has opted for a notification obligation for both parties. See *Parl. St.* Kamer 2007, nr. 51 2963/001 (Wetsontwerp op de openbaarmaking van belangrijke deelnemingen in emittenten waarvan aandelen zijn toegelaten tot de verhandeling op een gereglementeerde markt en houdende diverse bepalingen), p. 26–27.

[138] Previously art. L225-126 of the *Code de Commerce*.

[139] For this reason, Ringe proposes an attractive amendment to the Transparency Directive in the form of a 'notification of risk-modifying agreements', see for his proposal W. RINGE, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance*, Oxford, Oxford University Press, 2016, p. 193.

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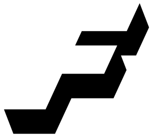

Another sore point is that the borrower does not have to disclose to the market its intentions for borrowing shares. While there are legitimate reasons to borrow shares, other strategies are arguably less desirable (e.g., to engage in negative voting as a short seller, or record date capture for the purpose of empty voting). These uses of securities lending cannot be detected by the existing regulatory framework.[140]

35. A relatively new and far-reaching EU transparency mechanism related to inter alia securities lending was installed in 2015 by the Securities Financing Transactions Regulation ('SFTR')[141], whose disclosure obligations only entered into force on 13 July 2020[142], 12 October 2020 and 11 January 2021. SFTR now requires counterparties[143] to a SFT to report the conclusion, modification or termination of a SFT to a trade repository within one day (T+1).[144] Whereas the Transparency Directive left room for doubt as to the person who should report a lending transaction, SFTR installs the principle of 'dual-sided reporting', meaning both lenders and borrowers must now disclose their side of the lending transaction to a trade repository who matches them according to the 'unique transaction identifiers' (UTI's) that are included in their submissions. Reporting obligations are generally delegated to lenders' and borrowers' lending agents.[145] SFTR has had a huge impact on the industry[146], especially in terms of standardization.[147] These transparency reports do not address the motivations of borrowers either, and the securities lending data is not shared with the market. The SFTR-disclosures to trade repositories, however, facilitate the large-scale data collection on SFTs, which can be shared with (national) market authorities (e.g. ESMA) (art. 12 SFTR). The main purpose of SFTR was thus to provide regulators with a clear view of the current risk exposures that remain in the market and to use the collected data to identify major shifts and trends in SFT's.

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[140] The lack in transparency "in terms of who is the ultimate borrower and for what purpose they are borrowing the stock" was also condemned in P. MADIGAN (BNY Mellon), "Stock Lending: Dispelling the Myths", January 2020, https://www.bnymellon.com/us/en/insights/aerial-view-magazine/stock-lending-dispelling-the-myths.html (accessed 21.09.22).
[141] See Regulation (EU) 2015/2365, *supra* fn. 12.
[142] The first phase of the reporting obligation was to become applicable on 11 April 2020, but was postponed by ESMA due to the COVID-19 crisis.
[143] A counterparty to a SFT is subject to SFTR-reporting when it is established in the EU, "including all its branches irrespective of where they are located", or if it is established in a third country, when "the SFT is concluded in the course of the operations of a branch in the Union of that counterparty" (art. 2 SFTR). The latter implies SFTR has a huge global reach, since also third-country counterparties that engage in SFT's through European branches are captured within its scope.
[144] Art. 4 (1) SFTR.
[145] Art. 4 (2) SFTR.
[146] REFINITIV , "Solving the SFTR Data Challenge", s.d., https://www.refinitiv.com/content/dam/marketing/en_us/documents/reports/solving-the-sftr-data-challenge.pdf , 5 p. (accessed 21.09.2022).
[147] Standardization of terms and by the use of SFT reports in common electronic and machine-readable form, which include Legal Entity Identifier (LEI) codes for issuers, ISIN-codes, and UTI's (art. 4 (10) SFTR).

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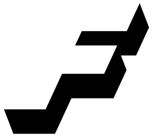

36. Increased transparency, however, is not a cure-all. The Mediobanca story illustrates that, even when a shareholder goes beyond its transparency obligations and voluntarily notifies the public that it is expanding its stake by borrowing additional shares (and voting rights), it can often not be prevented from doing so. This is because in most jurisdictions, as well as at the European level, there is currently no prohibition on borrowing shares in order to exercise voting rights. The UK forms an exception in this respect. The UK Money Markets Code proclaims that "it is accepted good practice in the market that securities should not be borrowed solely for the purpose of exercising the voting rights at, for example, an AGM or EGM. Lenders should also consider their corporate governance responsibilities before lending stock over a period in which an AGM or an EGM is expected to be held".[148] This rule is enforced on individuals subject to the Senior Managers and Certification Regime (SM&CR), who must adhere to the FCA's 'recognised codes', which include the UK Money Markets Code.[149] The European legislator and European member states have not jumped on the bandwagon (despite the ISLA's encouragements to do so), possibly because 'active' record date capturing and empty voting with great impact (and great media coverage) only occur very occasionally.[150] For the time being, monitoring the transparency notifications can be a useful instrument, but arguably *only* to assemble market information to provide a better empirical view of securities lending (and the various strategies that are maintained as a result) in the long-term. If at some point, a trend would be noticed, a ban such as that in the UK could be the legislator's next move. In any case, the market should not expect too much from transparency obligations since they will not solve problems like vote manipulation on an individual basis – as the *Mediobanca* story painfully demonstrates.

5. *Conclusion*

37. The relationship between securities financing transactions such as stock lending and corporate governance concerns has remained relatively unexplored in recent years. Activist shareholders may borrow shares for various reasons, but can also lend out (part of) their share portfolio. Both sides of the lending equation have an impact on the exercise of voting rights related to the shares: lenders must recall shares on loan to exercise voting rights and borrowers

[148] Chapter 4, article 6.3 UK Money Markets Code, https://www.bankofengland.co.uk/-/media/boe/files/markets/money-markets-committee/uk-money-markets-code.pdf (accessed 21.09.2022).
[149] FCA, "FCA confirms recognition of the FX Global and UK Money Markets Codes", 26 June 2019, https://www.fca.org.uk/news/statements/fca-confirms-recognition-fx-global-uk-money-markets-codes (accessed 21.09.2022).
[150] For example, the Mediobanca case took place in Italy, and the market authority *Commissione Nazionale per la Società e la Borsa* did not object to the transaction in any way.

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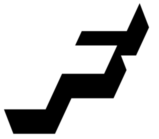

may employ stock borrowing practices to increase their voting power. The implications of lending transactions for voting rights were analysed more deeply in this paper.

38. While some argue that "securities lending impedes fund voting participation"[151] and "securities finance can be seen as a structural barrier to activism"[152], this paper's conclusions would not go this far. Not only can activists extract additional revenue by lending out part of their share portfolio, empirical research as well as the findings of practitioners show that recalls have become common practice and that fewer and fewer shares are lent out over the record date. Moreover, in the European Union, lenders have the advantage of exercising recalls in an informed manner at the time of announcement of the AGM (and are not confronted with 'hidden agendas' as in the US). On the other hand, stock lending techniques effectively prove to be a tool for shareholder activism, as the recent *Mediobanca* case illustrates. Although extending voting power by means of stock lending may be contrary to market best practices, it generally remains unprohibited.

39. As a final note, some recommendations and guidelines for future regulation of securities lending (from a corporate governance perspective) are included. First, it seems appropriate to prohibit investors from lending out at least one share of their stake in a company, so that information about the AGM reaches investors promptly and allows for timely recall of the remainder of his (lent out) shares. In this way, lenders will be less dependent on the cooperation of intermediaries (lending agents). Second, a disclosure requirement could be considered for lending agents of 1) the consequences of lending shares for the exercise of voting rights and 2) the distribution of lending fees between the intermediary and the investor. An additional mandatory acceptance of these consequences on the part of the lender may further eliminate any doubt about voting entitlements, as well as some of the risks highlighted in this paper. Furthermore, the European legislator could consider adding to the Shareholder Rights Directives a sufficiently long minimum period between the announcement of the AGM and the record date (for example, 10 days to facilitate timely (and duly informed) recalls.

On the borrower side, it was pointed out that – from the perspective of corporate governance –transparency notifications of increased voting rights and SFTR-reporting by counterparties

[151] J. XIE, "Are passive investors also passive voters? Evidence from securities lending by mutual funds", 28 February 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3754346, p. 33 (accessed 21.09.2022).

[152] J. BENJAMIN and L. GULLIFER, Stewardship and Collateral: The Advantages and Disadvantages of the No Look Through System, in L. GULLIFER and J. PAYNE (eds.), *Intermediation and Beyond*, Oxford, Hart Publishing, 2018, p. 230.

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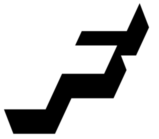

can be expected to have little to no effect on an individual basis. This is because transparency does not prevent activists from deliberately borrowing shares for the primary purpose of exercising the voting rights. Transparency can, however, prove useful to monitor how often vote borrowing occurs, so that future consideration can be given to a ban (to borrow shares for the primary purpose of exercising voting rights) such as it already exists in the UK today. The collection of data under, for example, the SFTR framework should be used for such an evaluative purpose.

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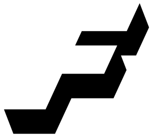

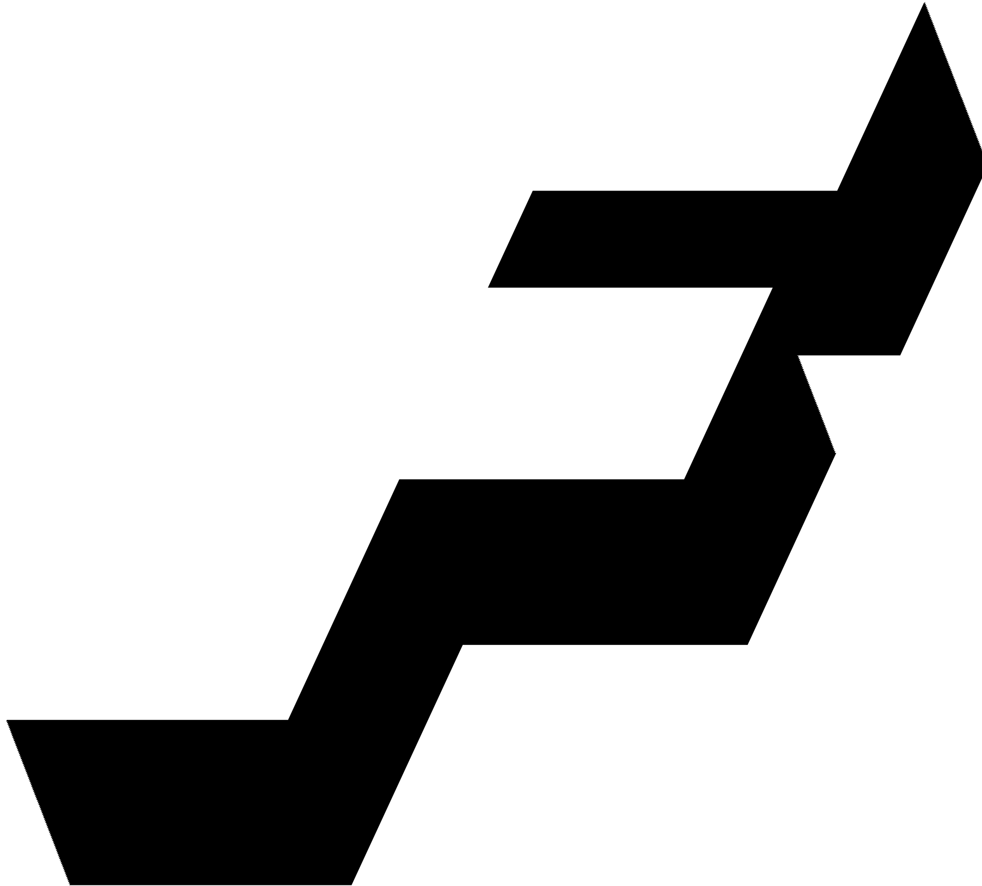

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