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One Borrowed Share, but One Very Real Vote

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SOME investors seem to be taking advantage of a loophole in financial regulations to cast shareholder votes that are far out of proportion to the number of shares they actually own, a new academic study suggests.

The study, entitled ''Vote Trading and Information Aggregation,'' has been circulating in academic circles for several months. Its authors are the finance professors Susan E. K. Christoffersen of McGill University in Montreal, Christopher C. Geczy and David K. Musto of the Wharton School of the University of Pennsylvania and Adam V. Reed of the University of North Carolina.

The authors describe a strategy that enables any investors, no matter how few of a company's shares they own, to profoundly affect the outcome of corporate resolutions that are put to a vote at the annual shareholder meeting. In effect, a shareholder can borrow a large number of shares for a nominal fee and use them to cast a corresponding number of votes.

As the study points out, the right to vote on a corporate resolution comes from possession, not ownership, of shares. That means a trader can borrow shares and thus be temporarily eligible to vote on corporate resolutions. The number of votes he can acquire is limited only by his ability to put up collateral -- which is required to be 102 percent of the value of shares borrowed -- and the number of shares available on the securities lending market. This market primarily serves those who wish to borrow shares in order to sell them short, but there is nothing to prevent its use by those whose motive is to influence the outcome of corporate votes.

As long as you have the collateral, borrowing shares is very inexpensive. The annual cost can be as low as 20 basis points, or two-tenths of a percentage point, on the cash that is put up. And because the borrower must hold the shares for just one day in order to have voting rights, the interest can be almost nothing. The cost to borrow $1 million of stock for one day, for example, could be less than $6, according to Professor Reed.

The professors are convinced that many traders are taking advantage of this loophole.

They reached this conclusion after studying what happens in the securities lending market immediately before and after the record dates for corporate votes. These are the dates when a shareholder needs to have possession of a stock in order to vote on a corporate resolution. The professors focused on 6,186 record dates for resolutions at publicly traded companies from November 1998 to October 1999.

They found that on the typical record date, there was a significant spike in the number of borrowed shares. And they found an almost-as-big decline in such shares, on average, the day after those record dates. In their opinion, the only plausible explanation is that traders borrowed shares solely to acquire votes. (A copy of the study is at papers.ssrn.com/sol3/papers.cfm?abstract-id=686026.)

The legal grounding for this practice is not entirely clear, according to the professors, as case law is in some respects ambiguous. But as a practical matter, Professor Reed said, there is ''no direct legal impediment'' to traders acquiring votes by borrowing shares.

Chester Spatt, chief economist at the Securities and Exchange Commission, said in an interview that it would be

inappropriate for him to comment on whether the agency might be contemplating any regulatory changes to prevent investors from borrowing shares in order to influence corporate elections. ''How voting works is at the heart of our proxy system,'' he said. ''The professors are to be commended for helping to shine the spotlight on this important issue.''

What effect could vote borrowing have on companies and their stock prices? There is no single answer, of course, because it depends on which investors are taking advantage of the loophole and what corporate policies they are supporting and opposing. Over the 12 months covered in the study, the professors found that a majority of vote borrowing was conducted by those who opposed management. But, the researchers also point out, there is no inherent reason that this should always be so. Indeed, corporate management could just as easily exploit this loophole to steer voting in its favor.

But it is clear that the opportunity to influence corporate elections exists. And it would be naive to expect institutional investors never to take advantage of it. Hedge funds come to mind in this regard, because they have all the prerequisites: many of these funds have already become involved in corporate governance issues; they are large enough to take full advantage of the securities lending market; they are aggressive; and they are eager to find ways to eke out extra profit.

Shareholder democracy is an ideal that is perhaps rarely achieved under the best of circumstances. It's not likely to be attained if sophisticated investors can manipulate the outcome of corporate voting merely by borrowing the shares they need.

Chart: ''Timely Borrowing''

The number of a company's shares borrowed in the securities lending market often spikes on the record date -- the day the shares must be held to vote on corporate resolutions -- and drops back the next day.

Graph tracks record date, borrowed shares, days after and days before.

Percentages of the average daily number of shares lent over the period from 10 days before the record date to 10 days after. Based on the average of 6,186 record dates at publicly traded companies from November 1998 to October 1999.

(Sources by Susan E. K. Christoffersen, Christopher C. Geczy, David K. Musto, Adam V. Reed)

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