



## Trapped in delusions: democracy, fairness and one-share-one-vote

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Establishing shareholder democracy and enforcing the one-share-one-vote mandatory rule in the EU have drawn much attention and controversy. In the pursuit of popular appeal for the proposal, EC policy-makers have tried to make equiproportional representation nearly an aphorism tied to corporate egalitarian sentiments underscoring justice, fairness and ethics. Economic justification of the move, however, as a value-enhancing technique of corporate governance in terms of fostering efficiency and competitiveness across the EU has been stunningly absent from the EC policy-agenda.

Proponents of shareholder democracy in the EU (see e.g. "One share one vote is the way to a fairer market" by Montagnon and Munsters, FT, August 14, 2006) have erroneously associated conceptual doctrine of political democracy with a corporate procedural voting rule, and consequently have argued that such a rule is needed to promote more fairness, accountability, liquidity and more active takeover markets. Such a perspective, however, is flawed and misguided.

First, shareholder democracy, as it emerged and evolved in the US, and contrary to what Montagnon and Munsters claim, is generally associated with shareholder empowerment and managerial accountability not with the one-share-one-vote rule. In the US, to the extent that a board's response is disproportionate to the threat posed, and defensive measures taken create a preclusive or coercive effect upon shareholders in a takeover context, the shareholders can indeed discharge the board from effectively continuing exercising its fiduciary duties. Moreover, after being in place in the US for 60 years, the one-share-one-vote mandatory rule was abolished based on growing recognition of the fact that it doesn't encourage high standards of corporate democracy on the one hand, and individual standards of corporate responsibility, integrity and accountability to shareholders on the other hand.

Second, academic literature is at best inconclusive as to whether differentiated voting rights lead to lower performance, managerial entrenchment and impair firm value. There is neither any clear evidence as to whether one-share-one-vote companies outperform multiple voting rights firms.

Third, the one-share-one-vote mandatory rule can further exacerbate the dark side of institutional shareholder activism i.e. short-termism. Not surprisingly, institutional shareholders have taken a greater advocacy role to support the rule

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but just for their own interest rather than that of their fellow or minority shareholders. Combining the rule with the application of different derivative techniques such as stock lending, equity swaps, direct and indirect hedges, hedge funds particularly can retain formally more voting control as compared to cash flow rights. This will effectively allow them voting more shares as compared to cash flow ownership, and hence, compromising long-term profitability for the sake of short-term payoffs. Remuneration of hedge fund managers generally composed of fixed 20 per cents of fund's profits and variable 1-2 per cents of total assets under management further exacerbates short-termism.

Fourth, the one-share-one-vote mandatory rule combined derivative techniques will allow hedge funds to destroy shareholder value through proxy fights for corporate control, if the hedge fund's net holding position of shares as defined by the difference between pure holdings and the short positions is negative. The destruction can take two forms. The hedge fund with a net negative position can block value-enhancing takeovers since any value-enhancing takeover will result in a net negative cash flow and hence losses from short positions. Alternatively, the hedge fund can vote for suboptimal tender offers in order to maximise payoffs associated with net short positions. Accordingly, the company can be either shielded from value-increasing takeovers or transferred to inefficient management. In both cases, the more stock prices slide and more shareholder value is destroyed, the more profits are made from short positions.

Generally, there is nothing undemocratic or unfair about differentiated voting rights. It is no more "unfair" to protect shareholders through differentiated voting rights structures than to invite destruction of shareholder value by activist hedge funds. The one-share-one-vote rule is simply one corporate decision-making rule among many, and not necessarily the best one. If EC policy-makers opt-in for a mandatory one-share-one-vote rule across the board in the EU, it will entail significant regulatory costs, foster inefficiency and impair competition. Paradoxically it can also demote shareholder rights and disenfranchise minority shareholders in the EU.

Against this background, a viable option forward, however, is to minimize legal intervention constraining investors' and issuers' choice with respect to voting and decision-making rules. As soon as companies make their corporate governance arrangements in general, and their voting, economic ownership structures and decision-making rules in particular publicly available during the IPO and the post-IPO stages through periodic disclosures, there is no reason to believe that investors are unable to make informed decisions and legal intervention is justified. Rigorous enforcement of harmonized disclosure rules such as those concerning rights attached to securities, directors and officers, compensation, long and short positions, articles of incorporation and bylaws can further boost rights of minority shareholders and other stakeholders in the EU.

It remains to be seen however, whether economic rationale will prevail over politically marketable rhetoric and delusory traps on the way to make corporate Europe more dynamic, efficient and competitive.