CONSCIOUSLY DECOUPLING: A RESPONSE TO PROFESSORS BARRY, HATFIELD, AND KOMINERS

*Michael C. Macchiarola**

IN *On Derivatives Markets and Social Welfare: A Theory of Empty Voting and Hidden Ownership*,[1] (the "Article") Professors Jordan M. Barry, John William Hatfield, and Scott Duke Kominers offer their spin on one of the most fascinating and confounding subjects in today's corporate law.[2] The Article represents a compelling addition to the still-burgeoning discussion of the bifurcation of voting rights and ownership interests.[3] The practice of decoupling the long-fused voting rights of shareholders from their underlying economic interests has become all too common with the explosive growth of the financial derivatives markets.[4] Such decoupling efforts challenge assumptions embedded in our capital markets, test our system of corporate governance, and strain a regulatory regime based on dis-

* Managing Director, Equinox Financial Solutions; A.B., College of the Holy Cross, 1994; J.D., New York University School of Law, 1997; M.B.A., Columbia Business School, 2001. The author of this Response traded derivatives and synthetics at a Wall Street firm, encountering many of the decoupling strategies during their earliest days. This Response is a private publication of the author, expresses only the author's views, and does not represent the views of any firm or any client or former client. The author would like to thank Derrick Aud, Woosin Sean Park, and the members of the Virginia Law Review Online for their splendid assistance.

[1] Jordan M. Barry, John William Hatfield & Scott Duke Kominers, On Derivatives Markets and Social Welfare: A Theory of Empty Voting and Hidden Ownership, 99 Va. L. Rev. 1103 (2013).

[2] Id. at 1107 ("Decoupling incidents have cast a long shadow over financial markets worldwide.").

[3] See, e.g., Henry T. C. Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 79 S. Cal. L. Rev. 811 (2006); Shaun Martin & Frank Partnoy, Encumbered Shares, 2005 U. Ill. L. Rev. 775; Wolf-Georg Ringe, Hedge Funds and Risk Decoupling: The Empty Voting Problem in the European Union, 36 Seattle U. L. Rev. 1027 (2013).

[4] See Barry, Hatfield & Kominers, supra note 1, at 1116 ("Modern finance offers a multitude of ways for an investor to hold divergent interests with respect to the economics and control of a corporation.").

closure.[5] The Article succeeds in illuminating this troubling trend. More importantly, it establishes a firm foundation for additional examination and discovery on the sources and methods of decoupling, its potential benefits and abuses, and the proper regulatory regime by which the behavior might be best regulated.

This short Response attempts to further advance the discussion on this important topic. The Response proceeds in four parts. Part I will revive the Article, offering a brief summary of the types of decoupling that the Article addresses. This Part will also highlight the complex and dynamic nature of the subject, noting that even the "shareholder as economic owner" lodestar is today vulnerable to some debate within the academy. Part II will pay special attention to the Article's most lasting contribution—the introduction of an alternative "core outcome" model by which particular decoupling tactics can be better analyzed. Part III will challenge the notion that there are potential benefits to decoupling. The Part will attempt to persuade the reader that decoupling is, by its very nature, upsetting to the natural order, and its persistence threatens the predictability and stability of the overall market. This Part will assert that the Article suffers, at times, from contortions undertaken to arrive at an all-encompassing explanation. Such twists are not only unnecessary, but they excuse certain undesirable behavior and might, in the process, frustrate the search for a far simpler regulatory regime. Regardless of whether the core outcome model becomes generally accepted, any desirable regulatory framework must begin with an ironclad mandate for full and fair disclosure not easily side-stepped by derivatives. While others have offered such a prescription[6] and the authors embrace the idea,[7] there has been little tangible success to date. Finally, Part IV will conclude the Response, with a brief summary of the Article's contribution and a hope that focus on a desirable explanatory model does not siphon attention from efforts

---

[5] See id. at 1110 ("By effectively separating ownership and control rights, large, opaque derivatives markets can render financial markets unpredictable, unstable, and inefficient.").

[6] See, e.g., Hu & Black, supra note 3, at 819.

[7] Barry, Hatfield & Kominers, supra note 1, at 1110 ("Our analysis therefore provides a strong justification for a comprehensive mandatory disclosure regime for securities markets, including derivatives markets.").

underway to improve the quality and depth of the information available to market participants.

Decoupling practices, which seemed both clever and innovative in their earliest days, now represent a growing threat to corporate law.[8] As the authors concede, our current set of mandatory disclosures—crafted without derivatives in mind—remains overmatched by the strategies that can be employed from a full menu of available decoupling devices.[9] More troubling is the idea that "as derivatives markets continue to grow, decoupling should become easier, and ownership and control should diverge even further."[10] The seriousness and complexity of the subject matter, and its tangible ramifications for firms and their shareholders necessitate continued attention. The Article has done a great service, introducing a robust "core outcome" model and offering meaningful observations on the subject of decoupling. It is hoped that this Response plays some role in advancing that discussion.

PART I

Shareholders play an essential and indispensable role within the framework of a corporation.[11] As residual claimants, shareholders are the "economic 'owners' of the firm; they ultimately reap the benefits, or bear the costs, of any change in the firm's value."[12] It is this position of economic ownership, then, that is said to inform the shareholder's actions, aligning her economic interests with those of

[8] See, e.g., Eugenio De Nardis & Matteo Tonello, The Conference Bd., Know Your Shareholders: The Use of Cash-Settled Equity Derivatives to Hide Corporate Ownership Interests 1 (2010) (commenting that regulators "are increasingly aware of the market and governance distortions that may result from situations of hidden ownership, where investors use cash-settled equity derivatives to eschew disclosure rules while stealthily building up stakes in public corporations").

[9] Barry, Hatfield & Kominers, supra note 1, at 1154.

[10] Id.

[11] See id. at 1111–12.

[12] Id. at 1112; see also Henry T.C. Hu, New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare, 69 Tex. L. Rev. 1273, 1279 (1991) ("The traditional conception of the basic pecuniary goals of a corporation is based on the simple premise that what is good for the corporation is good for the shareholder.").

the firm generally.[13] In essence, the reliability and steadiness of this connection—between voting and economic interest—transform the shareholder from a mere passive investor to a more muscular corporate sentinel.[14] And, the classical theory portends that, if the shareholder's economic interests remain aligned with her voting interests, she can be relied on to function in a manner consistent with the maximization of the corporation's value.[15]

Today, this classical theory is itself subject to some debate within the academy. For example, in her recent book, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*, Professor Lynn Stout refutes the oft-repeated notions that shareholders enjoy special status as (i) owners, (ii) principals, or (iii) residual claimants of the corporation.[16] Professor Stout alleges that, to the extent that any special status is attached to the shareholder, it is more a "clumsy result of convenience" than any dependable reality.[17] In spite of any shortcomings, however, the shareholdshareholder primacy model offers a valuable signaling mechanism, lending predictability to all of the corporation's constituents, however defined.[18]

Any stability that stems from the special status of the shareholder, however, faces further erosion "when control rights can be bought and sold independently of ownership rights."[19] It is, therefore, imperative that the particular rights of the shareholder are ap-

[13] See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 63, 67 (1991) ("[W]hy do shareholders alone have voting rights? . . . The reason is that shareholders are the residual claimants to the firm's income.").

[14] See also Hu & Black, supra note 3, at 814 (adding that voting rights also provide shareholders "the power to oversee company managers").

[15] See Barry, Hatfield & Kominers, supra note 1, at 1112.

[16] Lynn Stout, The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public (2012); see also Jesse Eisinger, Challenging the Long-Held Belief in 'Shareholder Value,' N.Y. Times DealBook, Jun. 27, 2012, http://nyti.ms/1qGCQMz ("It's almost as if the legal world has been keeping a giant secret from the economists, business schools, investors and journalists.").

[17] Michael C. Macchiarola, Book Review, Ariz. St. L.J. Blog (Sep. 17, 2012), http://arizonastatelawjournal.org/book-review-the-shareholder-value-myth-how-putting-shareholders-first-harms-investors-corporations-and-the-public-by-lynn-stout/ (reviewing Lynn Stout, The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public (2012)).

[18] Id.

[19] Barry, Hatfield & Kominers, supra note 1, at 1109.

preciated both as a bundle and as individual sticks.[20] As the authors observe, "[a]nalyzing decoupling requires a model that includes both ownership rights and control rights."[21] And, the two most popular forms of decoupling illustrate the strains caused by the introduction of the ability to unbundle voting from ownership.

Decoupling behavior comes in two main varieties. First, so-called "empty voting" involves a process by which an investor comes to hold more votes than shares.[22] In such a case, the votes are said to "have been emptied of an accompanying economic stake."[23] In an extreme example, similar to the Henderson Investment scenario described at the beginning of the Article, shareholders might even hold votes when they have a negative economic interest in the underlying firm.[24] The undesirability of empty voting scenarios is apparent. Such episodes turn the notion of the shareholder as the economic protector of the firm's value on its head. Bifurcation, in the empty voting context, frustrates any reliance on the fundamental notion that a particular voter will act consistently with maximizing the firm's value.

The second form of decoupling—the so-called "hidden ownership" strain—is no less unsettling. It involves the inverse of empty voting. In its most basic variety, "hidden ownership" refers to an undisclosed economic ownership, which allows greater economic exposure than the investor's formal (and disclosed) voting rights would imply.[25] The classic hidden ownership example is the 2003 case involving a hedge fund that employed a series of equity swap

[20] See, e.g., Bernard Black, Equity Decoupling and Empty Voting: The TELUS Zero-Premium Share Swap, 16 M&A Law. 1, 4 (2012) (observing that economic, voting, and other rights are "often bundled together in the form of voting common stock").

[21] Barry, Hatfield & Kominers, supra note 1, at 1131.

[22] See "Empty Voting" and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds, M&A Deal Commentary (Latham & Watkins), Apr. 2007, available at http://lw.com/upload/pubContent/_pdf/pub1878_1.Commentary.Empty.Voting.pdf ("Empty voting is a generic term embracing a variety of factual circumstances that result in a partial and often total separation of the right to vote at a shareholders' meeting from beneficial ownership of the shares on the meeting date.").

[23] Hu & Black, supra note 3, at 815.

[24] Id.; see Barry, Hatfield & Kominers, supra note 1, at 1105–07.

[25] See Barry, Hatfield & Kominers, supra note 1, at 1105–07. Additional distinctions between "hidden ownership" and "morphable ownership" are beyond the scope of this Response.

transactions with dealer-counterparties in order to maintain a sixteen percent economic stake in a company, without triggering a disclosure rule that applied to five percent shareholders.[26] The hedge fund laid in wait, and when the timing was right, "returned to its dealers, unwound the swaps, acquired the 'matched shares' held by the dealers to hedge the swaps, and thus obtained formal voting rights."[27] Needless to say, other market participants were both surprised and dismayed by the hedge fund's spontaneous appearance as a (previously undisclosed) major shareholder.

In light of the stresses that empty voting and hidden ownership techniques place on the expectations of market participants, it is unsurprising that the traditional market models have disappointed in their ability to analyze decoupling.[28] In fact, as the authors observe, the much-celebrated competitive equilibrium analysis "makes few, if any, useful predictions regarding market outcomes, and cannot rule out inefficient outcomes."[29]

PART II

Faced with such a disquieting reality, Professors Barry, Hatfield, and Kominers posited their "core outcome" model. The model attempts to fill a void, as the traditional competitive equilibrium models are "even less likely to exist when—as large derivatives markets allow—control rights and economic rights can be traded separately from each other."[30] Under the improved model offered by the Article, core outcomes are said to include those where it "cannot be possible for any group of actors to change their behavior in a way that makes the group as a whole better off."[31] By examining the market participants in the aggregate, the new model effectively eliminates activities that the authors label "Bet and Switch," where one party profits "by confounding other parties' expectations."[32] In essence,

[26] See Ithaca (Custodians) Ltd. v. Perry Corp. [2003] 2 NZLR 216 (HC) ¶¶ 108, 232, *rev'd* [2004] 1 NZLR 731 (CA) ¶ 22. The United States has a similar disclosure statute. See Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (2012).
[27] Hu & Black, supra note 3, at 817.
[28] See Barry, Hatfield & Kominers, supra note 1, at 1149.
[29] Id.
[30] Id. at 1138.
[31] Id. at 1139 (emphasis removed).
[32] Id. at 1141.

the model measures the desirability of corporate decisions by whether they increase total social welfare.

The appeal of the core outcome model, as presented, is readily apparent. It offers market participants, regulators, and observers an opportunity to move beyond a heavy reliance on the integrity of market prices alone to inform predictions of corporate decision-making. In essence, the newer model can be understood as a corporeal rejection of the weak form of the efficient market hypothesis ("EMH")—a philosophy that has dominated the approach to market regulation for the last generation.[33] The weak form of the EMH holds that security prices reflect the information contained in past prices. The theory prescribes that, at any time, the actual price of a security will represent a fair approximation of its intrinsic value.[34] It follows that a consistent and reliable presentation of past prices would be all that is required to make a market informationally efficient.

While the core outcome model promises "precise predictions about firms' decisions and securities' values,"[35] it requires more than mere security price information to deliver that benefit. In fact, it is superior information that undergirds any advantage provided by the core outcome model. For, "when actors are well-informed, market transactions will produce efficient, predictable, and stable results."[36] The authors, however, seem only marginally concerned with ensuring that the available information keeps pace with the innovations created by the derivatives markets. While they concede that the disclosure regime of the U.S. securities markets has failed to keep pace,[37] they offer little by way of a remedy. And, after admitting that mandatory disclosure rules have "the potential to provide significant benefits,"[38] practical concerns give way to academic high-mindedness, as the authors feel compelled to make a case that dis-

---

[33] See, e.g., William W. Bratton, Corporate Finance: Cases and Materials 23 (6th ed. 2007) ("The weak form of the hypothesis has the strongest empirical support."); Michael C. Jensen, Some Anomalous Evidence Regarding Market Efficiency, 6 J. Fin. Econ. 95, 95 (1978) ("There is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis.").

[34] See Michael C. Macchiarola, Beware of Risk Everywhere: An Important Lesson from the Current Credit Crisis, 5 Hastings Bus. L.J. 267, 281–83 (2009) (describing the three forms of the efficient market hypothesis).

[35] Barry, Hatfield & Kominers, supra note 1, at 1149.

[36] Id. at 1150.

[37] See id. at 1154.

[38] Id. at 1157.

closure requirements "may reduce efficiency by discouraging actors from gathering information."[39]

In light of the instability that has resulted from splitting control rights and ownership rights, and the fact that the information required to buttress a model like that offered by the Article is unobtainable, it seems wise to contemplate some presumption against bifurcation. At the very least, caution might dictate that some consideration be given to a decoupling moratorium, at least until such time as meaningful progress was realized toward the long-desired integrated disclosure system.[40] Curiously, however, the authors seem more inclined to accommodation than one might expect—even offering that there exist "instances in which decoupling seems beneficial."[41] And so, the Article pursues "a way to distinguish between beneficial and problematic decoupling" in order to allow regulators to avoid "throwing the baby out with the bathwater."[42]

PART III

The authors' discussion of the "potential benefits of decoupling" is the least appealing of the Article.[43] The section reveals a reluctance to see the world in black and white. Moreover, it abandons familiar, reliable, and measurable guideposts, like maximizing shareholder value, in favor of the more utopian and amorphous elixir of maximizing social welfare. Professors Barry, Hatfield, and Kominers credit the core outcome model with possessing the intellectual capacity and moral authority to prescribe an omnipotent regulatory regime able to assign rules equipped to tease out the social maximizing attributes of particular corporate decisions at particular times and places. Somehow, however, the measurement issues, which have existed since before the model was even divined, are glossed over. And, as flawed, frustrating, or displeasing as the maximization of shareholder value might be, corporate results are likely to be even more subjective and chaotic without it. The insistence that a regula-

[39] Id. at 1158.

[40] The authors seem to dismiss, out of hand, a more stringent and less practical plan to "suppress derivative markets, either by severely restricting derivatives or banning them altogether." Id. at 1154–56.

[41] Id. at 1108.

[42] Id.

[43] See id. at 1124–29.

tory regime need be designed to distinguish the benign form of decoupling from its more insidious cousin is all the more puzzling in light of the authors' concession that "decoupling is not strictly necessary to achieve any of the potential efficiency gains" that the Article details.[44] "In theory, all of them can be achieved without decoupling."[45]

In fact, the two potential beneficial scenarios offered by the authors seem far-fetched and aim at a goal that will prove both elusive and subjective. Concerned that there "are instances in which the course of action that is best for a corporation is not the best for society at large," the Article sets out to justify the potential benefits of certain hypothetical decoupling episodes.[46] In the first scenario, the authors offer that disinterested shareholders (as we understand them in our normal parlance) will somehow choose societal benefit to thwart monopolistic pricing.[47] In the second scenario, hidden ownership operates as an elixir to the problem of entrenched management.[48] Never mind that the result suggested in the first scenario is far from certain, or that there exist various other checks on the entrenched management decried in the second. In neither case is the need for decoupling economic interests from control rights supported or excused. And, when that very bifurcation upends the time-honored linkage between economic exposure and voting and threatens the stability derived from a system of full and fair disclosure, it seems a high price to pay indeed.

PART IV

As ironic as it might be, the Article's focus on a holistic model to explain decoupling behavior could actually siphon attention from ongoing efforts at information gathering. As a practical matter, today's policymakers should be less concerned with providing an explanation for behaviors than with establishing a more robust disclo-

[44] Id. at 1128.
[45] Id.
[46] Id. at 1124–25. In this regard, the authors join the earlier scholarship of Professors Hu and Black, who themselves contended that "[n]ot all vote buying is bad. Some could move votes from less informed to better informed investors and thus strengthen shareholder oversight." See Hu & Black, supra note 3, at 907.
[47] Barry, Hatfield & Kominers, supra note 1, at 1124–25.
[48] Id. at 1126.

sure regime. And, unless and until meaningful progress is made toward such an integrated disclosure system, the possibility remains that "[a]droitness in . . . financial technology may increasingly supplant the role of merit in determining the control of corporations."[49] In the meantime, the core outcome model represents a meaningful contribution toward better understanding the overall social utility of individual decision making in the corporate context. Because information is crucial to achieving a core outcome, the success of the model remains subject to the quality and completeness of the disclosure of economic interests and control rights that can be gathered. In that regard, we can only hope that the Article provides the impetus for the regulators to provide the informational enhancements for which academics and market participants have long been clamoring.

Professors Barry, Hatfield, and Kominers have done a great service in providing an excellent framework through which the academy, practitioners, investors, and corporations can more adequately consider the effects of episodes of empty voting and hidden ownership. The core outcome model represents only a first step, however, with the more important contribution still in the future. And, as that model highlights, tangible progress will be achieved when the informational playing field is again leveled. Only then will investors and regulators be provided with adequate intelligence to understand the relative position of all investors in the marketplace—decoupled or not.

[49] Hu & Black, supra note 3, at 907.