Testimony for the Record

Of

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President, Business Roundtable

On

Empowering Shareholders on Executive Compensation: H.R. 1257,

The Shareholder Vote on Executive Compensation Act

Before the U.S. House of Representatives
Committee on Financial Services

On

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Business Roundtable
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Dear Chairman Frank, Ranking Member Bachus, members of the committee:

Business Roundtable is pleased to provide testimony based upon our experience and perspective representing the chief executive officers of leading corporations.

We share with you the common goal of promoting public policies that foster economic growth, job creation, investor confidence, and the creation of long term shareholder value. We are committed to policies that ensure that U.S. based companies remain the economic engine of the global economy and our markets retain their competitive advantage over foreign exchanges.

Introduction

U.S. companies and their systems of corporate governance are the most transparent, efficient and accountable in the world. A wave of reforms over the past five years has resulted in improved investor confidence in our corporations, growth in the stock market, and continued shareholder returns.

Business Roundtable (www.businessroundtable.org) is an association of chief executive officers of leading U.S. companies with $4.5 trillion in annual revenues and more than 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock markets and represent over 40 percent of all corporate income taxes paid. Collectively, they returned $112 billion in dividends to shareholders and the economy in 2005.

Recent Reforms and Accountability

The Roundtable has a strong record of leadership in corporate governance that includes supporting the Sarbanes-Oxley reform legislation (2002); issuing *Principles of Corporate Governance* (2002 and updated in 2005); publishing *Principles of Executive Compensation* (2003 and updated in 2007)); creating the Business Roundtable Institute for Corporate Ethics (2004); and supporting the new Securities and Exchange Commission (SEC) compensation disclosure rules (2006). Going back to the late 1970s, Business Roundtable has issued a series of statements on corporate governance best practices, including specific statements relating to executive compensation.

Our *Principles of Executive Compensation,* which we recently updated to reflect developments in best practices and the new SEC executive compensation disclosure rules, recommend that executive compensation reflect the core principle of pay-for-results, including significant performance-based criteria. Additionally, we believe executive pay should be closely aligned with the long-term interests of shareholders and corporate goals and strategies.

The Roundtable supports complete, understandable and timely disclosure of compensation packages and, in keeping with this, supported the new rules issued by the SEC in 2006 that make it easier for investors to better understand exactly what CEOs are being paid. The new Compensation Disclosure and Analysis Section required in proxy statements under the SEC rules will provide important information about not only the objectives of a company's executive compensation program, but also why the company has chosen to pay each element of compensation (e.g. salary, bonus and long-term compensation) and the specific items of corporate performance that are taken into account in making compensation decisions. We believe that this increased transparency about compensation will benefit the marketplace as it will give investors more information on which to make decisions. These new disclosure requirements could have a significant impact on executive compensation practices.

Furthermore, Business Roundtable believes that the best people to set executive compensation and hold CEOs accountable for company performance are the independent members of a company's board of directors, acting upon the recommendations of their compensation committees. These committees are subject to strict independence requirements, and all directors are strictly accountable to all shareholders.

In recent years, corporations have made dramatic reforms to their systems of corporate governance. In order to ensure meaningful director elections, many companies have voluntarily shifted to a system of majority voting for directors. Currently 52% of the S&P 500 have adopted some form of majority voting, up from 20% last year.(1) This trend will continue, and it provides for enhanced accountability of board members to shareholders.

In addition, it is clear that corporate governance reforms are working and that corporate board directors have become more independent. The results of a 2006 corporate governance survey of Roundtable members reported that 85% of our company boards are composed of at least 80% independent directors. The Roundtable's *Principles of Corporate Governance* define an independent director as not having business, employment, charitable or personal relationship with the corporation or its management.

Directors are also more active, as they should be. In the Roundtable's 2006 survey, 75% of companies reported that their independent directors meet in executive session *at every meeting*, which is an increase from 55% in 2003. Our survey also showed that 91% of Audit Committees increased the number and length of their meetings, the same being true for 67% of Governance Committees and 76% of Compensation Committees.

It is also interesting to note that CEO turnover is increasing. The average tenure of a Business Roundtable CEO today is 4.5 years, nearly half of the eight-year average tenure in 1985. In addition, a 2005 study showed that CEO turnover was over 15%, the highest level in a decade.(2)

Role of Boards and Shareholders

In addressing any additional reforms, it is important to recognize that corporations are private entities designed to generate value for their shareholders. Company organization and structure is governed by state law, while federal securities laws generally govern the disclosure of information to investors.

As detailed in our *Principles of Corporate Governance*, the business of a corporation is managed under the direction of the Board of Directors. Making decisions regarding the selection, compensation and evaluation of a well-qualified CEO is the single most important responsibility of the board.

Directors, who are shareholders themselves, have a legal obligation to act in the best interests of *all* shareholders, and not represent the interests of particular constituencies. While cooperation and consensus is critical for a board to function, effective directors maintain an attitude of constructive skepticism, asking incisive questions requiring accurate and honest answers.

The role of shareholders is equally important. Shareholders provide capital, elect directors, approve mergers and other significant actions, and are recognized as the "owners" of the corporation. However, shareholders do not run companies and have no legal liability should something go wrong.

Shareholders come in different shapes and sizes with different motivations and goals. Some seek immediate gains on their investment and others look for long-term growth. There are small individual investors, large institutional investors, mutual funds, union pension funds and privately held hedge funds, all of whom invest for different reasons and for varying lengths of time. Investing in a corporation is voluntary and shareholders are free to invest elsewhere for any reason. Unlike democracies, shareholder rights vary based upon the size of their investment, and by definition corporate decision making is not a democratic process.

Considerations on Shareholder Participation

When considering shareholder approval for compensation decisions, we are concerned with several underlying issues.

First and foremost, we believe that requiring a shareholder vote on compensation – even an advisory vote – would seriously erode critical board responsibility. Determining compensation involves several factors: company goals, specific performance metrics, and amounts negotiated under the terms of an employment contract. It would be difficult to effectively subject some or all of these elements to a voting process.

Secondly, there are significant irregularities with the current voting process that have been identified by academics and more recently discussed at length in the *Wall Street Journal*. This article highlights the problems with hedge funds using their short term holdings for so called "empty voting".(3) Moreover, unregulated proxy advisory firms often vote on behalf of investors. Proxy materials are distributed by paper and electronically, and the distribution involves third parties who in some instances cast votes themselves on behalf of the actual shareholders.

In 2004, Business Roundtable petitioned the SEC to reform the shareholder communications process. We have been joined in this effort by the National Association of Corporate Directors, the National Investor Relations Institute, the Securities Transfer Association and the Society of Corporate Secretaries.(4)

While our petition remains under consideration at the SEC, we believe these issues are far more pressing than considering fundamental changes to the existing balance of responsibility that has produced so much economic growth.

We also believe that if we moved to a referendum system, fractured shareholder groups would subsequently campaign for or against ballot questions. Boards and CEOs would spend less time on planning, product development and oversight and more time meeting with advocacy groups and lobbyists.

Adversarial shareholder groups with divergent interests would form coalitions in an effort to influence proxy outcomes and then dictate policies and operational decisions to boards and management.

Furthermore, it would be naïve to think that once shareholders had the right to vote on compensation, special interests would have no interest in expanding the right to other major decisions.

For example, there are a number of other significant board decisions involving more resources than compensation, including capital investments, strategic plans, and marketing and endorsement deals. Subjecting these to shareholder approval would politicize the decision making process, slow company growth, and shareholder return would suffer.

The U.K. System

The U.K. system of shareholder advisory votes on compensation is not automatically applicable in the U.S., as some have suggested. There are key differences between the U.K. and U.S. corporate governance systems, making adoption of such a system in the United States unwise.

Briefly, a federally mandated shareholder advisory vote is counter to federalism principles. As noted earlier, in the U.S., state law remains the prominent source relating to the governance of corporations. The determination of what topics shareholders are required to vote on is generally left to the states. Even the sweeping Sarbanes-Oxley reforms of 2002 did not override this structure—its provisions relating to boards of directors were limited to audit committees and the Congress deferred to the stock exchanges rather than calling for direct SEC rulemaking.

Secondly, U.S. boards of directors are substantially more independent than in the U.K. In the U.S., boards are required to have a majority of independent directors and must comply with the NYSE's rigorous definition of independence. In the U.K., boards include many more company executives and are subject to a "comply or explain" regime rather than subject to a mandatory definition of independence. An independent 2006 survey of leading companies found that the percentage of independent board members was 81% in the U.S., and only 61% in the U.K.[(5)]

Because boards in the U.K. are less independent of management, the shareholder vote on compensation may be necessary to resolve the conflicts of interest present in executives and non-independent directors determining executive compensation. In contrast, in the U.S., exclusively independent directors make compensation decisions and therefore a shareholder vote on executive compensation is less necessary. NYSE companies also are required to have a mechanism for shareholders to communicate with directors, which provides shareholders a means of sharing their views with respect to executive compensation.

Third, there is a fundamental difference between the U.S. & U.K. legal systems. In the United States, directors are subject to potentially significant litigation and personal liability as result of their board duties. In the U.K., directors may be protected against legal actions brought against them where board decisions have been put to a shareholder vote; this means that directors may be essentially immunized against litigation.

And finally, unlike the U.S., the U.K. has a “loser pays” system which discourages lawsuits. We have large scale securities class actions in the U.S., while the U.K. does not allow such cases. Indeed, their shareholder advisory vote is, in part, a substitute for such class actions. Thus, their system includes a balance between the two, not a piling on of one on top of the other.

<u>Conclusion</u>

The U.S. system of corporate governance has had more reform in the past five years than in the previous 50 years, and those reforms are working. Boards are more independent, have taken significant steps to increase performance metrics, align CEO pay with shareholder interests, and replace CEOs that fail to produce results.

The recent reforms have led to greater accountability of CEOs and Boards to shareholders. At the same time, individual and institutional shareholders have enjoyed enormous returns by participating in the market.

In the past 15 years, the market has dramatically grown, from $5 trillion to $19 trillion. During the same period, participation in the market by U.S. households has increased 156% - from $3.89 trillion in 1992 to $9.98 trillion in 2006. In the same timeframe, the average annual return on the S&P 500 index was 11.98% per year[(6)].

We therefore need to be careful before we erode critical Board responsibilities and alter the underlying model and record of success.

We thank you for your consideration and look forward to working with you. I am available to answer any questions and provide additional information.

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The Washington Post
washingtonpost.com

Job Security Wanes in Executive Suites; CEO Turnover at Top Companies Was 15.3% in 2005, Highest in a Decade

Brooke A. Masters
The Washington Post
05/18/2006

It's getting shaky at the top.

More than 15 percent of the world's 2,500 biggest companies lost their chief executives last year, and only half of the departures were voluntary, according to a study that will be released by the consulting firm Booz Allen &Hamilton today.

The number of chief executives who left -- 383 -- was up slightly from last year and the 15.3 percent turnover rate was the highest recorded in the 10 years Booz Allen has studied the matter. Turnover was highest in Japan, with 19 percent, and in North America, where the 16.2 percent turnover rate was the highest since 2000.

"We think this level of turnover is here to stay," said Paul Kocourek, a Booz Allen senior vice president and an author of the study. "Boards are much more activist, and they are not going to tolerate poor performance. . . . If your [company is] performing at 2.5 percent below the Standard &Poor's 500 index, you are at risk."

The statistics from North America tend to bear that out. Thirty-five percent of chief executives who departed in 2005 were forced out -- the most ever recorded in the survey -- compared with 44 percent who left voluntarily and 25 percent who lost their jobs because of mergers. Among the high-profile departures last year were Harry C. Stonecipher, forced out at Boeing Co. after a scandal; Hewlett-Packard Co.'s Carly Fiorina; Walt Disney Co.'s Michael D. Eisner, and Morgan Stanley's Philip J. Purcell.

Retirements and other voluntary departures have not changed significantly since 1995, but the number of chief executives forced out for performance-related reasons has more than quadrupled, Kocourek said.

Much of the change seems to stem from regulatory changes that have emphasized director independence and made them feel more personally responsible for company performance, as well as the growing willingness of large investors to challenge company strategies when share prices are lagging.

High chief-executive turnover can have both good and bad consequences.

"It's very good. It creates a culture of accountability," said Charles M. Elson, who directs the Center for Corporate Responsibility at the University of Delaware. "Boards who remove CEOs are to be congratulated. They're doing their job. . . . In the old days, there were lots of reasons to remove [corporate leaders], but boards dominated by CEOs didn't do it."

For employees, change can create uncertainty. "CEO turnover is often coupled with broader organizational change along the lines of layoffs and selling businesses and changing strategies," said Paul Oyer, an associate professor of economics at Stanford University's business school. "When CEOs turn over, that's both a problem and an opportunity."

On the other hand, high turnover could make chief-executive jobs less attractive. "If you ask CEOs to take the risk of having to resign in a fairly public manner . . . people might be less willing to take the job and want higher compensation, which means you shrink the pool," said Constance E. Helfat, a strategy professor at Dartmouth's Tuck School of Business who studies chief-executive turnover.

Some analysts wondered whether the problem will be exacerbated if the Securities and Exchange Commission adopts a proposal to require more disclosure of executive perks. If it does, they said, top business executives might decide to work for a privately held company or a venture capital firm rather than a publicly traded firm, to avoid the risk of public scrutiny.

The Booz Allen study also looked at the succession process and concluded that over the short term, companies that brought in new chief executives from the outside did better than those that promoted someone from the inside. But insider chiefs tended to serve longer and provided better shareholder return over the long haul.

Others who have studied the matter said the Booz Allen study may overstate the benefits of outsiders, even in the short term, because outsiders are more likely to inherit companies that are in bad shape where investors are primed to respond positively to any kind of change. Helfat said that in her study of chief executives during the first three years of their tenure, she found that once she adjusted for the company's previous performance, outsiders and insiders performed, on average, equally well. Outsider chiefs were more of a gamble, she said, because they were more likely to do spectacularly badly or spectacularly well, while insiders tended to stick closer to average.

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OUTSIDE INFLUENCE

How Borrowed Shares Swing Company Votes

SEC and Others Fear Hedge-Fund Strategy May Subvert Elections

By KARA SCANNELL

Private investment firms have found a simple way to profit from the workings of public companies: Borrow their shares, and then swing the outcomes of their votes.

In some cases, the strategy has allowed speculators to gamble that a company's stock will drop, and then vote for decisions that will ensure that it does—without their ever having to own any stock themselves. Some outside interests have used the strategy to hide their voting power within a company until the last moment. Often, individual shareholders don't realize their own stocks, and their voting rights, have been borrowed from their brokerage accounts, until it's too late.

Fueling the practice—dubbed "empty voting" in a study by two University of Texas professors—is a booming business in lending shares. That business has nearly doubled in the past five years, according to one report, and now earns $8 billion a year for big brokerages and banks plus an unknown amount for institutional investors. Voting rights are lent along with the shares, and increasingly, that is leading to unintended consequences.

Vote counters often fail to keep track accurately and let the borrowers and owners of the same shares both cast votes. Four big banks paid the New York Stock Exchange $2.35 million last year to settle charges in this area. Meanwhile, other shareholders often are unaware that a big voting bloc has no real ownership stake in the company—and that it may vote directly opposite the wishes of the

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Taking Stock

Private investment firms are borrowing shares to sway shareholder votes:

Company announces the "record date" on which investors must hold stock to vote at the next shareholder meeting.

Hedge fund seeks to borrow stock in the **company before that date.**

Broker taps shares from institutional lender or an individual's account for the hedge fund.

Broker transfers the shares, along with voting rights, to the **hedge fund** in exchange for collateral and a fee.

Hedge fund votes with the borrowed stock. Institutions or individuals who own the shares lose their votes. **Hedge fund** can return the shares at any time after the record date.

Continued from Page One
stock's actual owners.

This phenomenon has gotten the attention of regulators, who fear it is escalating just as shareholder voting is gaining importance as a way to improve corporate governance and keep management excesses in check. If elections can be too easily gamed, critics fear, a basic foundation of public companies—that shareholders vote in the company's best interest—will be undermined.

The practice "is almost certainly going to force further regulatory response to ensure that investors' interests are protected," Securities and Exchange Commission Chairman Christopher Cox said in an interview. "This is already a serious issue and it is showing all signs of growing."

THE SEC HAS NO firm plans yet. Britain's securities regulator, the Financial Services Authority, has begun a study into whether to force greater disclosure of large investors' stakes in companies, regardless of whether they own stocks or are just borrowing them. One of the largest pension-fund managers there, Hermes, has called for regulators to outlaw voting altogether by borrowers of shares. In Hong Kong, the Securities and Futures Commission said it is studying "issues relating to borrowed shares and voting."

The concern arises just as more companies are moving toward requiring a majority of all shares to elect directors, instead of simply a plurality of those casting votes. A recent U.S. federal appeals court decision opened the door to giving shareholders a greater say in the election and nomination of directors, and the SEC recently approved a rule to make it easier for investors to put up their own slates of directors. But the vulnerability of the voting system could set back such efforts.

"It seems in trying to perfect corporate governance, we were polishing an apple that had a lot of worms inside, and we didn't know it," says Carol Hayes, corporate secretary of Coca-Cola Co., and a member of the Society of Corporate Secretaries and Governance Professionals.

The opportunity for "empty voting" arises when brokerage firms or institutional fund managers lend the shares they manage to hedge funds or other firms, for a fee that can rise with how difficult the shares are to get. The value of securities borrowed on any given day has reached $1.6 trillion after several years of double-digit growth, according to Astec Marketing Research Group Inc., a New York capital-markets research firm.

When it comes times for a shareholder vote, it's the borrowers that hold the voting rights. Under Delaware law, where most large companies are incorporated, voting rights belong to whoever holds the stock on a date the company chooses in advance of its stockholder meeting. It's as if in the U.S. electoral system, someone could borrow your voting rights and use them to vote in your place without your knowing it. Individual share owners often are unaware that contracts with brokerages normally allow the brokerages to make money by lending out stock if it's held in margin accounts, just as banks profit from lending their cash deposits.

The owners must ask for their stock to be recalled if they want to vote—which means they would have to know the stock was lent and that the vote was coming. If their stocks are lent, the borrowers of the shares, not the owners, are supposed to receive invitations to vote. Stocks in cash accounts aren't affected.

No one knows how widespread "empty voting" is. Law professors Henry Hu and Bernard Black at the University of Texas at Austin have studied 22 instances world-wide from 2001 through 2006 in which either borrowed stock or hedging strategies, or both, were used. Consider one example:

> **On Borrowed Time**
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> ❖ **The Issue:** Hedge funds can vote shares they don't own by borrowing them.
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> ❖ **The Stakes:** Critics say shareholder elections are corrupted if investors who don't have an economic stake can vote.
>
> ❖ **The Bottom Line:** Regulators face difficulties if they try to curtail the practice.

HENDERSON LAND Development Co., Hong Kong's third-largest property developer, owned 73% of a subsidiary called Henderson Investment. It offered a rich premium in November 2005 to buy the rest. It had failed in a similar effort three years earlier, but this time it came back with a better offer. Under Hong Kong law, the deal would go through unless 10% of all the shares opposed it. Since the parent owned such a large stake and large institutions backed the deal, passage was considered a foregone conclusion.

Yet the acquisition was voted down early last year by a slim margin. Several market participants were quoted in news reports saying there was a surge in borrowed shares by at least one hedge fund ahead of the vote, compared with little if any lending in Henderson shares over the previous seven months.

By borrowing the shares and simultaneously shorting the underlying stock, the hedge funds gained the voting rights to squash the deal and stood to profit when the stock dropped 18% the next day. After the Henderson vote, the Hong Kong regulator said it was examining voting practices.

"It appears that one or more hedge funds borrowed Henderson Investment shares before the record date, voted against the buyout, and then sold those shares short, thus profiting from its private knowledge that the buyout would be defeated," the Texas professors wrote in the May 2006 Southern California Law Review. A Henderson spokeswoman declined to comment.

Altogether the professors analyzed 12 instances in which it appeared that hedge funds or other large shareholders voted to try to swing public-company contests in their favor without much ownership stake. In 10 others, they said investors just hid their stake in the company until a vote.

THE SHAREHOLDER VOTE is rooted firmly in corporate law, which is based on the notion that shareholders vote in the best interests of the company in which they own stock. The effects of short-selling and other sophisticated instruments that can separate a vote from economic interest were never considered. "You have this whole superstructure built on this notion that there is this coupling of economic interest and voting power," says Mr. Hu. "With these financial innovations, you're screwing around with the foundation."

Hedge funds say their actions are legitimate, lawful and many times in the best interest of their investors. Often they borrow stock or use a hedging strategy to minimize the risk of their stake without any intention to affect the votes of the companies. They also say that if institutions can make money by lending shares, there shouldn't be a judgment against those who borrow.

"You should be able to vote your shares irrationally if you want," says Marc Weingarten, a partner in New York with law firm Schulte Roth & Zabel who advises hedge funds. He adds, "The rules and state law simply haven't caught up with the marketplace for sophisticated trading techniques. They never contemplated the slicing and dicing of ownership and voting power that's done in the marketplace."

It's routine for hedge funds and other investors to borrow shares to vote them. Many individual investors hold their shares in margin accounts with their brokers. Brokers lend those shares out, often when they are requested by short-sellers, who borrow shares in the expectation the price will fall, sell them and hope to profit by buying them back at a lower price.

The California Public Employees' Retirement System reported in October that it made $129.4 million in net income from lending securities for the year ending March 31, 2006. Critics say investors like Calpers shouldn't lend their shares if borrowers will use them in ways to undermine corporate governance. Proponents of securities lending say Calpers and other institutional investors have a fiduciary duty to make the most money for their constituents.

Not everyone agrees where the fiduciary duty lies. Lord, Abbett & Co., a mutual-fund company, has scaled back its stock lending program recently, saying it sometimes didn't get securities back in time to vote and decided that the money it was earning from lending out stocks wasn't worth it. "It was impeding our corporate governance efforts in a troubling number of circumstances," says Robert Morris, chief investment officer at Lord Abbett.

Calpers says it prohibits lending its 30 largest equity investments to make sure they will be available for voting, and on a second list monitors 300 of its largest so that if Calpers wants to vote the shares, it can try to get them back. A Calpers spokesman called those measures "a sufficient safeguard for our interests, for the time being."

Brokerage firms keep records of which shares are lent out when, and which holders of stocks are supposed to have the votes. But shares can be lent and re-lent and the records don't always keep up. Sometimes proxies are sent to both owners and borrowers, leading to "overvoting."

The New York Stock Exchange, which says tracking of votes has become inadequate, found overvotes in almost all the shareholder votes it tested at Deutsche Bank in 2002 and 2003: 23 of 27 instances. "There shouldn't be overvoting," John Thain, chief executive of NYSE Group Inc., said in a speech last year. "The question is, 'How do we prevent that from happening?' "

The phenomenon has gotten the attention of regulators.

Last February, Deutsche Bank agreed to pay $1 million, without admitting or denying wrongdoing, to settle NYSE allegations that the brokerage firm didn't have proper systems in place. In June, UBS Securities, Goldman Sachs Group Inc. and Credit Suisse Securities agreed to pay a total of $1.35 million, without admitting or denying wrongdoing, to settle similar NYSE charges.

JAMES MORPHY, the head of mergers and acquisitions at New York-based law firm Sullivan & Cromwell, says because the votes haven't yet affected many outcomes in general corporate elections, companies haven't spent the time or money to dig deeply into who actually owns and votes their stocks. "To the extent there are a lot more voting contests, these issues are going to come to the fore," he said. As shareholders are getting more power in the wake of management scandals, votes are narrowing, which forces companies to pay more attention to who their shareholders are—as have the growth and increased combativeness of hedge funds.

One way "empty voting" occurs is by borrowing stock ahead of the date that companies use to determine which stockholders can vote at a particular meeting. Record dates are usually set 30 days before a vote, designed to give companies adequate time to print and mail information to its shareholders of record.

In 2002, activist British hedge fund Laxey Partners, which owned a 1% stake in British Land, a major British property owner, sought to break up the company and oust its chairman John Ritblat. With a key proxy vote approaching, Laxey boosted its voting stake in British Land to 9% by borrowing more than 40 million shares days before the record date. By being shareholders of record on the record date, Laxey was entitled to vote at the next meeting.

IN THE END, Laxey's proposals were defeated. But Mr. Ritblat criticized Laxey for borrowing the shares, saying it wasn't good corporate governance. The three institutions that lent out shares—Hermes, Barclays Global Investors and Scottish Widows, a life insurance and investment arm of Lloyds TSB—apologized to British Land. Hermes says it didn't lend shares to Laxey but apologized to British Land for not recalling its shares and voting its full strength in support of management.

Since then, several large pension funds have taken notice and established internal systems to allow them to recall shares ahead of a vote and better monitor which shares are lent.

Because corporate voting is mostly governed by state law, the SEC's main tool in voting issues is requiring more disclosure. "Empty voting" usually doesn't trigger current disclosure rules because they don't cover borrowed stock or derivative holdings unless an investor owns more than 5%. Many hedge funds own just shy of 5%, Mr. Hu says—and then use empty-voting strategies to enlarge or hide their stake.

Paul Atkins, a Republican SEC commissioner, expressed concern in a speech this week that empty-voting and other techniques should be considered as the SEC looks to tackle other shareholder proposals. That could delay the SEC from moving forward in resolving whether shareholders are permitted to nominate their own directors on corporate ballots.

One potential solution is to give institutional investors better notice of important proxy votes so they can know to recall shares—and the attached voting rights—that they've lent. Some investors already write recall options into their lending contracts, but brokerage firms have advised it could make borrowing those shares less attractive.

Professors Hu and Black recommend regulators require disclosure of an investor's complete stake, however it is held. Disclosure now "is so patchwork, you almost never see it," says Mr. Hu. "We need to get a better grip on just how extensive these practices are."

Regulators, however, don't want to disrupt the stock-lending market, and also have to be careful that any fix doesn't have the reverse effect that they intend. For instance, weighing votes by how long the stock has been held could curtail empty voting but disenfranchise individual investors, too.

—Tom Lauricella contributed to this article.