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The Impact of Hedge Fund Activism: Evidence and Implications

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Abstract

Hedge fund activism has increased almost hyperbolically. Some view this optimistically as a means for bridging the separation of ownership and control; others are more pessimistic, seeing mainly wealth transfers from bondholders or speculative expectations of a takeover as fueling the spike. Equivalent division exists over the impact of this increased activism, with optimists seeing real gains that do not erode over time and improvements in operating performance, and pessimists predicting shortened investment horizons, increased leverage, and reduced investment in research and development.

Our perspective is analytic. We begin by surveying the regulatory and institutional developments that have reduced the costs and increased the expected payoff from activism for hedge funds. Here, we focus particularly on the formation of "wolf packs"—namely, loose knit associations of hedge funds that are formed prior to, or contemporaneously with, the filing of a Schedule 13D. We then look at other new institutional structures that are appearing, as typified by the alliance between Pershing Square Capital Management and Valeant Pharmaceuticals in their bid for Allergan.

Then, we survey the empirical evidence on the impact of activism, looking successively at (1) who are the targets of activism?; (2) does hedge fund activism create real value?; (3) what are the sources of gains from activism?; and (4) do the targets of activism experience post-intervention changes in real variables? Although confident claims have been made by some researchers, we find the evidence decidedly mixed on most questions (other than the short term stock price impact). In particular, we find the conclusions about improvements in target operating performance that have been expressed by some to be overextended beyond their actual data and premature.

Finally, we examine the policy levers that could encourage or chill hedge fund activism and consider the feasibility of reforms. The gains from hedge fund activism may be high both because such activity is relatively low risk (if asymmetric information can be exploited that is acquired before the filing of a Schedule 13D) and short-term (with the median hedge fund activist holding for approximately nine months). Still, we predict that the impact of most regulatory changes are likely to be marginal. Conversely, we believe that private ordering (through techniques such as a "window-closing" poison pill) could achieve at least as much as regulatory changes.

Keywords: hedge fund, institutional investor, Schedule 13D, shareholder activism, Williams Act, wolf pack

JEL Classifications: G23, G28, G32, G34, G35, K22

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The Impact of Hedge Fund Activism: Evidence and Implications

by

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I. Introduction

Hedge fund activism has recently spiked, almost hyperbolically.[1] No one disputes this, but divergent explanations exist for it. Some see activist hedge funds as the natural champions of dispersed shareholders, who are not economically capable of collective action in their own interest.[2] So viewed, hedge fund activism can bridge the separation of ownership and control. That, however, may assume what is to be proved. Others believe that hedge funds have interests that differ materially from those of other shareholders.[3] We begin therefore with a more modest, two-part explanation for increased activism: First, the costs of activism have declined, in part because of changes in SEC rules, in part because of changes in corporate governance norms (for example, the sharp decline in staggered boards), and in part because of the new power of proxy

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[1] See text and notes infra at notes 14 to 25.

[2] For a leading statement of this view, see Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863 (2013). See also Lucian Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833 (2005).

[3] See, e.g., Iman Anabtawi, Some Skepticism about Increasing Shareholder Power, 53 UCLA L. Rev. 561 (2006); Iman Anabtawi and Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 Stan. L. Rev. 1255 (2008); Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1083 (2007) (viewing hedge funds as the "archetypal short-term investor"); William W. Bratton and Michael Wachter, The Case Against Shareholder Empowerment, 158 U. Pa. L. Rev. 653 (2010); Justin Fox and Jay W. Lorsch, The Big Idea: What Good Are Shareholders?, 48 Harv. Bus. Rev. 50, 51 (2012). Still others believe that "activist" hedge funds (or at least those with a high portfolio turnover) are systematically biased towards the short-term and thus persistently undervalue long-term investments. See Brian Bushee, The Influence of Institutional Investors on Myopic R&D Investment Behavior, 73 Acc. Rev. 315 330 (1998). See also text and notes infra at notes 89 to 91. For similar views, see Lynn Stout, The Mythical Benefits of Shareholder Control, 93 Va. L. Rev. 789 (2007); Lynn Dallas, Short-Termism, The Financial Crisis and Corporate Governances, 37 J. Corp. L. 265 (2011).

advisors (which is in turn a product of legal rules and the fact that some institutional investors have effectively outsourced their proxy voting decisions to these advisors).[4] Second, activist hedge funds have recently reaped high profits.[5] If the costs go down and the profits go up, it is unsurprising that activism surges. But that does not answer the question of whether there are externalities associated with this new activism.

From a closer-in perspective, the single most important cause of increased hedge fund activism may be the development of a new tactic: namely, the formation of a "wolf pack" that can take collective (or, at least, parallel) action without forming a "group" for purposes of the federal securities laws (which would trigger an earlier disclosure obligation).[6] Hedge funds have learned that this tactic promises relatively riskless gains, particularly to those hedge funds who hold only for the short-term. If riskless gains are possible (even for a transitional period), one can expect that this tactic will be exploited—and possibly overused.[7]

Of course, new tactics are not necessarily bad and may be efficiency-enhancing. Here, most studies have found that hedge fund activist campaigns result *on average* in short-term gains for shareholders, but the evidence is more mixed with respect to long-term gains (where the most

[4] See text and notes infra at notes 32 to 40 and 185 to 186.

[5] See text and notes infra at notes 21 to 22.

[6] The "wolf pack" tactic and the case law on "group" formation is examined infra in the text and notes at notes 54 to 70.

[7] As the number of hedge funds pursuing "activist" strategies has soared, it follows that at some point the number of profitable opportunities for such intervention will decrease. Active competition among hedge funds implies that increasingly marginal opportunities for activist gains will be pursued.

recent study reports long-term gains that are statistically insignificant).[8] Even if one concludes that hedge fund activism is associated on average with stock price gains for shareholders, any conclusion that hedge fund activism is therefore efficiency-enhancing is still premature because of four limitations on these studies:

(1) These studies tend to ignore or downplay the distribution of returns and the fact that a significant proportion of firms experience losses as a result of hedge fund activism;

(2) There are significant differences among these studies as to their definition of the control group (in particular, firms that did not experience an activist intervention are not randomly chosen, which introduces a bias into the regression results); claims about "causality" are therefore premature;

(3) The positive abnormal stock returns that they report are not clearly attributable to actions of hedge fund activists that reduced agency costs, but may instead result from other factors (including market speculation about an expected takeover or simply a regression to the mean); and

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[8] See Alon Brav, Wei Jiang, Frank Partnoy and Randall S. Thomas, Hedge Fund Activism, Corporate Governance and Firm Performance, 63 J. Fin. 1729 (2008) (finding on average an abnormal short-term return of 7% to 8% over the period before and after the filing of a Schedule 13D announcing an activist's acquisition of 5% or more of the stock of a target firm). The most recent (and entirely consistent) study is Lucian Bebchuk, Alon Brav, and Wei Jiang, The Long-Term Effects of Hedge Fund Activism, Working Paper (available at http://ssrn.com/abstract=2291577)(April 10, 2014) (forthcoming in Columbia Law Review). They find an approximately 6% average abnormal return during the 20-day window before and after a Schedule 13D filing. Id at 16 and Figure 2. This and other studies are considered infra at notes 109 to 158.

(4) They overlook (or give only inadequate attention to) the possibility that whatever shareholder wealth is created by hedge fund activism may reflect only a wealth transfer from bondholders, employees, or other claimants.

These limitations are important. If the distribution of returns shows that a significant number of firms experience losses (and sizeable ones), then hedge fund activism looks very different depending on whether one examines it from the perspective of the hedge fund manager or the corporate director. To the diversified fund manager, a tactic is justified if it produces a portfolio-wide positive return. In contrast, a corporate director is responsible for, and must consider the welfare of, only one company. Thus, the possibility of a negative return (particularly when the upside return may be only modest) may reasonably cause a board of directors to reject a strategy favored by a group of hedge funds that, like them, also wants to maximize shareholder value.

Similarly, the failure to compare the positive return on those corporations experiencing activist campaigns to the return on a similarly situated control group means that we do not know if some characteristic shared by all the firms would have also caused the control group to experience a similar return. What we do know is that the targets of hedge fund activism are not randomly distributed, but rather tend to have some common characteristics, including in most (but not all) studies a low Tobin's Q, below average leverage, a low dividend payout, and a "value," as opposed to a "growth," orientation.[9] This raises the possibility that such companies may experience a stock price cycle, first falling out of favor, but then recovering. Others have

[9] See text and notes infra at notes 109 to 117.

suggested that the follow-on gains in stock price experienced by the subjects of hedge fund activism may reflect simply a regression to the mean,[10] and we further evaluate that possibility.

In order to establish causality on the part of hedge fund activists, these studies would need to use a method such as propensity score matching.[11] In such methodologies, one can examine what is often referred to as the "but for" explanation. In our context, targets and non-targets would be matched in all observable firm characteristics in the pre-Schedule 13D filing period (that is, they would have the closest propensity score). Thus, rather than simply controlling for size and industry group (as many studies do), other variables, such as life cycle liquidity effects, would also be considered. This approach should permit the investigator to determine whether, "but for" the intervention of the activist hedge fund, shareholder value would have been created in the post-Schedule 13D filing period. This refinement has not, however, been used in any existing study of which we are aware.

Finally, although shareholders are basically entitled to seek gains from any source (including bondholders), public policy has little reason to encourage wealth transfers. Public policy is ultimately our focus. If new rules that promoted greater transparency with regard to hedge funds' activities chilled primarily wealth transfers, that cost would seem acceptable.

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[10] See Yvan Allaire and Francois Dauphain, "Activist hedge funds: creators of lasting wealth? What do the empirical studies really say?" at 12-13 (Institute for Governance of Private and Public Organizations) (July 2014) (reporting a "clear pattern of convergence towards the mean"). Their point is that firms that outperform or underperform the mean over one period move closer to the mean over the next period.

[11] For example, see Paul R. Rosenbaum and Donald R. Rubin, The Central Rule of The Propensity Score in Observational Studies for Causal Effects, 70 Biomedica 41 (1983) and Guido W. Imbens and Donald R. Rubin, CAUSAL INFERENCE IN STATISTICS, SOCIAL AND BIOMEDICAL SCIENCES: An Introduction (2014).

Our concern with public policy stems from the possibility that hedge fund activism may exacerbate an important externality: namely, it may encourage corporate boards and managements to forego long-term investments (particularly in research and development) in favor of a short-term policy of maximizing dividend payouts and stock buybacks. Such a shift towards shorter-term profit maximization might ultimately prove costly to the American economy, but those costs would not necessarily be observable within the time periods examined in the existing studies. Nor would these costs be borne only by the actual subjects of hedge fund activism that these studies cover, as other corporations would predictably take similar defensive measures. Worse yet, if such a short-term investment horizon were to be imposed (or at least encouraged) by hedge fund activism and if the gains to shareholders were primarily wealth transfers from bondholders and others, then on the macro level the American economy would suffer an injury without any compensating benefit.

In this light, we begin in Section II with an analysis of those factors that have spurred greater activism on the part of hedge funds. Then, in Section III, we consider evidence suggesting that a danger exists of a shift toward a short-term investment horizon that is suboptimal. We do not claim that we can prove such a shift has occurred because any such shift involves the decision-making of a broad community of corporate executives, not just those who have been subjected to an activist campaign. In effect, we are asking: "What is the general deterrent effect of hedge fund activism. Does it reduce agency costs or deter long-term investments—or both?" This is not a question that can today be answered with confidence. Although it is possible (with difficulty) to measure the impact on firms that experience an activist campaign, it is far more difficult to estimate that impact on all firms (including the much larger number of firms that have not experienced such a campaign). Yet, it is implausible to believe that other firms will ignore the heightened risk of a proxy fight that may remove their directors and officers. Indeed, there is evidence in some industries that managers are keenly aware that long-term investments may be disfavored by hedge fund activists and may elicit a proxy contest.

In Section IV, we survey recent studies to reach assessments about: (1) who are the targets of hedge fund activism; (2) the stock price returns from hedge fund activism and the distribution of those returns; (3) the degree to which wealth transfers explain the positive stock price returns to activism; (4) the post-intervention evidence about changes in operating performance of hedge fund targets; and (5) the holding periods and exit strategies of hedge fund activists. In Section V, we evaluate some policy options, looking for the least drastic means of accomplishing policy goals. Section VI offers a brief conclusion.

In brief, given the mixed results that we survey, it is clear to us that much work still needs to be done, in particular with respect to whether contemporary forms of activism are impacting real firm variables.

II: The Changed Environment: What Factors Have Spurred Enhanced Activism by Hedge Funds?

Once upon a time, institutional investors followed the "Wall Street Rule": if dissatisfied with management, they sold their stock, but they did not attempt to intervene or challenge management. This passivity was probably the consequence of shareholder dispersion (which made activism costly) and conflicts of interest (large banks—both commercial and investment—did not want to alienate corporate clients). With the growth in institutional ownership, however, behavior changed. This was particularly true in the case of hedge funds,[12] which, unlike mutual funds, typically hold concentrated blocks in a limited number of companies (rather than a broadly diversified portfolio).[13] Concentrated ownership makes shareholder activism rational from a cost/benefit standpoint.

The types of activist campaigns run by hedge funds range from modest interventions in corporate governance (e.g., proposals to separate the positions of CEO and Board Chairman) to more intrusive interventions seeking to sell the company, fire the CEO, or spin off divisions. As will be seen, the more intrusive the intervention, the greater the likely positive stock market

[12] A number of commentators date the appearance of "activist" hedge funds conducting proxy fights to 2005. See Thomas W. Briggs, Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis, 32 J. Corp. L. 681, 685 (Summer 2007). We make no claim as to when they first appeared, but they at least began to receive widespread press attention in 2005. But see statistics discussed infra at note 16.

[13] It is necessary to acknowledge here that there is no generally accepted definition of the term "hedge fund." Everyone makes this observation at the outset of their article or memorandum and then suggests a working definition. See Linda Chatman Thomsen, Daniel M. Hawke, and Pauline E. Calande, Hedge Funds: An Enforcement Perspective, 39 Rutgers L.J. 541, 543 (2008). Four characteristics usually identify hedge funds (and in any event most commentators seem to believe that they "know one when they see one"). Those four key characteristics are:

> "(1) they are pooled, privately organized investment vehicles;
>
> (2) they are administered by professional investment managers with performance-based compensation and significant investments in the fund;
>
> (3) they cater to a small number of sophisticated investors and are not generally readily available to the retail-investment market; and
>
> (4) they mostly operate outside of securities regulation and registration requirements."

See Richard Lee and Jason D. Schloetzer, Director Notes: "The Activism of Carl Icahn and Bill Ackman," (The Conference Board May 2014) at 2.

response. The frequency of such campaigns has skyrocketed, with one recent survey counting 1,115 activist campaigns between 2010 and 2014.[14] The first six months of 2014 have alone seen 148 such activist campaigns.[15] Clearly, this level is in sharp contrast to earlier periods when, for example, only 52 campaigns could be identified over a 20 consecutive month stretch in 2005-2006.[16]

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[14] See Liz Hoffman and David Benoit, "Activist Funds Dust Off Greenmail Playbook," The Wall Street Journal Europe, June 13, 2014 at 22.

[15] See Rob Copeland, "Activists' Returns Rise about the Din," The Wall Street Journal, July 9, 2014 at C-1 (citing data from FactSet SharkWatch).

[16] See Briggs, supra note 12, at 695-696. This study covered all of 2005 and the first eight months of 2006 and found only 52 corporations "to have become the subject of a significant hedge fund campaign" during this time period. Id. at 696. Similarly, a Conference Board study reports that the number of "shareholder activist events" rose from 97 events in 2001 to 219 events in 2012. See Lee and Schloetzer, supra note 13, at 1.

Different definitions of activist "interventions" are possible. If we look simply to the number of Schedule 13D filings by activist hedge funds, Bebchuk, Brav, Jackson and Jiang present the following data:

Schedule 13D Filings By Activist Funds

Year	Filings
1994	10
1995	37
1996	99
1997	212
1998	161
1999	118
2000	120
2001	96

Historically, hedge fund activism focused on smaller cap companies because it was too costly to assemble a sizeable stake in a larger cap company. But this is changing. In 2013, for the first time, almost one third of activist campaigns focused on companies with a market capitalization of over $2 billion.[17] If we instead use $10 billion as our dividing line for "large cap" stocks, we find that only 17 such companies were targeted by activist investors in 2010,[18] but then in 2011 to 2013, the number of such activist campaigns rose to 21, 23, and 42, respectively.[19] In effect, they have doubled since 2011. Finally, in 2014, Pershing Square Capital Management L.P. joined with a strategic bidder in a $53 billion joint tender offer for Allergan, Inc.[20] In short, whatever their size, few companies today seem immune from the reach of hedge fund activism.

2002	134
2003	127
2004	148
2005	237
2006	269
2007	272
Total	2040

See Lucian A. Bebchuck, Alon Brav, Robert J. Jackson, Jr., and Wei Jiang, Pre-Disclosure Accumulation by Activist Investors: Evidence and Policy, 39 Iowa J. Corp. L. 1 (2013) at *9 (Table I). Although the number of filings has waxed and waned in the past, the years 2005 to 2007 showed a marked increase. Activism then waned with the 2008 financial crisis, but rebounded sharply since 2010.

17 See Lee and Schloetzer, supra note 13, at 3.

18 Id.

19 Id.

20 See text and notes infra at notes 94 to 104.

Only a specialized group of hedge funds engage in activist campaign and proxy fights, but they have recently done very well. "Activist" hedge funds earned a 6.5% rate of return in the first half of 2014, more than doubling the 3.1% rate of return for that same period for hedge funds as a group.[21] Equally important, the assets managed by "activist" hedge funds have soared, growing over seven times from $23 billion in 2002 to $166 billion in early 2014, and the top ten activist hedge funds alone attracted $30 billion in new investment in 2013.[22]

Hedge funds initiated the majority of proxy contests in 2013, accounting for 24 of the 35 contests conducted with respect to Russell 3000 companies.[23] Although long more active than other investors, the percentage of all proxy contests waged by hedge funds continues to increase, rising from 39% in 2009 to 69% in 2013.[24] Even more importantly, they are winning these fights, securing partial or complete victories in 19 of the 24 contests they initiated in 2013.[25] This nearly 80% rate of success implies that the pace may yet quicken.

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[21] See Copeland, supra note 15, at C-1.

[22] See Lee and Schloetzer, supra note 13, at 2. For slightly different numbers, see Juliet Chung and David Benoit, "Activist Investors Add to Their War Chests." The Wall Street Journal, September 12, 2014 at C1 (finding that the assets under management at a specific group of activist hedge funds grew by $9.4 billion in the first half of 2014 and now total $111 billion). The size and reach of activist hedge funds may soon increase by an order of magnitude, as hedge fund manager William Ackman has announced plans for a $2 billion IPO of a new fund in London, which will be listed on Euronext Amsterdam, thus giving him more permanent capital that cannot be withdrawn by investors. See Maarten van Tartwijk, "Pershing Square, $2 billion IPO planned," The Wall Street Journal, September 16, 2014 at C2.

[23] Id at 3.

[24] Id.

[25] Id.

To be sure, increased engagement between shareholders and management has entered the mainstream. An Ernst & Young report finds that half of all S&P 500 companies disclosed engaging with investors in 2013, up from only 23% in 2012.[26] Yet, even if there is a greater shareholder desire for engagement with management, hedge fund activism is qualitatively different. As others have stressed, traditional institutional investors—basically, pension funds and mutual funds—are essentially "defensive" in their activism, while hedge funds are "offensive," seeking a target in which to invest in order to pursue a proactive agenda.[27] From such an "offensive" perspective, activist hedge funds attempt to identify target firms with special characteristics, either to create shareholder value or to realize the private benefits of control.[28]

Initially, we need to focus on what factors explain the increased frequency and success of activism. The following stand out, but are not exhaustive:

[26] See EY Center for Board Matters, "2014 Proxy Season Review: New developments raise bar for effective communication" (August 6, 2014). Some groups, most notably The Conference Board, are working to develop standards to apply in this new environment. See The Conference Board, Recommendations of the Task Force on Corporate/Investor Engagement (Research Report 1539-14-RR) (2014). At present, it seems at least uncertain and probably unlikely that "activist" hedge funds will accept these standards.

[27] See Brian Cheffins and John Armour, The Past, Present and Future of Shareholder Activism by Hedge Funds, 37 Iowa. J. Corp. L. 51 (2011). As they argue, "defensive" activists take action to protect an existing investment, whereas "offensive" activists seek a target to fit their agenda for activism.

[28] We will not focus on this theme of private benefits in this memorandum, but "offensive" activists appear to often plan their "exit" in advance and have increasingly used "greenmail" transactions (i.e., issuer purchases of their shares) to assure that "exit." See Hoffman and Benoit, supra note 14. Although the sale of their block back to the issuer may be at the market price, a sale of the same block into the market would likely reduce the price they received.

A. The Decline of Staggered Boards. A threat to sell the company or fire the CEO is an empty one if the activist faces a staggered board and can only elect one third of the directors at the next annual election. Although once popular, staggered boards have recently declined to the point that they will soon be rare. In 2000, 300 of the S&P 500 had staggered boards, but as of the end of 2013, only 60 did.[29] This decline is immediately attributable to a campaign led by Harvard Law School Professor Lucian Bebchuck, whose Harvard Law School Shareholder Rights Project has successfully sponsored numerous shareholder resolutions calling on boards to eliminate the staggered board.[30] But the disappearance of staggered boards probably owes even more to the growing influence of the proxy advisors (and most notably Institutional Shareholder Services ("ISS"), which regularly supports proposals seeking to declassify the board and may oppose the board nominees of companies that maintain staggered boards.

With the decline in staggered boards, corporate management come under greater pressure and face the prospect of a proxy fight that could remove the entire board. In 2012-2013, proxy

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[29] See David Benoit, "Clash Over Board Will Be Measure of Activist Clout," The Wall Street Journal, May 23, 2004 at C-1.

[30] See Steven Davidoff, "The Case Against the Staggered Board," New York Times Blogs (Dealbook) (March 20, 2012). Overall, the Shareholder Rights Project has been extraordinarily successful. In the 2012 proxy season alone, the Shareholder Rights Project succeeded in destaggering one third of the staggered boards in the S&P 500. See Brandon Gold, Agents Unchained: The Determinant of Takeover Defenses in IPO Firms (available at http://ssrn.com/abstract=2262095) (May 6, 2013), at 20. Although the board need not respond affirmatively to these shareholder resolutions, they are likely to incur the displeasure of ISS (or other proxy advisors) if they do not.

campaigns to obtain full or majority control rose to 42% of all proxy battles, which is a substantial increase over prior years.[31] The threat of sudden ouster is thus real and increasing.

B. The Enhanced Power of Proxy Advisors. Even more important than the decline of staggered boards has been the rise of proxy advisors. Their rise to prominence began in the early 1980s in the wake of a U.S. Department of Labor's interpretation of the Employees Retirement Income Security Act ("ERISA"), which seemed to require a prudent trustee to vote the shares it held in portfolio companies.[32] Failing to vote shares in its view implied wasting a portfolio asset and signaled that the fiduciary was breaching its duty of care. Somewhat belatedly, the SEC took a similar position in 2003, adopting rules that are at least read by the registered investment advisors to mutual funds to require them both to vote their shares "in the best interests of clients" and to disclose annually how they actually voted.[33] This year, under criticism that its rules delegated too much power to proxy advisors, the SEC has suggested that

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[31] See Benoit, supra note 29, at C-1. Only about 20% of the 520 proxy fights since 2008 have attempted to replace the entire board (according to data compiled by FactSet SharkWatch). Id.

[32] The Department of Labor codified these policies in 1994, after previously announcing them less formally in earlier advisory letters. See 29 C.F.R. §2509.94-2. Specialists disagree as to what both the Department of Labor and the SEC's rules actually require, but their impact on institutional investors is clear.

[33] See Investment Advisers Act Release No. 2106 ("Proxy Voting by Investment Advisers"), 68 Fed. Reg. 6585, 6593 (Feb. 7, 2003) (adopting Rule 206(4)-6 ("Proxy Voting")), 17 C.F.R. §275. 206(4)-6. Rule 206(4)-6 requires "written policies and procedures to ensure that [advisers]…vote client securities in the best interests of clients." See also Securities Act Release No. 8188 ("Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies"), 68 Fed. Reg. 6564 (Feb. 7, 2003) (adopting Investment Company Act Rule 30b1-4). Rule 30b1-4 ("Report of Proxy Voting Record") requires the investment company to file an annual report with the SEC disclosing its "proxy voting record" for the previous twelve-month period.

investment advisers are not required to vote on every issue, but it has not suggested that voting in an election of directors could be omitted.[34]

Because many mutual funds compete by attempting to minimize overhead costs and thus have only small in-house staffs, these funds found it easier to outsource the voting decision to a third party. Proxy advisors—most notably Institutional Shareholder Services (ISS) and Glass-Lewis—developed to fill this role. Both mutual funds and pension funds differ in terms of how much they rely on ISS's recommendations, but many appear to defer almost entirely. One study this year finds that over 25% of mutual funds vote almost exactly as ISS recommends.[35] Other funds rely less and vote independently, but a Business Roundtable survey found that 40% of its member firms' shares were held by institutions that basically followed ISS's voting recommendations.[36]

Both ISS and Glass Lewis publish their voting policies, and both strongly support shareholder activism, opposing takeover defenses and seeking to maximize shareholder power.[37] Both also determine their voting policies based on interactions with (and polling of) institutional

[34] See Division of Investment Management, Division of Corporation Finance, Securities and Exchange Commission, Staff Legal Bulletin No. 20 ("Proxy Voting. Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisor Firms") (June 30, 2014).

[35] See Peter Iliev and Michelle Lowry, "Are Mutual Funds Active Voters?" (available at http://ssrn.com/abstract=2145398) (April 15, 2014) (finding over 25% of mutual funds "to rely almost entirely on ISS recommendations").

[36] See Briggs, supra note 12, at 692 (discussing 2003 memorandum by the Business Roundtable).

[37] See Institutional Shareholders Services Inc., "2014 U.S. Proxy Voting Summary Guidelines" (January 31, 2014); Glass Lewis & Co., "Guidelines 2014 Proxy Season: An Overview of the Glass Lewis Approach to Proxy Advice" (2014).

investors, so that proxy advisors and their clients reciprocally influence each other. Estimates differ as to the impact that an ISS recommendation will have in a contested proxy vote,[38] but it is clearly significant and can easily make the difference between victory and defeat. One measure of ISS's influence is that most public companies in order to comply with ISS's guidelines have either redeemed their poison pill or adopted a poison pill that is consistent with ISS's guidelines (and thus has a duration of one year or less).[39]

As noted later, controversy has arisen as to the propriety of the apparent deference given by many institutional investors to ISS, but no conservative challenger to ISS and Glass-Lewis's activist stance has been able to gain any significant market share. This probably reflects the

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[38] For the finding that an ISS recommendation can change certain votes by 30% on average, see Yonca Ertimur, Fabrizo Ferri, and David Oesch, Shareholder Votes and Proxy Advisors: Evidence from Say on Pay (available at http://ssrn.com/abstract=2019239) (August 2, 2013). This 30% average impact was in the context of "say on pay" votes (where institutional investors may have less interest) and probably overstates the impact of an ISS recommendation on director elections. Conversely, Professors Choi, Fisch, and Kahan estimate that a recommendation from ISS, the most influential of the proxy advisors, shifts investor votes by between 6% and 10%. Stephan Choi, Jill Fisch and Marcel Kahan, The Power of Proxy Advisors: Myth or Reality, 50 Emory L. J. 869 (2010). This may understate the current impact of an ISS recommendation, given the increasing tendency of some mutual funds today to defer entirely to ISS. See Iliev and Lowry, supra note 35. Even if the proxy advisor's impact cannot be more precisely quantified than somewhere between 10% and 30%, this amount is sufficient to swing many elections where (a) retail shareholders may not vote, and (b) other hedge and mutual funds may bring the total activist ownership up to 30% or more. See text and note infra at note 66 (describing silent ownership by hedge funds in the Sotheby's proxy contest).

[39] ISS's policy is to require a shareholder vote for any poison pill plan having a duration longer than 12 months. That is, the board must put the poison pill to a shareholder vote within that period or face an ISS disapproval. See Institutional Shareholder Services, Inc., supra note 37, at 25.

market's satisfaction with their leadership. Still, some event studies have found that when institutions vote as ISS recommends, the outcome (at least in some contexts) is actually to decrease share value.[40]

C. SEC Rules. Once, the SEC's proxy rules swept very broadly. Because they define the term "solicitation" to include any communication made "under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy,"[41] corporations could deem "almost any statement of views" by a shareholder (or an agent thereof) as amounting to a proxy solicitation, even when the maker of the statement was not seeking proxies.[42] As a result, the issuer (or the SEC) could sue the maker of such a statement or opinion, seeking to bar it from further solicitation on the ground that it had failed to file a proxy statement. This had a clearly chilling impact on shareholder speech and dissent, as compliance with the SEC's rules required the proponent to file a preliminary proxy statement with the SEC for its review before mailing it to shareholders. For decades, this had implied both delay and inhibited speech, plus the substantial costs of printing and mailing an often lengthy document. Moreover, these rules made the SEC into a *de facto* censor of the proxy contestant's speech. The

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[40] One recent study finds a statistically negative impact on stock price as the results of certain compensation program changes made by public companies in response to comments from proxy advisory firms. See David F. Lareker, Allan L. McCall, Gaizka Ormazabal, Outsourcing Shareholder Voting to Proxy Advisory Firms (available at http://ssrn.com/abstract=2101453) (June 13, 2014).

[41] See SEC Rule 14a-1 ("Definitions") which defines the term "solicit" and "solicitation" for purposes of the proxy rules in this fashion. (17 C.F.R. §240.14a-1).

[42] The SEC conceded in a 1992 release that the term "solicitation" was broad and that "almost any statement of views" by a shareholder could be challenged as a proxy solicitation. See Securities Exchange Act Release No. 31, 326 ("Regulation of Communications Among Shareholders") (October 16, 1992).

SEC could effectively determine that statements were unfair or unsubstantiated and bar them. The proponent could avoid these rules only if it solicited ten or fewer shareholders.

But then in 1992, the SEC decided to deregulate, and it abandoned its former role as proxy censor.[43] This greatly reduced delay, and the new rules also permitted "freer" speech. For example, Rule 14a-2(b)(3) permits proxy advisors to distribute "proxy voting advice" to shareholders, at least so long as it was not acting as an agent for a proxy contestant.[44] Similarly, Rule 14a-2(b)(1) broadly allows statements amounting to a proxy solicitation so long as the solicitor does not seek proxy authority.[45] Effectively, this allowed institutional investors (and hedge funds) to communicate with each other in an uninhibited fashion. They could now publically oppose management's nominees (but not seek to obtain proxies for their own candidates) without preparing a proxy statement.

The 1992 reforms also authorized "short slates"—that is, proxy contests in which the insurgent sought only to elect a minority of the board seats up for election.[46] This was important

[43] See Securities Exchange Act Release No. 31,326, supra note 42. The SEC finally recognized in 1992 that if it remained a censor with whom contestants had to pre-clear their materials, proxy contestants would not be able to respond to their opponents in a timely manner. Several commentators have made this argument, none more effectively than Professor Bernard Black. See Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520 (1990). For an overview of the impact of the SEC's 1992 reforms, see Briggs, supra note 12, at 686-689.

[44] See 17 C.F.R. §240.14a-2(b)(3). There are other preconditions to this rule, including that the proxy advisor discloses to the recipient of the advice "any significant relationship" that it has with the issuer or a proxy contestant.

[45] See 17 C.F.R. §240.14a-2(b)(1).

[46] See 17 C.F.R. §240.14a-4(d). Originally, this had not been much used, because strategic bidders wanted control. However, the "short slate" rule well suits the needs of hedge funds, who typically would rather play the role of auctioneer than the role of acquirer. As a result, most proxy contests initiated by hedge funds today are for a minority of the board.

because, in the absence of a takeover bid, the shareholders might be understandably reluctant to pass control to an insurgent group that was not offering them any control premium. Instead, under the short slate rule, the insurgent could seek minority representation on the board in order to push a specific agenda (e.g., the spinoff of a division, a higher dividend payout, a stock buyback, etc.) This rule encouraged hedge funds to seek board representation with the possible objective of putting the company up for sale, but without themselves acquiring control.[47] Because hedge funds are not typically strategic bidders and traditionally did not want control (which carried some risk of liability), this rule well served their needs.

The next major step for the SEC toward deregulation came in 1999 with the adoption of Rule 14a-12.[48] So long as no proxy card was furnished shareholders, Rule 14a-12 allowed virtually unlimited communication with other shareholders before any proxy statement was filed. In effect, the election contest could precede the filing of the proxy statement, if all written materials so used were promptly filed with the SEC and contained certain prescribed legends. Oral communications were entirely deregulated (subject to the antifraud rules) and did not need to be filed in any form with the SEC.

In practice, the impact of Rule 14a-12 was to eliminate the need for a proxy statement in several contexts. First, if the insurgent found that it could not attract majority support, it could

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[47] The goal of the short slate rule also was to encourage "constructive engagement" through minority board representation—without a confrontational battle between activists and the issuer. See Ronald J. Gilson et. al., How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors, 17 J. Corp. L. 29 (1991) (advocating the adoption of a short slate rule).

[48] Rule 14a-12 was adopted by Securities Act Release No. 7760 ("Regulation of Takeovers and Security Holder Communications"), 64 Fed. Reg. 61, 488 (Nov. 1999). For an overview of its impact, see Briggs, supra note 12, at 689-691.

simply abandon its campaign and never file a proxy statement. Second, facing a likely loss, the target corporation might decide to settle with the insurgent and voluntarily place some of the insurgent's nominees on its board, thereby again eliminating the need for the insurgent to file a formal proxy statement. After 2000, the prospective shelter of this rule enabled insurgents to circulate lengthy documents, sometimes of several hundred page length, without any prior proxy statement being distributed.[49]

Although insurgents faced high costs in mailing a proxy statement to all shareholders, they did not actually need to do so. The SEC has long permitted them to mail only to the shareholders whose votes they solicited.[50] Thus, they could direct their mailings to institutional shareholders and ignore retail shareholders with small holdings. In 2005, the SEC further reduced these costs to insurgents by eliminating the need to mail any proxy statement to shareholders.[51] Instead, consistent with the SEC's earlier-adopted "access-equals-delivery" model for registration statements in the public offering context, the proxy contestant needed only

[49] See Briggs, supra note 12, at 696-697 (discussing example of a 348 page "book" distributed by Carl Icahn's investment banker pursuant to Rule 14a-12).

[50] See Securities Exchange Act Release No. 55, 146 ("Internet Availability at Proxy Materials"), 72 Fed. Reg. 4148, 4158 (January 29, 2007) (noting that insurgents can economize by soliciting only "those with large holdings").

[51] Instead, the proxy contestant could simply email a Notice of Internet Availability of Proxy Materials and leave it to the shareholder to seek out its proxy statement on the dissident's website. See Securities Exchange Act Release No. 55, 146 ("Internet Availability of Proxy Materials"), 72 Fed. Reg. 4148, 4150-60 (January 29, 2007). The insurgent will have to mail or otherwise send its proxy statement to requesting shareholders, but such requests are few.

This policy change followed the SEC's earlier and similar decision in 2005 to move the distribution of prospectuses to a "notice equals access" model. See Securities Act Release No. 8591, 70 Fed. Reg. 44, 722, 44, 782-86 (August 3, 2005).

to email a short notice to shareholders that its proxy materials were available online at a website or at the SEC in order to comply. Thus, a proxy statement would be filed, but not mailed, and the proxy contestant saved significant costs, but could still file and seek proxy authority if the contest went the full distance to a vote.

In sum, deregulation has greatly reduced the costs of proxy contests and thereby encouraged hedge fund activism.

D. <u>Broker Votes</u>. Historically, brokers were permitted to vote shares held in their "street name" for their clients, at least on "routine" matters.[52] As a practical matter, this did not significantly affect contested elections for board seats (which were not considered "routine" and so brokers could not vote), but it did mean that in voting on shareholder proposals or on corporate governance issues, brokers would typically vote the shares held by retail shareholders in favor of management's position. Institutional shareholders would still vote their own shares in order to comply with the policies on voting of the Department of Labor and the SEC. Then, in 2010, both the New York Stock Exchange and the Dodd-Frank Act acted independently to change this landscape, by barring brokers from voting shares held in their names without shareholder instructions in most circumstances.[53]

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[52] For the old rule, see New York Stock Exchange Listed Company Manual §452 (2003) (permitting brokers to vote shares held in their name on an uninstructed, discretionary basis on "routine" matters). The New York Stock Exchange voted to change this practice even before the 2008 financial crisis, but had to await SEC approval of its rule change, which approval came only in 2009, effective for shareholder meetings occurring after January 1, 2010. For an overview, see Marcel Kahan and Edward Rock, <u>Embattled CEOs</u>, 88 Texas L. Rev. 987, 1015-1018 (2010).

[53] Section 957 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 6(b) of the Securities Exchange Act of 1934 to prohibit discretionary voting by brokers with respect to director elections and with respect to "any other significant matter" (as determined by the SEC).

The net impact is that the shares held by retail shareholders are less likely to be voted (as they tend toward passivity), thus giving greater relative weight to the voting preferences of institutional shareholders. In effect, in a vote to approve a merger or a vote on a shareholder proposal, management loses its previously built-in advantage based on brokers voting the shares of passive retail shareholders for management. Even more importantly, if the corporation's own bylaws require a director to submit his resignation if the director fails to receive a majority of the votes cast (and such "majority vote" provisions are now widely prevalent), broker votes can no longer be counted for this purpose, thus increasing the insurgent's chances to unseat an incumbent in a "withhold the vote" campaign. As a result, hedge funds can pressure boards to increase the payout to shareholders with the threat of a "withhold the vote" campaign, even when they do not choose to run their own candidates for the board. This is low-cost pressure.

E. The "Wolf Pack" Tactic. The term "wolf pack" is often used (including by courts), but it is seldom defined.[54] As used herein, it will mean a loose network of activist investors that act in a parallel fashion, but deliberately avoid forming a "group" under Section 13(d)(3) of the Securities Exchange Act of 1934. That provision states that "[w]hen two or more persons act as a…group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection."[55]

[54] For a careful review of the "wolf pack" strategy, see Briggs, supra note 12, at 697-99. Published in 2007, this article shows that the technique was being used at least as early as 2005. Only its prevalence has truly changed.

[55] See Section 13(d)(3) of the Securities Exchange Act of 1934, 15 U.S.C. §78m(d)(3). For the conclusion that hedge funds perceive themselves to face little risk of being deemed a group (so long as they do not explicitly agree to cooperate), see Briggs, supra note 12, at 691 ("hedge funds…engage in 'wolf pack' tactics against companies undeterred by a fear of somehow magically becoming a group because they hunt together and seek 'the same prey.'") Later, we will assess the prospects for changing this attitude.

Thus, if three “persons” each acquire 2% of the stock in a target company and their relationship makes them a “group”, their shares are aggregated by Section 13(d), which treats them as a single “person” who must file a Schedule 13D within ten days of the formation of the group because they have collectively crossed its 5% beneficial ownership threshold.

Why is it important not to form a “group” for Section 13(d) purposes? Multiple reasons can be given. First, it is possible that all members of a Section 13(d) “group” will be sued by the target company, who will assert alleged disclosure violations in their Schedule 13D. Avoiding joining a “group” protects those activist investors who individually own less than 5% of the target’s stock, because the target will usually not know of their existence. Unless these investors declare themselves part of a group, they are basically invisible so long as they individually stay below the 5% ownership level. Although Section 13(d) litigation is unlikely to result in significant civil liability, it can be costly to defend, and hedge funds (other than the leader of the “wolf pack”) can sidestep this cost by not joining a “group.”

Second, and more importantly, avoiding a “group” delays the moment at which the Schedule 13D must be filed. The individual hedge fund organizing the activist campaign can quietly buy up to 5% of the target’s stock at a price that does not reflect its incipient campaign (which campaign may likely be read by the market as signaling a possible takeover or control contest). Then, it can buy even more stock in the ten-day window that Section 13d(1) gives it after the acquirer crosses 5% before it must file its Schedule 13D. Shares acquired during this ten-day statutory window period may be more costly (as active purchasing will be detected and may alert the arbitrageurs), but the price will still be less than the level to which it will rise on the filing of the Schedule 13D. Acting in this fashion, the hedge fund activist organizing the campaign will typically wind up holding a stock position of 6% to 10% as of the time of its

Schedule 13D filing.[56] Much (but not the majority) of this stock will be acquired in the ten-day statutory window before a Schedule 13D must be filed after the investor crosses the 5% threshold. Generally, the typical activist will not cross the 10% threshold, probably because at that point it will become subject to Section 16(b) of the Securities Exchange Act, which may force it to surrender any "short swing" profits to the corporation on shares acquired in excess of 10%.[57] In sum, here again, there is a cost in becoming a "group," because if a half dozen hedge funds collectively owning 15% of the stock were deemed a "group," they might be required under some circumstances to forfeit their profits on the sale of shares over the 10% level. Such shares would also be illiquid until Sections 16(b)'s six month period ran.

A third problem with "group" formation involves the target's response to the filing of a Schedule 13D. The target may respond by adopting a "poison pill" (or shareholder rights plan,

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[56] Bebchuck, Brav, Jackson and Jiang find that "hedge fund activists typically disclose substantially less than 10% ownership with a median stake of 6.3%." See Lucian A. Bebchuk, Alon Brav, Robert J. Jackson and Wei Jiang, <u>Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy</u>, 39 Iowa J. Corp. Law 1, 3 (2013). Of course, the stake so disclosed represents only the holdings of those signing the Schedule 13D and not the total stake of the entire "wolf pack." An earlier study of 52 activist "interventions" in 2005 and 2006 found that in twenty-six (or 50%) of these "interventions," the disclosed activists held a stake of at least 9.5% and only five held a stake of less than 4.9%. In three of these 52 cases the participating institutions held a majority of the shares. See Briggs, supra note 12, at 697. Although the broader "group" of institutions may thus exceed 10%, no individual institution will typically exceed that level, probably because of the impact of Section 16(b), as discussed in the next footnote.

[57] Section 16(b) of the Securities Exchange Act of 1934 entitles any shareholder to sue to recover "short swing" profits for the corporation (plus attorney's fees) that are based on a purchase and sale, or a sale and purchase, within six months, of the stock of a "reporting company." See 15 U.S.C. §78p(b). Although Section 16(a) requires a "group" to disclose its beneficial ownership, Rule 16a-1(a)(4) permits each member of the group to disclaim beneficial ownership of the other group members' equity securities. See 17 C.F.R. §240.16a-1(a)(4).

as it is more formally known) that will effectively bar the "group" from acquiring more of the target's shares. Most public corporations today do not have a "standing" poison pill in place, but adopt one only in response to a perceived "threat".[58] Let us suppose then that the "wolf pack" leader buys 5.1% quietly and then another 3.9% more hurriedly during the ten-day window before it files (for a total of 9%). Simultaneously, some six to ten hedge fund allies (all of whom will deny forming a "group") buy another 12% to 15%, mainly in the same ten-day window period. This produces a grand total of 21% to 24% if we add the other funds' shares to the 9% of the "wolf pack" leader. If the leader and its allies were deemed a "group," two consequences would follow. First, they would have had to file a Schedule 13D at a much earlier point (as even the initial holdings of the group may already exceed 5% at the moment of group formation). This earlier filing will also make it more costly to acquire additional shares post-filing. Hence, the same group might wind up holding a much lower aggregate amount than 24%.

Second, the response of the target to the Schedule 13D's filing may be to adopt a poison pill that barred further acquisition of stock by any member of the group. Specifically, the poison pill might use a 10% ceiling (as has been upheld in a recent case).[59] But if no group is formed, the only person barred by any poison pill adopted on the Schedule 13D's filing will be the "wolf

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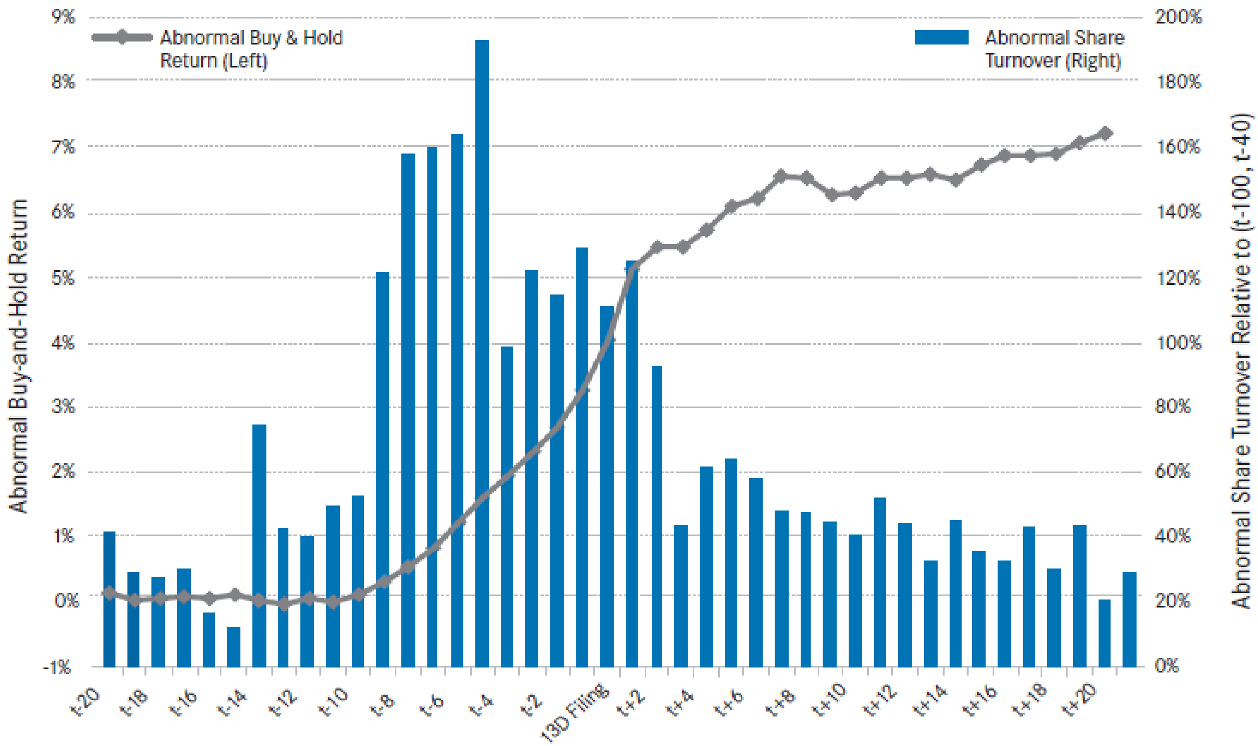
[58]As recently as 2005, 35% of public companies still had a poison pill in place. See Victor L. Lewkow and Sharah G. ten Siethoff, "The Embattled Poison Pill," Insights, April 2005, at 13. That number has since dropped markedly, probably because of the opposition to poison pills of ISS (and the fact that companies, once made the subject of a corporate control contest, can then adopt a poison pill).

[59] In the 2014 proxy contest over the board of Sotheby's, Sotheby's adopted a poison pill with a 10% ceiling for "activist" investors, but only a 20% for "passive" investors. "Activist" investors were those who filed a Schedule 13D, and "passive" investors were those who filed a Schedule 13G. See Third Point LLC. v. Ruprecht, 2014 Del. Ch. LEXIS 64 (May 2, 2014).

pack" leader filing the Schedule 13D. Although the poison pill will purport to apply to those who join with this "wolf pack" leader, their identities will remain unknown to the target company, and each of these allies will carefully keep its distance from the "wolf pack" leader. The bottom line then is that much more stock can thus be assembled by hedge funds loosely aligned with the wolf pack leader if they can avoid being deemed a "group."

Empirically, it is important to understand that most of the stock price appreciation and most of the high trading volume that surrounds the "wolf pack's" formation occurs just before the filing of the Schedule 13D during the ten-day window permitted by Section 13(d). The following chart shows this relationship:[60]



Source: Alon Brav, Wei Jiang, Frank Partnoy and Randall S. Thomas, "Hedge Fund Activism, Corporate Governance, and Firm Performance," *Journal of Finance*, 63, no. 4, August 2008, p. 1756

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[60] See Brav, Jiang, Partnoy and Thomas, supra note 8, at 1756. For a similar, consistent and more recent finding, see Bebchuk, Brav and Jiang, supra note 8, at 16 (Figure 2) (finding a 6% abnormal gain around the Schedule 13D filing, with most of the stock price gain preceding the filing).

After the Schedule 13D's filing, the stock may still appreciate further, but not at the same hyperbolic rate that it rose in the period just before the filing. Similarly, the abnormal trading volume drops sharply within two days after the Schedule 13D's filing.

This pattern should not be surprising. Those who learn of the incipient Schedule 13D filing face a nearly riskless opportunity for profitable trading, if they act quickly, as the Schedule 13D filing usually moves the market upward. Although the lead hedge fund organizing the "wolf pack" also typically buys during the ten-day window after it crosses 5%, it can buy cheaper earlier (as the above chart makes very clear). Because the lead hedge fund typically does not acquire more than a 10% position, it would buy at least half of its stake in the period before this ten-day window—and at a lower price. Rationally, its incentive is to tip others only after it has completed its own purchases (as otherwise it will be forced to buy in a rapidly rising market). Thus, much (and maybe most) of the buying during the ten-day window seems likely to be by other "wolf pack" members. From a tactical perspective, it is the interest of the "wolf pack" leader to tip such allies, as the larger the percentage of shares held by loosely affiliated hedge funds, the greater the likelihood of victory in any proxy contest brought by the lead hedge fund. Actual practices remain uncertain in some respects.

How much calculated tipping by the lead fund actually occurs is uncertain, as information could also leak out by way of gossip and body language within the hedge fund community. But clear examples of such tipping by hedge funds have come to light in litigated cases. [61] Still,

[61] See CSX Corp. v. Children's Inv. Fund Mgmt., (UK), LLP, 562 F. Supp. 2d 511, 525 (S.D.N.Y. 2008) (noting that defendant hedge fund contacted other hedge funds about the target to develop allies). Empirical data also points to large purchases by tippees in the ten-day window. One recent study finds that 40% of hedge fund activists "take advantage of a large part of the ten-day window." See Bebchuk, Brav, Jackson and Jiang, supra note 16, at 3. If only 40% of hedge fund activists buy in this window period, this suggests that other "wolf pack" members who do not

whether it tips or sends only veiled signals, the lead hedge fund has little need to insist on confidentiality, at least once it has largely completed its own purchases.

Such tipping by the "wolf pack" leader to its allies of its intent to launch an activist campaign may seem to resemble insider trading, but legally it is not equivalent. Although the information may be material and non-public, there is no breach of a fiduciary or other duty.[62] Indeed, it is in the interests of the lead hedge fund's own investors that allies be assembled. In short, the information is not misappropriated, but freely given in order to gain leverage over the target company. Under existing law, such tipping would be unlawful only if a tender offer for the target is made by the "wolf pack" leader. Then, Rule 14e-3 makes it unlawful for the bidder (or others) to tip information relating to an approaching tender offer, once the bidder has taken a "substantial step" towards making such an offer.[63] This issue has arisen in connection with the

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file a Schedule 13D are doing much of the buying in this ten-day window period. This study further finds that, to the extent the "wolf pack" leader does buy during the ten day window, it does so primarily on the day that it crosses the 5% threshold and the next day. *Id*. at 6. But as the above chart in the text indicates, the abnormal trading peaks several days later, implying that others in the "wolf pack" are responsible for it.

[62] Under Dirks v. SEC, 463 U.S. 646 (1983), a breach of some fiduciary-like duty is a necessary element before a defendant can violate the insider tradition prohibition. United States v. O'Hagan, 521 US. 642 (1997), does not change this result, but simply allows the requisite duty to be one owed to the source of the information, rather than the trading partner.

[63] See Rule 14e-3(a) begins by stating: "If any person has taken a substantial step or steps to commence…a tender offer…, it shall constitute a fraudulent, deceptive or manipulative act or practice…." See 17 C.F.R. §240.14e-3(a). What constitutes a "substantial step" will depend on the facts and circumstances, but steps such as arranging financing for the tender offer or hiring an investment banker for that purpose seem sufficient.

Valeant and Pershing Square Capital joint bid for Allergan, Inc.,[64] but, outside this rare context of a joint tender offer by a hedge fund, insider trading issues seem unlikely to arise.

The "wolf pack" so formed is a loosely knit organization, and some members may drop out well before the proxy contest is begun or comes to a vote. Most do not appear to hold for the long run. Indeed, one well-known study places the median duration for hedge funds from the first Schedule 13D filing to the investor's "exit" at 369 days (or roughly one year), but a more recent study by basically the same authors shortens the median period to 266 days.[65] Either way activists specialize in short-term interventions. In fact, if the proxy contest is about merely a corporate governance issue (where the impact on share price is likely to be modest), those who bought in the ten-day window period may have little incentive to remain as shareholders for any extended period after the Schedule 13D filing. Alternatively, if the Schedule 13D discloses that the "wolf pack" leader is seeking to sell the company, spin off significant assets, or otherwise trigger a corporate control contest, then the other members of the "wolf pack" may sense a future

[64] For a skeptical review of whether the Valeant/Pershing Square proposed transaction for Allergan may have involved insider trading in violation of Rule 14e-3, see Andrew Ross Sorkin, "Perhaps Too Clever To Be Legal," N.Y. Times, August 4, 2014 at p. B1. No view is here expressed or implied on this question.

[65] For the 266 day period between Schedule 13D filing and divestment, see Alon Brav, Wei Jiang and Hyunseob Kim, Hedge Fund Activism: A Review, Foundations and Trends in Finance (available at http://ssrn.com/abstract=1551953) at p. 18 and Table 4.2 Panel C (February 2010). For the earlier 369 day figure, see Brav, Jiang, Partnoy and Thomas, supra note 8, at 1769. The 25th and 75th percentile figures in this earlier study were 169 and 647 days, respectively. Id. In the case of "hostile" transactions, the median duration is even shorter—319 days (or a little over 10 months). Id. Of course, as the pace of activism has accelerated, the median duration may have become even briefer today than either study shows. Also, these reported figures are for those hedge funds that file a Schedule 13D. Other funds that simply join the "wolf pack," before or after the Schedule 13D filing, may hold for an even shorter duration.

takeover premium and hold their shares to reap a possible arbitrageur's profit. In any event, a leading study finds an average 7% positive abnormal stock price reaction to the Schedule 13D's filing, and this seems sufficient to attract hedge funds who learn in advance of the filing, particularly when they know that they do not have to face potential legal liability for trading on such information.

How large can the "wolf pack" get? Here, it is difficult to gain precise information because neither the "wolf pack" leader nor the target will necessarily know how many silent allies have joined with it. But proxy solicitors can gain an estimate. In the 2014 proxy contest for the Sotheby's board (where the insurgents had publicly called for the firing of Sotheby's CEO), the lead hedge fund (Third Point LLC) had, itself, acquired a 9.62% stake in Sotheby's, but Sotheby's expert witness in the Delaware Chancery Court litigation (the CEO of Mackenzie Partners, Inc., a prominent proxy solicitor) testified that by his estimate 32.86% of Sotheby's stock was held (at the time of the vote) by hedge funds (including Third Point).[66] This was in no respect a record level, and instances have been reported where a majority of the stock was acquired by insurgents.[67]

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[66] See Expert Report of Daniel H. Burch, Chief Executive Officer of Mackenzie Partners, Inc. This report was filed in Third Point LLC v. Ruprecht, supra note 59. Professor Coffee also served as an expert witness in this case for Sotheby's. Based on this level of hedge fund ownership (i.e., 32.86%), Mr. Burch concluded that "a holder of between 5% and 9.99% of the outstanding voting shares has a good chance of winning a minority-slate campaign."

[67] See Briggs, supra note 12, at 697 (finding three cases in his survey of hedge fund activism in 2005-2006 in which the institutions participating in the proxy campaign held a majority of the shares). Much attention has focused on the acquisition of 26.7% in J.C. Penney by Pershing Square and Vornado Realty Trust, most of which occurred during the ten-day window period after they crossed 5%. See Joshua Mitts, A Private Ordering Solution to Blockholder Disclosure, 35 N.C. Cent. L. Rev. 203, 204 (2013). This was not a "wolf pack," however, but two large "wolves,"

In any event, because art auction houses (such as Sotheby's) are low-tech companies that are not usually attractive to a hedge fund, this suggests that the Sotheby's contest provides a good illustration of "wolf pack" formation (as the Delaware Chancellor explicitly noted in upholding Sotheby's use of its poison pill).[68] To put this ownership level in perspective, it needs to be recognized that, in most proxy contests, some percentage of the shares (probably 15% to 20%) simply do not vote. If so, and if the "wolf pack" can assemble one third of the target's outstanding stock, then it only has to win another 7% to 10% of the remaining votes to obtain a *de facto* majority. Moreover, because the remaining shares will typically be held primarily by institutional investors (who may not be activists, but who do tend to follow the voting recommendations of their proxy advisors), the lead hedge fund can expect the support of shareholders outside the "wolf pack." Although ISS's and Glass Lewis's recommendations do not invariably favor the insurgents, they do support the insurgents much of the time. When they do so, the insurgents generally win.[69] These facts may explain why insurgents enjoyed a success rate approaching 80% in proxy contests last year.[70] Facing this prospect and aware that the vote was going against it, the Sotheby's board opted to settle and gave Third Point the seats it was seeking on the Sotheby's board. This pattern seems likely to play out similarly in future cases.

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arguably acting in concert. Still, it shows just how much can be acquired in the ten-day window under Section 13(d)(1).

[68] See Third Point LLC. v. Ruprecht, 2014 Del. Ch. LEXIS 64 (May 2, 2014) at *58 to *59. Based on what he saw as the board's objectively reasonable perception of a threat, Vice Chancellor Parsons upheld the use of a poison pill with a 10% ceiling for activist investors.

[69] See Briggs, supra note 12, at 698.

[70] See text and notes supra at notes 24 to 26.

Of course, it is theoretically possible that the "wolf pack" could vote against its leader, but this seems unlikely. Mutual funds must disclose their votes, and deference to ISS is deeply engrained. To the extent that hedge funds have been provided with a virtually certain opportunity for profit when they learn of the activist campaign before the Schedule 13D filing, hedge funds want to encourage other activists to give them similar advance notice in other cases. Voting against the "wolf pack" leader would thus seem a little like hedge funds biting the hand that feeds them. That may happen, but it is not to be expected.

As a result, the "wolf pack" tactic may tip the voting outcomes in favor of the insurgents—if not always, at least usually.

F. The Shrinking Concept of "Group." At the heart of the foregoing "wolf pack" tactic is the fact that parallel action by like-minded activist investors, even when accompanied by discussions among them, does not, without more, give rise to a "group" for purposes of Section 13(d)(3).[71] This outcome is not apparent from the face of the statute, and the SEC's rules go even further by recognizing that a "group" that must be disclosed can be formed for the purpose of voting shares (as well as for the purposes of buying, holding, or disposing of shares).[72] Still, recent judicial interpretation of the "group" concept has been conservative. For example, in Hallwood Realty Partners L.P. v. Gotham Partners, L.P.,[73] the Second Circuit decided that two Schedule 13D filers and a Schedule 13G filer were not a "group, even though one was a well-

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[71] Virtually all commentators agree that parallel actions by, and communications among, hedge funds do not make them a group.

[72] See Rule 13d-4(b)(1), 17 C.F.R. §240.13d-4(b)(1). This rule adds "voting" to the statutory terms in Section 13(d)(3), which section refers only to "acquiring, holding and disposing" of equity securities. Hence, based on this rule, a "voting group" must also file a Schedule 13D.

[73] 286 F.3d 613 (2d Cir. 2002).

known raider and all three discussed among themselves how to improve the value of the target company". In a later Southern District case, even a joint slate of directors proposed by the investors was not sufficient to make them a "group."[74]

In contrast, earlier cases were more prepared to find a "group." Thus, in both GAF Corp v. Milstein,[75] and Wellman v. Dickinson,[76] the Second Circuit did find in each case that a "group" was formed for purposes of Section 13(d)(3). In GAF Corp, the group was a family that pooled its holdings, and the defining criterion identified by the Second Circuit was that this effort threatened "the stability of the corporate structure."[77] Similarly, in Wellman v. Dickinson, the Second Circuit found that a fired CEO of a company and a number of friends constituted a selling "group" where they "reached an understanding to act in concert in disposing of their shares."[78] What made this association a "group"? The key fact to the Second Circuit may have been that the defendants "were linked by a desire to profit from a shift in the corporate control of Becton" (the target company).[79] But if that were the test, it applies broadly, as many hedge funds join in proxy control contests, hoping that a corporate acquirer will materialize and make a merger proposal or a tender offer for control. Under these tests, many loose associations of investors might be deemed "groups."

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[74] See meVC Draper Fisher Juvetson Fund I, Inc. v. Millenium Partners, L.P., 260 F. Supp. 2d 616, 631-633 (S.D.N.Y. 2003).

[75] 453 F.2d 709, 712 (2d Cir. 1971).

[76] 682 F.2d 355 (2d Cir. 1982).

[77] See GAF Corp v. Milstein, 453 F.2d 709, at 717-718 (2d Cir. 1971).

[78] 682 F.2d 355, at 363.

[79] Id at 365.

Differentiating Hallwood Realty Partners from GAF Corp and Wellman appears to have been the fact that each of the institutional investors in Hallwood "made an independent decision to purchase units, based on due diligence and a common understanding among knowledgeable investors that Hallwood units were undervalued."[80] This test places great emphasis on sophistication. Apparently, if sophisticated parties independently reach the same investment strategy, no group arises, even if they actively discuss their investment strategy for the company among themselves.

Decisions must be understood in their context. Hallwood Realty did not involve a proxy contest. Hence, its focus on independent decision-making makes more sense. Conversely, when a proxy contest is foreseeable, collective action becomes the critical issue, and independent decision-making is less relevant when the objective is to assemble a voting majority. Because there is strength in numbers, even sophisticated investors know that they need allies and that independent voting decisions have little impact. Arguably then, Hallwood Realty's test should be confined to its context, and ongoing discussions among investors should play a larger role in the proxy contest context in the determination of whether a "group" exists. Conscious parallelism in efforts to persuade or induce others to vote in a specific way could logically be viewed as demonstrating the existence of a "voting" group on the part of those soliciting. But that is not the current law.

Overshadowing even the formalistic definition of "group" as a cause of aggressive behavior by the "wolf pack's" leaders is the absence of any meaningful remedy if a "group" is formed but not reported. Suppose two hedge funds form a "group" that as of its formation holds 5.1% of the target's shares. They are required to file a Schedule 13D within ten days, but they

[80] 286 F.3d 613, at 616-618 (2d Cir. 2002).

do not. Indeed, after the expiration of ten days, they each buy up to just below 5% each and thus collectively hold just under 10%. Although the issuer may sue for corrective disclosure, this remedy only closes the barn door after the horse has been stolen. Under the current case law, the issuer has no realistic chance of obtaining an injunction that "sterilizes" (i.e., bars the voting of) the shares acquired in violation of the Williams Act's rules.[81] As a result, activists have every incentive to play fast and loose with the "group" concept, because, even if their violation is detected, all that will happen as a practical matter is that they will be forced to disclose their unlawful acquisition of shares. But the voting electorate will have been irrevocably changed, and some shareholders will have sold to the "group's" members at a discount off the price that would have prevailed had timely disclosure been made.

G. Tactics: The Game Plans for Each Side. In theory, activism and proxy fights are about insurgents seeking to convince shareholders that they have a better business plan than the incumbent management team. However, that explanation does not quite fit the data. One well-known study found no difference in abnormal returns between proxy contests in which the insurgents win a board seat and contests in which they lose.[82] In effect, the outcome is

[81] In CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), the district court found that a "group" had been formed by two hedge funds, which had acquired over 8% of the target's stock in violation of Section 13(d), but still concluded that it was powerless under the case law to order sterilization of the shares purchased in violation of the Williams Act's rules because "irreparable harm" could not be shown once corrective disclosure was made. Id at 567-571. Although the court said that it would have granted such an injunction to deter future violations, it found that it was barred by Treadway Cos v. Care Corp., 638 F. 2d 357, 380 (2d Cir. 1980), in which case the "group" members acquired a 31% block but still escaped sterilization.

[82] See J.H. Mulherin and A.B. Poulsen, Proxy Contests and Corporate Change: Change Implications for Shareholder Wealth, 47 J. Fin. Econ. 279, 300-302 (1998).

irrelevant. Why then does the market welcome such contests? In the foregoing study, the authors generalize that the gains come not from the identity of the victor, but from the predictable tendency of the incumbent management to implement the specific changes sought by the insurgents. These changes typically involve "liquidity events"—special dividends, stock buybacks, spinoff of assets.

Revealingly, some studies find that the average abnormal returns in proxy contests are higher when the incumbent management wins,[83] and at least one study finds negative abnormal returns following a proxy contest in which the insurgent wins seats.[84] Why? Possibly, shareholders want the increased payout through dividends or stock buybacks that the activists are demanding, but feel more comfortable when the incumbent management oversees this process. Shareholders may not trust amateurs (or at least newcomers) to run their business. Of course, such an increased payout may come at the expense of bondholders and other creditors, but that is not the shareholders' concern.

Recent events are consistent with this story. In the 2014 battle over Sotheby's board, Sotheby's advisers counseled that the best defensive course was to structure a "liquidity event" that would satisfy the non-hedge fund shareholders, and, pursuant thereto, Sotheby's paid out some $450 million in special dividends and stock buybacks in early 2014 (which came to roughly 15% of its equity market capitalization).[85] Similarly, when Darden's was faced with a

[83] See C.R. Alexander, M.A. Chen, D.J. Seppi and C.S. Spatt, Interim News and the Role of Proxy Voting Advice, 23 R. Fin. Stud. 4419, 4435 (2010).

[84] See D. Ikenberry and J. Lakonishok, Corporate Governance Through the Proxy Contest: Evidence and Implications, 66 J. Bus. 465 (1993).

[85] Specifically, Sotheby's paid a $300 million special dividend and began a $150 million stock repurchase in early 2014. See Third Point LLC v. Ruprecht, supra note 59, at *36.

demand from two hedge funds in 2014 to split itself into three divisions, it went part way and sold off its Red Lobster restaurant division for $2.1 billion in order to increase the payout to its shareholders.[86]

Hedge fund-led proxy fights are also often (and increasingly) nasty and personal. Why? Possibly, the "poison pen" letters and the vitriol that have become common are intended to convince shareholders that the two sides cannot reconcile, and thus even the election of a minority slate will entail management turnover and a more likely sale of the company. Thus, the market may be led to raise its estimate of a likely takeover premium. The bottom line is that these tactics are consistent with the view that the gains from this type of activism come from either (1) expected turnover premiums, or (2) liquidity events that transfer wealth from bondholders and creditors.

III. Are Hedge Funds Shortening the Investment Horizon of Corporate Managers?: Framing the Issue.

One of the most frequently voiced concerns about hedge fund activism is that it will lead to "short-termism"—a term that is notably undefined and may depend on the eye of the beholder. We will use this term to mean a managerial focus on increased distributions by way of dividends

[86] For an overview of this battle, see Steven M. Davidoff, "Battle over Darden Restaurants Leaves Little Room for Compromise," N.Y. Times, May 21, 2014 at B8. This "compromise" did not work, and the Darden CEO was forced to resign and three seats on its 12 person board were given to the hedge funds. See David Benoit and Julie Jargon, "Darden CEO to Depart in Shake-up," The Wall Street Journal, July 29, 2014 at B1. The activist—Starboard Value LP—is now seeking to win control of the entire board, and its suggested changes have clearly reached the point of micromanagement, as it is now instructing Darden as to how to boil its pasta water. See David Benoit, "Investor to Olive Gardens: Salt the Pasta Water," The Wall Street Journal, September 12, 2014, at B5.

and stock buybacks, achieved through increased leverage that results in reduced long-term investments (particularly in research and development). This claim is usually made by corporate lobbying groups (such as The Business Roundtable), but it has been rejected by most (but not all) academics. Some distinguished academics consider "short-termism" an illegitimate argument, at best a "debater's weapon" used only by corporate lobbyists.[87] Others accept that "short-termism" is associated with institutional activism, but defend it as socially desirable. We think, however, this claim deserves a more serious analysis.

To begin with, it is intuitively plausible that hedge funds could have a short-term bias, because their compensation structure so inclines them. Under the standard compensation formula, hedge fund managers charge annually 2% of the assets under management plus a performance fee of 20%.[88] In return for these generous fees, hedge fund investors expect returns that outperform the market. That is hard (or even impossible) to do consistently. But hedge fund investors are impatient and demanding and will move their investments to the recent winners in the intense competition among hedge funds. Given this competition, the conventional wisdom is that a number of hedge funds became "activists" because they found it too difficult to outperform the market consistently as passive stock-pickers. Instead, they became proactive. Nonetheless, hedge fund managers remain subject to short-term time constraints: if they do not outperform the market, their investors are likely to go elsewhere to others who may. Investors in hedge funds can withdraw their funds at regular intervals, are likely diversified, and probably have put much

[87] See Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance at 242-43 (1994).

[88] See Thomas, Hawke and Calande, supra note 13, at 558. The performance fee is computed on realized and unrealized gains.

of their wealth in lower-risk investments. Thus, they can tolerate risk, and they correspondingly expect hedge funds to assume risk in pursuit of short-term gains. Accordingly, these investors have no reason to object to a short-term focus.

More generally, some management scholars have reported empirical evidence showing a strong correlation between "short-termism" within firms and a high ownership level on the part of "activist" hedge funds and certain other institutional investors.[89] In particular, Wharton Professor Brian Bushee has found that "predominant ownership by transient institutions—which have high portfolio turnover and use momentum trading strategies…significantly increases the likelihood that managers cut R&D to manage earnings."[90] In a later study, he reports that "high levels of ownership by transient institutions are associated with overweighting of the near-term earnings component and underweighting of the long-term earnings component."[91] The archetypal "transient investor" may be the hedge fund (although many mutual hedge funds would qualify also). From this perspective, the more stock that the "wolf pack" of hedge funds acquires in a firm, the greater the likely underweighting of the firm's investments in research and development and the more the pressure to reduce those investments. Other studies have agreed and suggest both that a high percentage of short-term investors leads to weaker monitoring[92] and

[89] See Brian Bushee, <u>The Influence of Institutional Investors on Myopic R&D Investment Behavior</u>, 73 Acc. Rev. 315, 330 (1998).

[90] Id at 307.

[91] See Brian Bushee, <u>Do Institutional Investors Prefer Near-Term Earnings Over Long Run Value?</u>, 18 Contemp. Acct. Res. 207, 213 (2001); see also Kevin J. Laverty, <u>Economic "Short-Termism": The Debate, The Unresolved Issues, and the Implications for Management Practice and Research</u>, 21 Acad. Of Mgmt. Rev. 825 (1996).

[92] See, e.g., Yia Chen, Jarrad Harford, and Kui Li, <u>Monitoring: Which Institutions Matter?</u>, 86 J. Fin. Econ. 279 (2007) (arguing that traditional institutional investors with long-term horizons specialize in monitoring, while

a strong preference for near-term earnings (which in turn produce significant misvaluations and a desire to inflate short-term earnings at the expense of the longer term[93]).

This literature certainly suggests a linkage between increased hedge fund activism and shorter investment horizons for the corporations subject to that activism. But this evidence is far from dispositive. Realists would want to see "real world" examples of hedge funds actually enforcing such a short-term orientation. In that light, we next turn to the most significant effort (in terms of market value) yet made by a hedge fund to lead an activist campaign.

In 2014, Pershing Square Capital Management ("Pershing Square") teamed with Valeant Pharmaceuticals International ("Valeant") to seek to acquire Allergan, Inc. ("Allergan"), a major pharmaceutical company, in an over $50 billion transaction. Pershing Square created an entity, PS Fund I, LLC., a Delaware limited liability company ("PS Fund"), to acquire shares in Allergan and certain derivatives referencing Allergan common stock. Pershing Square began buying Allergan's shares quietly on February 25, 2014; then, as it approached the 5% level, PS Fund's LLC agreement was amended to add Valeant as a member on April 6, 2014. Thereafter,

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shorter-term holders focus on trading); Jose-Miguel Gaspar, Massimo Massa, and Pedro Matos, Shareholder Investment Horizons and the Market for Corporate Control, 76 J. Fin. Econ. 135 (2005); Francois Derrien, David Thesmar, and Ambrus Kecskes, Investor Horizons and Corporate Policies, Working Paper (available at http://ssrn.com/abstract=1491638) (June 27, 2012) (forthcoming in Journal of Financial and Quantitative Analyses) (longer investor horizons attenuate effect of stock mispricing and are associated with more investment and lower payout to shareholders).

[93] See Katherine Guthrie and Jan Sokolowsky, Large Shareholders and the Pressure to Manage Earnings, 16 J. Corp. Fin. 302 (2010); Victor L. Bernard & Jacob K Thomas, Evidence That Stock Prices Do Not Fully Reflect The Implications of Current Earnings for Future Earnings, 13 J. Acct. & Econ. 305 (1990).

the 5% level was quickly reached on or about April 11, 2014, and then PS Fund picked up the pace of its purchases.[94]

Ten days later, at the end of the ten-day window under Section 13(d)(1), Pershing Square and Valeant each filed on April 21, 2014 a Schedule 13D disclosing that PS Fund had acquired 9.7% of the outstanding shares of Allergan (with roughly 97% of the funds supplied by Pershing Square). The next day (April 22), Valeant made public its offer to acquire Allergan for a combination of cash and shares totaling over $50 billion (subsequently increased to $53 billion). Two months later, on June 18, 2014, Valeant announced a formal tender offer. Valeant described Pershing Square as a co-bidder, but Pershing Square is itself offering nothing to Allergan's shareholders (it will be only a seller to Valeant, not a buyer).

By staying below 10% (and thereby avoiding Section 16(b)) and by not joining in the merger bid, Pershing Square preserved its flexibility. Although it could conceivably have liability for misstatements or omissions in the tender offer, Pershing Square's shares acquired through PS Fund will ultimately be sold to Valeant pursuant to the latter's merger bid. Pershing Square has, however, retained the right to tender instead to any higher bidder that tops Valeant's offer. Although the two parties characterize Pershing Square as a "joint bidder," it is unlikely that Pershing Square intends to become a long-term owner of Allergan stock (beyond a one year period over which it has committed to hold Valeant stock received in the prospective merger).

[94] These facts are taken from the Schedule 14A preliminary proxy statement filed by Pershing Square with respect to Allergan, dated May 16, 2014, from The Amendment No. 1 to Form S-4 Registration Statement filed by Valeant Pharmaceuticals International Inc. on July 22, 2014, and the Schedule 13D filed by Pershing Square with respect to its acquisition of stock in Allergan on April 21, 2014.

What is clear, however, is that it had the best of both worlds: advance knowledge of a tender offer without any obligation to make any portion of the acquisition itself.

Also on April 22, Allergan predictably adopted a poison pill that blocked any acquisition, and shortly thereafter Pershing Square began a proxy contest, which now seeks to convene a special meeting of Allergan's shareholders at which Pershing Square and Valeant are seeking to remove and replace Allergan's directors.[95]

What advantage did each participant gain by forming this unique combination of a hedge fund and a strategic bidder? On Valeant's side, it not only received financing from Pershing Square (i.e., 97% of the funds expended by PS Fund came from Pershing Square), but by using PS Fund as the acquirer of the 9.7% block, Valeant was also able "to sidestep antitrust rules" that would have delayed its ability to acquire a sizeable block in a competitor.[96] Pershing Square will, of course, vote its stock to support Valeant in any proxy contest, and it has agreed to waive cash and accept Valeant stock exclusively for its shares, thus reducing the burden on the highly leveraged Valeant to borrow to finance its acquisition. On Pershing Square's side, the advantages in this relationship are clearer: it was able to buy a large block of stock before a merger or tender offer at the pre-announcement price by entering into an alliance with the bidder. The legality of this arrangement is being challenged by Allergan and would appear to depend both on (1) whether Valeant's 3% contribution to the PS Fund truly made Pershing Square a co-

[95] Allergan is seeking to resist such a shareholders meeting and litigation seems certain. See Steven Davidoff Solomon, "In Allergan Fight, A Focus on Clever Strategy Overshadows Goal," N.Y. Times, August 13, 2014 at B4. Allergan also appears to be seeking a defensive merger with another pharmaceutical company that would block the hostile bid, but has scheduled a special shareholder meeting in December, 2014 at which Valeant and Pershing Square will seek to replace its board.

[96] Id. Such advance approval is required under the Hart-Scott-Rodino Antitrust Improvements Act of 1976.

bidder with Valeant and thereby gave it an exemption from Rule 14e-3's broad insider trading prohibition, and (2) whether Valeant had taken a "substantial step" towards commencing a tender offer by the time of Pershing Square's purchases.

Equally striking and even more novel than this unique combination was the motivation of Valeant. The product of a series of mergers and acquisitions, Valeant is known for its business model under which, as a "serial acquirer," it buys pharmaceutical companies with established products and cuts back on, or ceases, their research and development efforts in order to maximize the cash flow from their established products.[97] According to a Wall Street Journal report on Valeant, "large pharmaceutical companies often spend as much as 20% of their sales on R&D."[98] In sharp contrast, in 2013, Valeant spent only 2.7% of its $5.77 billion in revenues on R&D.[99] Disinclined to invest in research and development, Valeant valued Allergan for one product: Botox, a drug with an expanding number of uses, but internationally known as a wrinkle-erasing medication.

Valeant's CEO did not attempt to hide his plans to cut both research and development and Allergan's employees if Valeant could take control. Specifically, in April, 2014, when he announced his merger proposal, Valeant's CEO estimated that about 20% of the combined company's 28,000 employees would lose their jobs.[100] Valeant similarly estimated that, on a

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[97] Id. (describing Valeant as a "serial acquirer"). Valeant had recently acquired Biovail and Bausch & Lomb. Valeant has also attracted attention and criticism for its alleged inattention to safety issues. See Jesse Eisinger, "Valeant's Cost-Cutting Ethos May Yet Give Wall Street Indigestion," N.Y. Times, July 21, 2014 at B6.

[98] See Joseph Walker, "Botox Itself Aims Not to Age," The Wall Street Journal, May 19, 2014 at B-1.

[99] Id.

[100] See Joseph Walker and Liz Hoffman, "Allergan's Defense: Be Like Valeant," The Wall Street Journal, July 22 2014 at B-1.

merger with Allergan, "it would reduce the combined company R&D spending by 69%."[101] In short, it would strip Allergan of R&D not related to Botox, but would seek to expand the uses for that product.

The next step is perhaps even more unusual. Faced with shareholder support for Valeant's lucrative offer, Allergan's management decided that if it could not beat Valeant's strategy, it would mimic it. Thus, in July, 2014, Allergan announced that it would cut its work force by 13%—less than Valeant's 20% goal but still substantial.[102] Allergan similarly announced that it would reduce research and development spending to about 13% of annual sales, as compared with its historical rate of 16% to 17%.[103] In overview, this response should not surprise, because it resembles the earlier noted tactic used by target firms of structuring a large dividend or stock buyback to forestall a proxy contest. In reality, Allergan probably had little choice. Although there has been little public disclosure concerning the size of the "wolf pack" backing Pershing Square and Valeant, Paulson & Co disclosed in a Section 13(f) filing that it acquired 5.6 million shares of Allergan, valued at $948 million, sometime during the Second Quarter of 2014.[104] Other hedge funds have likely also joined the Pershing Square/Valeant team, giving the bidders a likely prospective victory in any proxy contest.

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[101] Id.

[102] See Joseph Walker and Liz Hoffman, supra note 100, at B-1.

[103] Id. at B-2.

[104] See Kelly Bit, "Paulson Wagers on Allergan Bid, as Ackman Defends Tactics," Bloomberg, August 15, 2014 (available at http://www.bloomberg.com/news/print/2014-08-15/paulson-wagers-on-Allergan-bid-as-Ackman-defends-tactics.html). This disclosure did not indicate when John Paulson made this investment (and specifically whether it was prior to Pershing Square's Schedule 13D filing). We do not suggest that Paulson & Co. formed a

Some may dismiss the Allergan story as a mere anecdote (although a record-setting $53 billion transaction seems more than a trivial "anecdote"). Yet, the pattern it reveals is important: corporate managers quickly recognize a hostile bidder's strategy and seek to preempt it. If the bidder appears able to maximize value and win shareholder support by cutting R&D and employees, target firms will emulate its strategy (even if reluctantly).

Equally important, the significance of this apparent hedge fund distaste for long-term investment in research and development (at least in the pharmaceutical industry) appears not to have been missed by other corporate managers in this industry. A Financial Times survey in July, 2014, noted a "fundamental trend" in this industry: namely, that pharmaceutical and household consumer products companies are divesting their non-core divisions and "reassessing their portfolios."[105] The most obvious example was Reckitt Benckiser's decision, announced in July, 2014, to spin off its pharmaceutical business[106], but that case does not stand alone. Just in 2014, Johnson & Johnson, Eli Lilly, Merck & Co. and Sanofi announced sales or spinoffs of significant pharmaceutical divisions.[107] No claim is here made that the Allergan takeover bid caused all these transactions. Arguably, hedge funds are only enforcing the market's apparent skepticism about long-term R&D investments in the pharmaceutical industry. Yet, a Pershing Square can profit whether or not a Valeant's strategy succeeds, and that ability to profit from a mistake poses the deeper issue with hedge fund activism: namely, it is often riskless.

"group" with the two bidders; our point is only that the size of the "wolf pack" and its holdings are usually much larger than is disclosed in the Schedule 13D.

[105] See Scherazade Daneshku, Andrew Ward and Adam Thomson, "Drugmakers juggle non-core assets," Financial Times, July 25, 2014, at 13.

[106] Adam Sherman, "Reciktt Poised to Spin Off Pharma Business," Financial Times, July 29, 2014, at 1.

[107] Daneshkhu, Ward and Thomson, supra note 105, at 13.

Even in an efficient market, it is likely that the corporate managers at potential target firms know more about their firms' prospects and potential than does the market (i.e., they possess asymmetric information) about the prospects of many drugs in early stage testing. They may also want to remain silent about these projects in order not to alert rivals about their favorable prospects, as they understandably do not want to encourage competition. If drugs with favorable prospects are being abandoned, there could be both a loss to shareholders and to society. Even if shareholders are generally more right than wrong, it remains debatable how easily public policy should enable activists to discipline corporate managers for making such investments, thereby deterring long-term research and development. Put differently, how much margin for error should managers at target firms enjoy? The optimal answer is probably not zero, but we may be moving in that direction.

Once, activism was easily defended as necessary to reduce managerial agency costs. But much has changed. Today, corporate managers are heavily compensated through incentive compensation formulas that encourage them to maximize share value and that align their interests much more closely with those of the shareholders than with any other constituency. The days in which managers could simply ignore the market are long since over. Also, managers have material, non-public information that the market lacks. Given this asymmetry, instantaneous accountability may not be desirable when managers know more than shareholders. In the Allergan example, shareholders are not removing managers who have made clearly erroneous judgments about R&D; rather, they are prophylactically preventing a board and its management from pursuing a research strategy that the latter believes will maximize shareholder value over the long-term.

We use the Allergan example not to prove any thesis dispositively, but to frame several questions: (1) How easy should it be for activist investors to overrule the board (and even remove them), particularly when the dispute seems increasingly to be about issues relating to leverage, risk, and long-term investments?; (2) What will be the impact on corporate managers at other firms that shareholders have not yet challenged, but who also fear they could be attacked if they continue to make long-term investments in research and development?; (3) Given the extraordinary surge in hedge fund activism, can there be a point at which a tactic becomes overused?; and (4) Does an increased number of proxy contests imply that shareholders are curtailing managerial slack and reducing agency costs—or is this increased activism more simply explained by the market's willingness to perceive shareholder dissent as implying an increased likelihood of a takeover at a premium?

If short-term activism is essentially riskless with the median hedge fund buying shortly before or after the Schedule 13D is filed and typically exiting within one year thereafter,[108] then hedge funds may today profit even when they are wrong (that is, when their business judgment proves incorrect and some other corporation eventually wins big by developing the same product or drug that was terminated under hedge fund pressure). The prospect of profit without risk can encourage a bubble. Put differently, the demand side of the market for control is outpacing the supply side, as more and more hedge funds stalk fewer and fewer companies that could benefit from their intervention. Predictably, competition will shrink the gains from activism.

[108] This appears to be the contemporary pattern with the median hedge fund departing within one year. See text and note supra at note 65. Also, those hedge funds who join the "wolf pack" but do not file a Schedule 13D may leave even sooner.

Posing these questions does not imply that "activist" investors should be prevented from taking collective action. That is not our argument. But the more detailed analysis that we next undertake is intended to inform the question of whether additional transparency is desirable—even if increased transparency carries some cost.

IV. A Survey of the Evidence.

Academic studies of the effect of hedge fund activism have found mixed evidence, both as to their efficacy in generating value for shareholders, bondholders and other corporate claimants, and as to their impact on research and development, leverage and long-term investment. We survey this evidence below, emphasizing whether studies used a control consisting of: firms not targeted by activist hedge funds, whether findings are industry-adjusted, size-adjusted, and book-to-market-adjusted. We are also mindful that all of these studies end generally no later than hedge fund interventions initiated in 2007. Since that time, hedge funds activism has accelerated at a pace and had an impact that these studies may not capture.

A. Who are the Targets of Hedge Fund Activism? Although the studies do not fully agree, many report that the typical target firm of an activist investor is smaller, more profitable, has a large institutional ownership level, and has more of a "value" orientation (namely, a higher book-to-market ratio) than a control sample of firms.[109] But these targets are not simply

[109] See Brav, Jiang, Partnoy and Thomas, supra note 8 (here, the control sample consists of firms not targeted by activist hedge funds but are otherwise similar in size, book-to-market and industry); Christopher P. Clifford, Value Creation or Value Destruction? Hedge Funds as Shareholder Activists, 14 J. Corp. Fin. 323 (2008) (here, the control sample consists of firms who face a 13G filing rather than the activist investor's 13D filing); April Klein and Emanuel Zur, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors, 64 J. Fin. 187

"losers." Indeed, Brav, Jiang, Partnoy and Thomas find that the probability of a firm being targeted by an activist hedge fund is positively related to its return-on-assets. [110] Khorana, Hoover, Shivdasani, Sigurdsson and Zhang find over one third of the firms being targeted since 2006 actually experienced stock price overperformance prior to being targeted and this proportion is growing over time.[111] We observe that target firms are often more profitable than the control sample, suggesting that these targets are not poorly performing firms as some advocates for activist hedge fund activism suggest. In fact one study finds that target firms of activist hedge funds have lower bankruptcy risk than a control sample of non-targeted firms that are matched by size, book-to-market and industry.[112]

One common argument made by proponents of hedge fund activism is that these interventions result from agency problems between corporate managers and their dispersed shareholders. Under this argument, managers exploit free cash flow by sub-optimally investing

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(2009) (here, the control sample consists of firms not targeted by activist hedge funds but otherwise similar in size, book-to-market and industry); Y. Hamao, K. Kutsuna, and P. Matos, Investor Activism in Japan: The First 100 Years, Working Paper, Columbia Business School (2010) (here, the control sample consists of firms not targeted by activist hedge funds but are otherwise similar in size, book-to-market and industry); Nicole M. Boyson and Robert Mooradian, Corporate Governance and Hedge Fund Activism, 14 Rev. Deriv. Res. 169 (2011) (here, the control sample consists of firms not targeted by activist hedge funds but are otherwise similar in size, book-to-market and industry); and April Klein and Emanuel Zur, The Impact of Hedge Fund on the Target Firm's Existing Bondholders, 24 Rev. Fin. Stud. 1735 (2011) (here, the control sample consists of firms not targeted by activist hedge funds but otherwise similar in bond rating, liquidity, maturity and industry).

[110] See Brav, Jiang, Partnoy and Thomas, supra note 8, at 1753.

[111] A. Khorana, E. Hoover, A. Shivdasani, G. Sigurdsson, and M. Zhang, "Rising Tide of Global Shareholder Activism," Citi Corporate and Investment Banking (November 12, 2013) at 7.

[112] See Klein and Zur (2009) supra note 109, at 203-204.

in negative net present value projects, rather than dispersing cash to shareholders via dividends, share repurchases.[113] From this perspective, cutting back on wasteful R&D and capital expenditure programs maximizes shareholder value. Similarly, increasing leverage substantially and forcing managers to focus on servicing this debt is one way to reduce free cash flow problems. If this managerial agency argument is valid and fairly characterizes the targets of activism, then one would expect to find that target firms would have higher capital expenditures, higher wasteful R&D expenditures, lower dividends and stock buybacks, and lower leverage than a control sample of firms not targeted by activists. Although some studies support this thesis, the majority do not report evidence of changes in real variables consistent with this free cash flow hypothesis. For example, some studies have found that target firms of activist hedge fund investors have less leverage,[114] whereas others have found similar or higher leverage[115] than the control sample. Similarly, one study found that that target firms of activist hedge fund investors have lower dividend payouts,[116] whereas another found similar dividends,[117] in comparison to the control sample.

To sum up, although many generalizations have been advanced about the characteristics of target firms, the evidence consistently supports only the generalization that targets of activism often tend to have a lower Tobin's Q and a "value" orientation, but these characteristics are not, by themselves, proof of poor managerial performance or high agency costs.

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[113] See Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance and Takeovers, 76. Amer. Eco. Rev. 323 (1986).

[114] See Boyson and Mooradian, supra note 109, at 181; Hamao, Kutsuna, and Matos, supra note 109, at 18.

[115] See Clifford, supra note 109, at 330; Klein and Zur (2011), supra note 109, at 1751.

[116] See Klein and Zur (2011), supra note 109, at 1751.

[117] See Clifford, supra note 109, at 330.

B. Does Hedge Fund Activism Create Real Value? For ease of exposition, in this sub-section, we subdivide the evidence into two parts, based on whether the measurement period is the short run (a few days) or the long run (a few years).

1. Short-horizon event studies of stock returns: Many studies have examined what happens to targets firm's stock price when there is a Schedule 13D filing with the SEC. The date of filing is called the event date, and the studies examine whether a target firm earns abnormal returns (generally defined as actual returns less returns adjusted for market movements) in the few days before and after the event date (called the "event window"). Most studies have found that target firms of activist hedge funds earn *on average* positive abnormal returns in the event window, although differences exist in the studies in their definition of event windows and the economic magnitude of the abnormal returns earned.[118]

[118] For ease of exposition, let us define [-x, +y] to be x days before the 13D filing, to y days after the filing. On this basis, Brav, Jiang, Partnoy and Thomas, supra note 8, find that target firms of activist hedge funds earned on average 7.2% abnormal returns in [-10, +10], consisting of 3.2% abnormal returns in [-10,-1], 2% in [0,+1], and 2% in [+2,+10]; Klein and Zur, supra note 109, find that target firms of activist hedge funds earned on average 7.2% abnormal returns in [-30, +30]; R. Greenwood and M. Schoar, Investor Activism and Takeovers, 92 J. Fin. Eco. 362 (2009), find that target firms of activist hedge funds earned on average 3.5% market, size and momentum-adjusted abnormal returns in [-10, +5]; Clifford, supra note 109, finds that target firms of activist hedge funds earned on average 3.4% abnormal returns in [-2, +2]; Boyson and Mooradian, supra note 109, find that target firms of activist hedge funds earned on average 8.1% abnormal returns in [-25, +25], and 2.45% abnormal returns in [0, +25]; Bebchuk, Brav and Jiang, supra note 8, find that target firms of activist hedge funds earned on average 6% abnormal returns in [-20, +20]; Stuart Gillian and L. Starks, Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors, 57 J. Fin. Eco. 275 (2000), find that target firms of institutional investors earned zero abnormal returns in [-1,+7]; M. Becht, J. Franks, C. Mayer and S. Rossi, Returns to Shareholder Activism: Evidence

There are two interpretive issues with the above results. First, although it is generally true that the average stock return performance around the event date is positive, substantial differences exist in the distribution of abnormal returns earned by target firms. A significant proportion of firms actually earned *negative* abnormal returns in the above studies.[119] This finding implies a significant conflict between the goals of activists and corporations. Activists typically invest in many firms concurrently, resulting in superior fund performance even if only some of their targets earn substantial return performance. Corporations do not have this luxury of diversification, as they are invested only in themselves. Thus, the possibility of a negative return (particularly when the upside return may be only modest) may reasonably cause a board of directors to reject a strategy favored by a group of hedge funds.

Probably the best known example of such a financial disaster caused by aggressive intervention by hedge funds was the joint acquisition by Pershing Square and Vornado Realty Trust of over 26% of the stock of J.C. Penney. Most of this stock was purchased during the ten-day window under Section 13(d), and the two activists obtained board representation, forced the resignation of J.C. Penney's incumbent CEO, and announced a new marketing philosophy.

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form a Clinical Study of the Hermes UK Focus Fund, 22 Rev. Fin. Stud. 3093 (2009), find a 5.74% market-adjusted abnormal return in [-5, +5]; and Hamao, Katsuna and Matos, supra note 109, find that target firms of activist hedge funds earned on average 2% abnormal returns in [-5, +1].

[119] Studies are cited supra at notes 109 and 118. For example, Brav, Jiang, Partnoy and Thomas, supra note 8, find that 38% of target firms of activist hedge funds earned negative abnormal returns. Consistent with this argument, the 25th percentile of their hedge fund targets earned -5.3% abnormal returns; Klein and Zur (2009), supra note 109, find that the 25th percentile of hedge fund targets earned -2.7% abnormal returns; Clifford, supra note 109, finds that 37.2% of target firms of activist hedge funds earned negative abnormal returns; and Becht, Franks, Mayer and Rossi, supra note 118, find that 28.3% of target firms earned negative abnormal returns.

Although J.C. Penney's stock rose initially, customers fled in droves, and J.C. Penney's stock price fell some 59.5% over the period between the initial Schedule 13D filing and Ackman's eventual resignation from the board.[120]

Beyond the distribution of returns (and the risk inherent in running an operating company without prior experience in the field), the second problem with much of the data on hedge fund activism is the missing evidence as to what causes the stock price gains that are observed. If the positive abnormal stock returns are attributable to actions by activists that reduce managerial agency problems, they should leave some trail. That is, there should be evidence about changed capital structure, reduced executive compensation, dividend payouts, or altered investments. Yet, most of the studies find that the positive abnormal returns are *not* statistically significantly related to changes in real variables that occur subsequently to the activists' intervention.[121]

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[120] For a detailed review of Pershing Square's failure (and hubris), see James Surowiecki, "When Shareholder Activism Goes Too Far," The New Yorker, Aug. 15, 2013. Over the same period, the stock market soared, thus magnifying the loss.

[121] For example, Brav, Jiang, Partnoy and Thomas, supra note 8, find no statistically significant relationship between the target's abnormal returns and their governance and capital structure. But they find a positive relationship to business strategy and general purpose; Klein and Zur, supra note 109, find no statistically significant relationship between the target's abnormal returns and replacing the CEO, cutting CEO pay, and other corporate governance issues; Greenwood and Schoar, supra note 118, find no statistically significant relationship between the target's abnormal returns and capital structure changes, corporate governance issues, corporate strategy reasons, or proposing a spinoff. Clifford, supra note 109, finds all activities other than selling part or whole of firm are not related to the target's abnormal returns; Boyson and Mooradian, supra note 109, find no statistically significant relationship between the target's abnormal returns and providing finance, changing capital structure, and changing the firm's operations; Gillian and Starks, supra note 118, find a statistically insignificant relationship between the target's abnormal returns and certain governance issues involving the board of directors, confidential voting, repeal

2. Long-horizon stock return studies: Bebchuk, Brav and Jiang find that buy and hold stock returns are on average positive in the three-years and five-years after the Schedule 13D filing.[122] In doing so, they control for the returns on the market portfolio and the returns on small size, value and momentum portfolios (often referred to as the four-factor model of stock returns). These positive average long-horizon abnormal returns have also been found in other studies. [123] Still, it is well-known that studying long-horizon stock returns can lead to false positive abnormal returns.[124] Bebchuk, Brav and Jiang do not adjust their test statistics for the skewness bias that arises in long-run abnormal return studies as suggested by leading

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of poison pill, and others. In one study, Becht, Franks, Mayer and Rossi, supra note 118, find that target firm earned negative abnormal returns when the stated objective was to force restructuring, or replacing the Chairman or CEO.

[122] Bebchuk, Brav, and Jiang, supra note 8, at 19-20.

[123] Unless otherwise defined, let [-x, +y] be x months before the Schedule 13D filing, to y months after the filing. On this basis, Brav, Jiang, Partnoy and Thomas, supra note 8, find that the average annualized market-adjusted holding period return in the period [-1, day of activist exit] is 20.6%, and the average size-adjusted holding period returns during the same period is 14.3%; Greenwood and Schoar, supra note 118, find that the average market-, size- and momentum-adjusted holding period return in [-1, +18] is 10.3%; Clifford, supra note 109, finds that the average market-, size-, value- and momentum-adjusted holding period return in [-1, +36] is 1.3%; Khorana, Hoover, Shivdasani, Sigurdsson, and Zhang, supra note 111, find abnormal market-adjusted returns on [-1 month, 2 years] of 33.8%.

[124] See S. Kothari and J. Warner, Measuring Long-Horizon Security Price Performance, 43 J. Fin. Econ. 301 (1996) and B. Barber and J. Lyon, Detecting Long-Run Abnormal Stock Returns: The Empirical Power and Specification of Test Statistics, 43 J. Fin. Econ 341 (1997).

methodological specialists in this field.[125] By not doing so, their resulting t-statistics for statistical significance may be overly optimistic.

In any event, when Bebchuk, Brav and Jiang examine the three-year and five-year calendar year returns before and after the filing date, they find them to be statistically insignificant from zero. This suggests that an activist investor cannot beat the performance of the four-factor stock return model. If so, the sophisticated hedge fund will quickly learn to profit from the short-term return and then exit. Indeed, this may already be the dominant pattern.

Finally, focusing only on the average abnormal returns may miss much of the story. A significant fraction of target firms earn *negative* long-horizon abnormal returns. In fact, one study finds that a small majority of target firms (52%) earn negative abnormal returns in the one-month before to one-year after the filing period.[126] Another study which has one author overlapping with the above Bebchuk study, has also found that a significant fraction of target firms earn negative abnormal returns.[127] Finally, Clifford finds that both activist and passive investors earn positive abnormal returns but there is an insignificant difference in their returns.[128] If the activist's actions are what drives the higher returns, then the abnormal returns earned by the activist should logically be greater than the abnormal returns earned by passive institutional investors.

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[125] J. Lyon, B. Barber and C-L. Tsai, Improved Methods for Tests of Long-Run Abnormal Stock Returns, 54 J. Fin. 165 (1999).

[126] See Khorana, Hoover, Shivdasani, Sigurdsson, and Zhang, supra note 111, at 14.

[127] Brav, Jiang, Partnoy and Thomas, supra note 8, find that the 25th percentile of their hedge fund targets earned -19.7% in market-adjusted holding period returns and -25% for size-adjusted holding period returns.

[128] See Clifford, supra note 109, at 329.

C. What Are the Sources of Gains From Activism? In this subsection, we survey the evidence on the sources of shareholder gains from activism. To what extent are they the result of wealth transfers?

1. Improvements in operating performance. The evidence on whether the operating performance of target companies has improved due to activist hedge fund intervention is again mixed, with the preponderance of the studies finding no improvement. Operating performance is defined as the firm's return on assets ("ROA"), and/or operating profits, and/or operating margins, and/or cash flows. Defining the year of the Schedule 13D filing as year t, studies have compared the differences in the operating performance of target firms in the years after filing to years before filing or the year of filing. Brav, Jiang, Partnoy and Thomas conduct two sorts of matches.[129] The first matching procedure, matches target firm by year to a similar industry, size and momentum firm. Interestingly, ROA and operating margins of target firms are better than the matched firm in year t-2, and then dip in the year of filing. By year t+2, the ROA and operating margins of target firms are once again better than the matched firm in similar fashion as in year t-2. This suggests that activist hedge funds target firms who were more profitable in years t-2, t+1, but that had short-term underperformance in year t. A similar pattern emerges when firms are matched by performance.[130] Bebchuk, Brav, and Jiang also report that targeted firms have a

[129] Brav, Jiang, Partnoy and Thomas (2008) supra note 8, at 1751.

[130] Several studies do not control for differences with a sample of matched non-targeted firms making their results difficult to interpret. For example, Bebchuk, Brav and Jiang, supra note 8, does not control for firm size, and Becht, Franks, Mayer and Rossi, supra note 118, does not control for industry or firm size.

higher ROA and Tobin's Q in the five years after intervention as compared to the year of intervention, but their data does not seem to clearly support their conclusions.[131]

Conversely, Klein and Zur find no evidence that target firms of activist hedge funds had better operating profits than a control sample of firms measured one-year before and after filing Schedule 13D.[132] Clifford finds, however, that firms targeted by activists do experience a median increase in ROA in comparison to firms targeted by passive institutional investors, but he attributes this difference to the fact that firms targeted by activists tend to shed assets (rather than improve cash flow).[133] Boyson and Mooradian find that target firms of active investors did not have a statistically different change in ROA (year after to year before filing) than control firms.[134] A similar insignificant result is found for changes in cash flows.[135] Although these studies differ slightly, all three—Klein and Zur, Clifford, and Boyson and Mooradian—find no significant improvement in cash flow at the targeted firm.

2. Capture of Takeover Premium. If improvements in operating performance do not generally drive the higher abnormal stock returns found in the short-horizon stock return studies, value might instead be derived from activist hedge funds capturing an increase in the expected takeover premium for their targets. Khorana, Hoover, Shivdasani, Sigurdsson and Zhang find

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[131] See Bebchuk, Brav and Jiang, supra note 8, at 8-12. Their Table 4, which reports ROA and Tobin's Q over the six years that begin with the event year, shows only eight out of twenty-four regression coefficients (or one third) to be positive. Thus, the majority of coefficients are not positive, which is hardly support for their conclusion. Id. at 12.

[132] See Klein and Zur, supra note 109, at 201.

[133] See Clifford, supra note 109, at 330-331. He concludes: "Thus, the improvements in operational efficiency are caused by a reduction in firm assets, more so than an improvement in cash flow." Id.

[134] See Boyson and Mooradian, supra note 109, at 191.

[135] Id. at 191.

that a common way for an activist firm to get higher value is to seek to put the target firm into "play".[136] They find that following an activist campaign more than 7% of the targets that outperformed in the six month following the filing date were acquired or sold in the subsequent six months. This acquisition frequency is three times higher for targets that underperformed following the activist campaign. Similarly, Brav, Jiang, Partnoy and Thomas find that the short-horizon abnormal stock returns are highest (8.54%) when the activist hedge funds stated objective is to sell the company.[137] Klein and Zur find short-horizon abnormal stock returns of 13.1% when the hedge fund is buying the company;[138] Greenwood and Schoar find positive abnormal returns for targets that are ultimately acquired, and zero abnormal returns when targets remain independent;[139] and Clifford finds positive abnormal returns when the target firms sell themselves to another firm.[140] All told, this evidence suggests that changes in the expected takeover premium, more than operating improvements, account for most of the stock price gain.

3. Wealth transfers. Definitionally, the value of the target firm is the sum of the value of its debt and equity. Can the higher stock returns found in the above studies be a transfer of wealth from bondholders to shareholders? Klein and Zur suggest that this may be the case.[141] They find that the average abnormal bond returns 10-days before and one-day after the filing date is negative (-3.9%). Furthermore, the average abnormal bond returns for one-year after the filing date is an additional -4.5%. Finally, the study finds that the abnormal stock returns are

[136] See Khorana, Hoover, Shivdasani, Sigurdsson and Zhang, supra note 111, at 14.

[137] See Brav, Jiang, Partnoy and Thomas, supra note 8, at 1758.

[138] See Klein and Zur (2009), supra note 109, at 210.

[139] See Greenwood and Schoar, supra note 118, at 368.

[140] See Clifford, supra note 109, at 328.

[141] See Klein and Zur (2011), supra note 109, at 1735.

negatively related to the abnormal bond returns at both the short-term and long-term intervals. This last result convincingly shows that there is a wealth transfer from bond holders to shareholders.

It is also possible that there is wealth transfer from the target firm's employees to their shareholders. This could be from reduction in the employees promised pension payouts or salary reductions or layoffs. Brav, Jiang and Kim find that the workers of target firms do not benefit from hedge fund activism.[142] Although their productivity rises, there is stagnation in their wages and only insignificant changes in the hours worked.

4. Reduction in managerial agency problems. If positive abnormal stock returns occur because of the actions of hedge fund activists in reducing managerial agency problems, then there should be observable changes in real variables, including changes in corporate governance, reduction of excessive managerial compensation, movement away from non-optimal capital structures, etc. However, most of the evidence shows that the positive abnormal returns are not statistically significantly related to such changes, even if they were stressed by the activist hedge fund in its Schedule 13D filing.[143]

D. Do the Targets of Hedge Fund Activism Experience Post-Announcement Changes in Real Variables? In this sub-section we summarize the evidence found in the various studies that examine whether the target firms experienced changes in real variables after filing Schedule 13Ds when compared to a control sample of non-target firms. In summary, we find neither a

[142] See Alon Brav, Wei Jiang and Hyunseob Kim, The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation and Industry Concentration, (available at http://ssrn.com/abstract=2022904) at 3 (May 23, 2013).

[143] See studies cited supra at note 109.

positive relationship between abnormal stock price returns and changes in real variables nor any consistent evidence of a directional change in the target's firm variables when compared to the control sample.

1. Risk. Klein and Zur find that the target's idiosyncratic volatility of stock returns, or risk, goes up post-filing when compared to the target's pre-filing risk.[144]

2. Leverage. Some studies have found leverage to increase[145] after the Schedule 13D filing when compared to before the Schedule 13D filing, but other studies find no statistically significant increase or decrease in leverage.[146] Thus, although the evidence on leverage seems to be mixed, increases in leverage, which a number of studies find, is consistent with an explanation that hedge fund activism transfers wealth from bondholders to shareholders.

3. Investment expenditures. Boyson and Mooradian and Klein and Zur both find no statistical change in capital expenditure and R&D expenses before and after the Schedule 13D filing as compared to a control sample.[147] In contrast, in a more recent study, Bebchuk, Brav and Jiang focus on a subsample of "investment-limiting" activist interventions that are followed by substantially increased leverage, higher payouts to shareholders, or reduced long-term investments over the two years following the year of intervention.[148] To identify these cases, they classify an activist intervention as "investment limiting" if it falls into one of the three following subcategories (each of which involves extreme departures from the norm): a) the increase in R&D and capital expenditure from the base year (t-1) to year t, t+1 or t+2 falls within

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[144] See Klein and Zur (2011), supra note 109, at 1751.

[145] See Brav, Jiang, Partnoy and Thomas, supra note 8, at 1772; Klein and Zur (2011), supra note 109, at 1751.

[146] See Clifford, supra note 109, at 330; Boyson and Mooradian, supra note 109, at 191.

[147] See Boyson and Mooradian, supra note 109, at 192; Klein and Zur (2009), supra note 109, at 201.

[148] See Bebchuk, Brav and Jiang, supra note 8, at 27-31.

the bottom five-percent of all firms in that year; (b) the increase in payout yield (including therein both dividends and share buybacks) from the base year (t-1) to any of the three following years (t, t+1, and t+2) falls within the top 5% of payout increases among all public companies in that year; or (c) the increase in leverage from the base year to any of the three following years falls within the top 5% of leverage increases among all public companies in that year. In short, each of these subcategories involves not just a company cutting research and capital expenditures, or increasing leverage or payout to shareholders, but doing so by such a degree as to make it into the top (or bottom) 5% of all public companies in that year.

Given the extreme selectivity of their criteria (i.e., they are in effect defining the bull's eye of a broader target), their most important and eye-opening finding may be that 19% of all activist interventions fall into one of these extreme subcategories, and about 25% of these interventions fall into two or more of these subcategories.[149] Had their categories been moderately expanded to include the top (or bottom) 10% of all public companies, one wonders how many more hedge fund interventions would have been captured. Even on their highly selective basis, the conclusion seems inescapable that activist interventions (or at least many of them) are associated with a decline in research and development and long-term investment. Our earlier Allergan example does not then stand alone as an idiosyncratic outlier.

But these interventions may boost profits. In particular, Bebchuck, Brav, and Jiang assert that ROA and Tobin's Q are positively related to year dummy variables t through year t+5, and they suggest that this shows that so called "investment-limiting" actually lifts profits.[150] Their data, however, does not prove clearly this claim because only a small minority of their results are

[149] Id. at 28 and n. 61.

[150] Id. at 30.

positively related to ROA.[151] Indeed, in the case of Tobin's Q, the coefficients are often negative and the positive coefficients are statistically insignificant, suggesting that when activist hedge funds increase leverage and shareholder payouts and decrease R&D, Tobin's Q actually falls.

4. Growth. On the one hand, it is arguable that activist hedge funds can use their managerial and industry expertise and access to capital to accelerate the growth of target firms. On the other hand, the activists can sell assets and slow down the fast-growing target firms. Boyson and Mooradian find no statistical change in the growth of sales or asset size[152], whereas Klein and Zur (2011) found the size of assets to decrease.[153]

5. Payouts. Clifford,[154]and Klein and Zur[155] find no statistical change in the level of payouts after the Schedule 13D filing when compared to before the Schedule 13D filing. In contrast to the above four studies, Brav, Jiang, Partnoy and Thomas find payouts to increase after the Schedule 13D filing as compared to before the Schedule 13D filing. [156]

6. Cash. Clifford finds no statistical change in the level of payouts after the Schedule 13D filing when compared to before the Schedule 13D filing, [157] but Klein and Zur[158] find cash levels to go down.

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[151] Id. at 30. Their Table 11 shows only three out of 12 coefficients to be positive and statistically significant.

[152] Boyson and Mooradian, supra note 109, at 191.

[153] See Klein and Zur (2011), supra note 109, at 1751.

[154] Clifford, supra note 109, at 330.

[155] Klein and Zur (2009), supra note 109, at 201; Klein and Zur (2011), supra note 109, at 1759.

[156] Brav, Jiang, Partnoy and Thomas, supra note 8, at 1771.

[157] Clifford, supra note 109, at 330.

[158] Klein and Zur (2011), supra note 109, at 1751.

E. An Initial Evaluation. Some of the inconsistencies between these studies may be the result of timing differences. More recent studies (such as Bebchuk, Brav and Jiang) find leverage increases and reductions in R&D and long-term investment, while earlier studies do not. Also, it should be remembered that none of these studies are examining activist interventions over the last five years—a period over which the pace of activism has increased and tactics may have changed.

Overall, the evidence is clearest that there is a short-term positive stock price reaction to a Schedule 13D's filing, less clear that there is any statistically significant positive long-term price reaction, and very unclear that operating performance improves after activist interventions.

The question of who is targeted also produces generally consistent findings: namely, companies with a low Tobin's Q and a "value" orientation. But little evidence suggests that these firms are industry laggards. Finally, even if we use severe and demanding criteria (as Bebchuk, Brav and Jiang do), it is clear that a material subset of activist interventions do increase leverage and shareholder payout, while reducing R&D and long-term investment.

V. Implications

Ultimately, if shareholders want to shorten the investment horizons of their corporation, discourage long-term investment by it, and/or curb its commitment to research and development expenditures, there is little in American corporate law to stop them from doing so. The board of directors can resist for only so long. Nor do we propose to reshape American corporate law and governance so as to deny shareholders the ability to pursue value-maximizing strategies (as they perceive them). But it is also not clear that American corporate and securities law needs to roll out a red carpet to activists seeking to increase leverage and reduce R&D.

Today, a formidable "wolf pack" of activist hedge funds can be assembled more quickly and with less disclosure in the United States than is possible in the other major capital markets.

Also, there is the real possibility that activists may seek to launch proxy campaigns simply to roil the waters in the belief that noisy activism will be read by the market as signaling a possible takeover or a major liquidity event. If such a campaign can lead the market to assign a higher expected takeover premium to the stock, then the activists will have succeeded. That enhanced premium might slowly erode over a period of years, but that will not matter to activists who typically exit the company within nine months to a year.[159] As a result, incentives may today exist for activists to create a "noisy" signal that suggests future actions by third parties. That is, some activists may be motivated to launch corporate governance campaigns, based less on the inherent merits of the policies proposed than on the high probability that those who purchase shares in the target firm before the filing of a Schedule 13D will profit handsomely on its filing and thereafter be able to exit quickly. This possibility of a relatively riskless profit that is divorced from the merits of the policy proposal concerns us because it may encourage pretextual corporate governance campaigns, based on the premise that noise generates profit.

This possibility is plausible to the extent that the market focuses primarily on the activist's proposal as a signal of an increased possibility of either a takeover or a major "liquidity event" (i.e., a dividend distribution or a stock repurchase made by a threatened management as a defensive tactic). Indeed, such a tactic is not irrational because, whatever the intent of the proponent, the response of target management is often to structure such a liquidity event as a

[159] The median duration between the Schedule 13D filing and the hedge fund's "exit" appears to be 266 days in the most recent study. See Brav, Jiang and Kim, supra note 65, at 18; see also Brav, Jiang, Partnoy and Thomas, supra note 8, at 1769.

defensive strategy. So viewed, the problem is that the merits of the activist's proposal may be only marginally relevant. Arguably, what is more relevant is the perception that the company has been put into potential play. If the market so perceives events, the expected takeover premium embedded in the target's stock price should increase (at least for an indeterminate period).

In this light, two different views of contemporary shareholder activism are possible. The first view, held almost as a matter of faith by some academics, sees activists as far-sighted investors who carefully monitor managements and seek to market new ideas for enhancing shareholder value to their fellow shareholders. The second and alternative perspective views activists' ideas as secondary to their ability to assemble a sizeable block before announcing a campaign that will predictably raise the expected takeover premium associated with that stock. In this view, noise (at least if it comes from a vociferous insurgent) moves the market. Moreover, if the median hedge fund holds for only 266 days,[160] it is difficult to understand how such activists can implement meaningful organizational change in that period. To be sure, they can seek to fire the CEO, spinoff a division, or mandate a stock buyback, but subtler changes arguably cannot be implemented during the limited duration over which they are willing to hold their investment.

We do not argue that one view is correct and the other wrong. Certainly, we do not suggest that all activists are pursuing governance changes just to create pretextual campaigns that will roil the markets. But both views could be partially correct, applying to some cases and not others. If so, are there policy measures that could reduce the perverse incentive to launch an

[160] See text and note supra at note 65.

activist campaign simply to signal that the company was "in play," without discouraging all such campaigns? We next survey the policy options:

A. Closing the Section 13(d) Window. In the United Kingdom (and elsewhere), the activist does not have the same ten-day window provided by Section 13(d)(1) before it must disclose its acquisition of a greater than 5% stake.[161] Disclosure may be required within two business days. The shorter the window, the smaller the position that can be assembled. In 2010, the Dodd-Frank Act authorized the SEC to shorten the Williams Act's ten-day window,[162] and, unsurprisingly, the Wachtell Lipton firm promptly petitioned the SEC to exercise this

[161] Disclosure of beneficial ownership must be filed within two trading days after crossing the 3% ownership level in the United Kingdom. See David Katz and Laura A. McIntosh, "Corporate Governance Update: Section 13(d) Reporting Requirements Need Updating," N.Y.L.J., March 22, 2014, at 4. In Australia, Germany and Hong Kong, the requirements range between two and four trading days. Canada requires "prompt disclosure" and limits additional share purchases until one business day after the required disclosure is made. Id. at 4-5. Although the U.S. was ahead of other countries in requiring beneficial ownership disclosure, they have surpassed us in the rigor of their current requirements.

[162] Section 929R of the Dodd-Frank Act of 2010 amended Section 13(d)(1) of the Securities Exchange Act of 1934 to shorten its ten-day window to "such shorter time as the Commission may establish by rule." For a discussion of the events leading to this change, see Mitts, supra note 67, at 214-215.

authority.[163] Their request was met by an outpouring of academic writing, advising the SEC not to do so.[164] Among the reasons given were the following:

First, because hedge fund activists rarely acquire all the stock of the target, they cannot capture all the gains from their governance strategy and must share the gains with other shareholders.[165] Closing the ten-day window would thus deny hedge fund activists the opportunity to make a sufficient profit from their campaign to motivate them properly to maximize shareholder value.

Second, the empirical evidence does not show any new trend toward increased accumulations by hedge fund activists (or anyone else) during the ten-day window. Rather, one well-known study reports that the size of pre-disclosure accumulations by those filing the Schedule 13D "has remained relatively stable throughout the 14-year period" that they study.[166] In fact, most of the stock acquired by the activists who file a Schedule 13D at the end of the ten-day window is "concentrated on the day they cross the threshold as well as the following day."[167]

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[163] See Letter from Wachtell Lipton Rosen & Katz to Elizabeth M. Murray, Sec'y, U.S. Securities & Exchange Commission (May 7, 2011), available at http://www.sec.gov/rules/petition/2011/petn4-624.pdf. For a further statement by the Wachtell firm, see Adam O. Emmerich, Theodore N. Mirvis, Eric S. Robinson & William Savitt, <u>Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure and the Use and Abuse of Shareholder Power</u>, 3 Harv Bus. L. J. 135 (2013).

[164] Lucian A. Bebchuk and Robert J. Jackson, Jr., <u>The Law and Economics of Blockholder Disclosure</u>, 2 Harv. Bus. L. Rev. 39 (2012); Bebchuk, Brav, Jackson and Jiang, supra note 56; Gilson and Gordon, supra note 2.

[165] Bebchuk and Jackson, supra note 164, at 49-50.

[166] See Bebchuk, Brav, Jackson and Jiang, supra note 56, at 5.

[167] Id. at *6.

Third, given the "proliferation of low-threshold poison pills in the United States" (i.e., poison pills with a threshold of 15% or lower), shortening the ten-day window would subject activists to defensive tactics that locked them into no more than a 10% to 15% stake, possibly making it more difficult to win a proxy contest from such a reduced base.[168]

Fourth, a shortened window for the purposes of Williams Act reporting would also be costly to non-activist investors, who greatly outnumber hedge fund activists.[169]

Although none of these arguments can be ignored, each seems overstated. First, although it is true that a hedge fund cannot capture all the gains from a corporate governance campaign, such an activist also avoids taking all of the risk. Instead, a hedge fund that stops below 10% (as most do) maintains a portfolio that has at least some diversification. If the median stake of the activist hedge fund under the current ten-day window is only 6.3% (as these scholars find[170]), and if the lead activist concentrates its purchases on the day that it crosses the 5% threshold and the next day (as they apparently do[171]), this failure to exploit the full ten-day period was a voluntary choice that shows that activists did not want to assume the risk of a larger position. In short, even under the current and permissive ten-day window, individual hedge fund activists generally stay below the 10% level, and thus it appears that economic, legal and financial considerations constrain them that are quite independent of the length of the statutory

[168] Id.

[169] Id. at *5.

[170] Id. at *3.

[171] Id. at *6 ("Their purchases are likely concentrated on the day they cross the threshold as well as the following day").

window for SEC reporting.[172] Even a high-risk hedge fund may feel compelled to stop short of risking all (or most of) its portfolio on one transaction (and thus one roll of the proverbial dice). The bottom line then is that the Williams Act (and its statutory window) are not placing a legal ceiling on the maximum stake that a hedge fund activist can acquire, but other factors may do this. As a result, hedge funds may prefer to share the gains among themselves by using an organizational structure that unites a number of funds into a loosely knit organization (i.e., the "wolf pack") that may acquire 30% or more of the target. Although the lead hedge fund may not fully exploit the gains in the transaction it leads, it may receive reciprocal treatment from other hedge funds that later invite it to join it to their "wolf packs."[173]

Second, if the principal hedge fund activists buy mainly on the day they cross the 5% threshold and the next day (as these scholars find[174]), shortening the ten-day window to two business days would not prejudice them to any significant degree. Apparently, they could do the same even under a two business day window. More importantly, however, the finding announced by these scholars that pre-disclosure accumulations have not increased is incomplete and misses the forest for the trees. It may be that the lead hedge fund usually stops short of 10%, but the rest of the "wolf pack" on a collective basis does not. Because these other and allied

[172] As previously discussed, Section 16(b) is one such factor. Fear of illiquidity may be another. We, of course, acknowledge that large blocks (such as the 26.7% acquired in the J.C. Penney's battle) can be acquired during the ten-day window. See discussion supra at note 67. But these are the exception, not the rule.

[173] This is an unexplored area, and we express no firm conclusion. But norms of reciprocity characterize many areas of commercial life. Thus, before we accept the thesis advanced by Bebchuk and Jackson that the activist "hedge fund" is undercompensated for its efforts to increase shareholder value, we would want to know more about the possibility of reciprocity within the hedge fund community.

[174] See Bebchuk, Brav, Jackson and Jiang, supra note 56, at *6.

activists never concede being a "group," they never disclose publicly their holdings. Hence, the reported finding that pre-announcement purchases have not increased focuses only (and myopically) on those who report in the Schedule 13D and ignores the rest of the "wolf pack." This is akin to measuring the size of an iceberg by examining only that portion that floats above the water and ignoring the much greater magnitude below. In the Sotheby's litigation, the rest of the "wolf pack" brought the total ownership in Sotheby's up from 9.6% to nearly 33%.[175] In short, empirical research that focuses only on the disclosed ownership ignores the reality of the "wolf pack's" aggregate stake, which remains out of sight—but may tip the balance in a proxy contest. To be sure, if the ten-day window were shortened to two business days (i.e., the British approach), these hidden allies would still not be disclosed under the existing rules on "grouphood." Still, the "wolf pack" leader would have much less time to assemble them or to tip other expected allies of its plans. Hence, the "wolf pack" might be smaller.

Finally, while shortening the ten-day window might impact some non-activist investors, these investors have the option of filing a Schedule 13G (which is filed on an annual basis) so long as they do not attempt to seek to "change or influence" control.[176] In short, non-activist investors have little to fear from a partial closing of the ten-day window.

To sum up, the arguments against "closing the window" work only if one assumes both that activists are the hero of the story and should not be restricted because they generate

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[175] See text and notes supra at notes 66 to 67.

[176] Under SEC Rule 13d-1(b)(1), a person otherwise obligated to file a Schedule 13D may instead file a shorter Schedule 13G if "such person has acquired such securities in the ordinary course of business and not with the purpose nor with the effect of changing or influencing the control of the issuer." See 17 C.F.R. § 290.13d-1(b)(1)(i). A Schedule G need only be filed within 45 days after the end of the calendar in which the person became obligated to file.

value for all shareholders. Neither assumption seems sound, at least without substantial qualification. Activists are reaping record returns at present, the number of such campaigns is accelerating, and fears for their future seem premature.

Even the alleged gains from activism are debatable because they are the gains that activists make in trading on asymmetric information (before the Schedule 13D filing), and they thus come at the expense of selling shareholders. This behavior may be lawful, but it represents another wealth transfer. Disclosure that is delayed ten days enables activists to profit from trading on asymmetric information over that period, and the abnormal share turnover over this window period suggests that this is occurring.[177] For example, others have estimated that Pershing Square and Vornado made a $230 million gain based on buying 26.7% of J.C. Penney at a discount to the price Penney's stock rose to on disclosure of their ownership.[178] Furthermore, evidence suggests such asymmetric trading harms other investors (not just the sellers), both by reducing liquidity and widening the bid-ask spread.[179] Closing or shortening the ten-day window is the simplest, most feasible means of restricting such trading (and primarily by parties—i.e., the tippees of the lead hedge fund—who were not responsible for the original idea). By shortening the ten-day window, new rules would primarily impact and chill not trading by the lead hedge fund (whose trading seems to culminate on the first day after it crosses the 5% threshold[180]), but trading by its allies and tippees in the "wolf pack." These may be exactly the parties that public policy most wants to deter.[181]

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[177] See the chart supra in the text at note 60.

[178] See Mitts, supra note 67, at 204.

[179] For an overview, see Kimberly D. Krawiec, Fairness, Efficiency and Insider Trading: Deconstructing the Coin of the Realm in the Information Age, 95 Nw. U. L. Rev. 443, 469-470 (2001) (citing studies).

[180] See text and note supra at note 60 (citing Brav, Jiang, Partnoy and Thomas, supra note 8, at 6).

At present, the SEC seems to have backed off of its original intent to shorten the Williams Act's ten-day window.[182] This may be because the SEC has been overwhelmed by the task of implementing the Dodd-Frank Act or because it wanted to avoid an unexpectedly controversial issue. But this is an issue that the SEC cannot easily duck without abdicating responsibility for transparency in the securities markets. Various compromises have been suggested, but none seem likely to be adopted.[183]

B. <u>Expanding the Definition of Insider Trading</u>. If a hedge fund's tipping to its prospective allies of its prospective Schedule 13D filing and/or its proxy campaign permits the exploitation of asymmetric information (as the law today seemingly does), a logical response might be to expand the definition of insider trading, either by statute or by SEC rule, to reach it. Some have urged this.[184] Nonetheless, of the various possible reforms, we believe this would be the worst option to pursue. In our judgment, it would vastly overextend the reach of the insider trading prohibition.

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[181] These silent allies are essentially "free riders" who do not need to receive an attractive return in order to encourage efficient monitoring.

[182] In the Fall of 2013, the SEC indicated that it was "withdrawing this item from the Unified Agenda because it does not expect to consider this item in the next 12 months, but the Commission may consider the item at a future date." See Bebchuk, Brav, Jackson and Jiang, supra note 56, at *3 n.3 (quoting the Commission's website).

[183] One such proposal is that the length of the Schedule 13D window should be left to the target company's shareholders to determine. See Mitts, supra note 67, for this proposal. Of course, once shareholder choice is legitimized, some may argue that shareholders should be able to opt out entirely from any disclosure of beneficial ownership or to specify a lengthy (say, six months) window that would make disclosure meaningless. Nonetheless, if the default rule were two business days (i.e., the British rule) and if shareholders could vote to extend this period to up to ten days (the current period), the net effect would probably chill "wolf pack" formation.

[184] We understand this from discussion with Congressional staffers.

At present, insider trading requires a breach of some duty. Either an insider has breached a fiduciary to shareholders or an outsider has misappropriated information belonging to another. Eliminate that requirement and the reach of the insider trading prohibition is extended by an order of magnitude. The term "insider trading" would become a misnomer, because the law would actually prohibit "outsider trading." Merely the use of material, nonpublic information would become criminal.

That has a number of ominous implications for both hedge funds and other investors. Activists would be constrained in their ability to talk to other institutions about prospective proxy contests or corporate governance generally; securities analysts would be at constant risk. We are talking here not about a disclosure obligation (such as Section 13(d) imposes), but criminal liability, with its inherent chilling effect.

C. Redefining Group. To the extent that the "wolf pack" is the tactic that has most fueled proxy activism, its feasibility depends on the ability of the lead hedge fund to disclose to allies its prospective Schedule 13D filing and/or proxy campaign without such communication making them members of a "group" for purposes of Section 13(d)(3). Once alerted to a material development that will boost the target's stock price, other hedge funds have little reason to resist trading in this stock.

But what if the act of trading on such information made them a member of a §13(d) "group"? The consequence of using the fact of a tip (or gift of information) from the lead activist to another as at least a major criterion in the definition of "group" would be that the "wolf pack" would have to be disclosed at a much earlier stage (and the disclosure might have to be amended as each additional member "joined" the team). Some investors would not want to join the "group" (possibly for fear of liability) and may not invest. Also, any poison pill adopted by the target in response to this disclosure would restrict all the “group” members, holding them to their disclosed stake. In short, the “wolf pack” could less easily grow to the size it reached in the Sotheby’s case. The proxy contest would thus be a closer battle.

The problem with this proposal is that it has little support in the case law. But this does not mean that the SEC could not adopt such a rule or—even more plausibly—that Congress could not so legislate. Unlike simply shortening the ten-day window, this approach directly addresses the perceived unfairness in passing material, non-public information to a selected few, and it brings the hidden allies out into the open. Still, it is by no means a “showstopper.” The leader of the “wolf pack” could still buy the target’s stock until it crossed the 5% threshold and then quickly tip its allies who could buy heavily during whatever period remained before the Schedule 13D filing disclosed their “group.” Its impact would likely be only to reduce the size and ownership of the “wolf pack” before it was disclosed (and allow the target to take more effective defensive steps).

D. Focusing on the Proxy Advisor. In Staff Legal Bulletin No. 20, issued earlier this year, the SEC has at last focused on the phenomenon of near total deference given by some institutional investors to ISS.[185] But it has still done little, essentially requiring only some additional monitoring.

What more could it reasonably do? A number of steps are possible. For example, the SEC could require a mutual fund to disclose to its shareholders that the fund had automatically adopted ISS’s voting recommendations (or at least disclose the actual percentage of all votes in which it followed its proxy advisor). This might embarrass some mutual funds, but it probably will have little effect on hedge funds, which hold smaller portfolios, behave very differently with

[185] See text and note supra at note 35.

respect to voting decisions, and may often be beyond the SEC's jurisdictional reach.[186] More intrusive attempts at restricting proxy advisors by means other than increased disclosure could raise constitutional issues and in any event will probably not affect the outcomes in many proxy contests.

Still, another sensible reform might be to require the proxy advisor to publish an annual scorecard showing its voting recommendations on specific issues. For example, how often had it recommended a vote for the insurgents in a contested director election?

E. An Initial Summary: Some Realism About Reform. Although the antagonists in the debate over shortening the ten-day window under the Williams Act tend to present the issue as one critical to the fate of contemporary corporate governance, we doubt that that such a reform (or any of the other reforms proposed in this section) would have decisive impact. In the case of a tender offer for a target at a premium (such as the ongoing bid for Allergan), we expect these reforms would not change the likely outcome. Shareholders will predictably vote for a lucrative takeover if given the chance.

What then could be achieved? These reforms might reduce the incentive for a pretextual governance campaign that is grounded less on the value of the proposed governance change than on the hope that a "noisy" signal will produce a short-term gain based on the market's perception of an increased prospect of a takeover. But these reforms will not much affect a real takeover. So viewed, they may (a) reduce the incentive to create noise for its own sake, and (b) reduce the gains from trading on asymmetric information. But these will be marginal changes.

[186] Hedge funds will generally not be subject to the Investment Company Act, and their investment advisers may not be registered with the SEC.

Private ordering responses might be more effective, but they also carry a risk that a novel defense might be invalidated. Two illustrations merit consideration. First, corporations fearful of a "wolf pack" could adopt a "standing" poison pill that would preclude any shareholder (with some possible exemption for "passive" shareholders) from exceeding a specified level (either 15% or possibly 10%), and such a poison pill could broadly define its coverage so as to apply to any persons "acting in concert" or "in conscious parallelism" with the leader of the "wolf pack."[187] The goal here is to define "group" for purpose of the poison pill much more broadly than the case law under the Williams Act has done in order to include persons who receive advance information of a Schedule 13D filing from a party making that filing (or an agent thereof). Second, a "window-closing" poison pill could be adopted that would be triggered by ownership of as little as 5.1% of the target's stock if the acquirer did not file a Schedule 13D within a defined period (say, 48 hours) after crossing 5%.[188]

These more sweeping poison pills would impede the wolf pack's formation, but would be subject to legal challenge and would anger the proxy advisors (who might recommend that institutions withhold their votes for the directors of this corporation). For this reason, some compromises might intelligently be struck in designing such a poison pill. For example, a "window-closing" poison pill that denied the bidder the ability to delay its Schedule 13D filing

[187] We have been advised by Charles Nathan, a leading expert in the M&A field, that such a poison pill has been designed by the law firm of Latham & Watkins LLP. Our suggestion is to focus less on an ineffable concept such as "conscious parallelism" and more on a concrete act, such as tipping.

[188] The point of this variant is to deny the acquirer the Williams Act's ten-day window, because the failure to file a Schedule 13D promptly after crossing 5% would trigger the pill. We have been advised that such a pill has been drafted by the law firm of Fried, Frank, Shriver & Jacobson LLP. We express no views on the validity of these pills, which need to be analyzed in a context-specific setting.

for the ten day window period permitted by the Williams Act might compensate for this harshness by allowing the bidder to accumulate a greater level of stock (say, 15 or 20%), so long as it filed with the SEC immediately after crossing 5%. This might lead the Delaware courts to accept it. The bottom line is that private initiatives by determined targets could both "close" the current ten day window and render irrelevant the inadequacies in the current case law's definition of "group." What can be done by regulation can also be done by private ordering.

Once a clear academic consensus existed that takeover defensive measures reduced shareholder value, but today fissures are appearing in that consensus. Some studies find defensive measures to increase value for some companies.[189] Even more ironically, the staggered board (long the target of universal academic scorn) has been cast in a new light by recent research. Employing Tobin's Q as a proxy for firm value, one study of the period 1978-2011 finds that destaggering the board reduces firm value, while staggering the board results in increasing value.[190] The authors surmise that staggered boards might be beneficial for some companies because they commit shareholders to longer-term horizons.[191] This association was strongest for firms with high R&D expenditures.[192] The bottom line is that serious academic

[189] See, e.g., William C. Johnson, Johnathan Karpoff and Sangho Yi, The Bonding Hypothesis of Takeover Defenses: Evidence from IPO firms (available at http://ssrn.com/abstract=1923667, (February 4, 2014).

[190] See K. J. Martijn Cremers, Lubomir P. Litov and M. Sepe, Staggered Boards and Firm Value, Revisited (available at http://ssrn.com/abstract=2364165, (July 14, 2014). Their findings depend upon viewing the data from a time series (rather than a cross-sectional) perspective.

[191] Id at 3, 4.

[192] Id at 7-8.

research now supports the view that staggered boards can provide stability and continuity that enhances shareholder value.[193]

Yet, it is probably already too late to save the staggered board, as momentum has gathered to purge it in all cases. Almost inevitably, resisting hedge fund activism will bring the company into conflict with its proxy advisors. Companies thus face a difficult choice between lying low or confronting the proxy advisor.

Conclusion

It understates to say simply that the pace of shareholder activism has recently accelerated. Rather, we are now witnessing activism on steroids. Most attempts to measure its impact have primarily examined whether shareholders benefit over the short-run. This is myopic, but even here the evidence in our judgment remains mixed (although the short-term abnormal returns are clear). The evidence on improvements in operating performance is particularly thin, and this should not surprise us, given the short holding period (nine months or so) of the median activist hedge fund.

But to limit one's focus solely to whether shareholders gain requires one to wear self-imposed blinders. Much of those gains may be wealth transfers from bondholders and employees, and much of the balance may derive from temporary increases in the target's expected takeover premium. We do not deny that there may be cases in which activism has curbed excessive compensation or trimmed bloated and inefficient conglomerates. But against these gains must be balanced the possibility that hedge fund activism is producing a significant

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[193] For another such study finding a negative stock price reaction to de-staggering votes, see David F. Larcker, Gaizka Omazabal and Daniel J. Taylor, The Market Reaction to Corporate Governance Regulation, 101 J. Fin. Econ. 431 (2011).

externality: namely, the shortening of investment horizons and the discouragement of research and development. The Allergan battle highlights this danger, and even the studies most favorable to hedge fund activism find that these interventions regularly increase leverage and reduce investment in R&D and long-term capital expenditures.[194] Others have warned that activism is focusing the corporate community excessively on the short-term.[195] Currently, academic opinion is only awakening to new evidence suggesting that defensive measures may sometimes be in the best interests of shareholders.

We do not assert that all increases in leverage and all decreases in research and development are bad. We offer no theory of what is optimal. But we do observe that strong (and possibly perverse) incentives are pushing in those directions. In particular, we make two assertions about contemporary activism:

(1) The level of activism can become excessive to the extent that it is relatively riskless (that is, to the extent that members of the "wolf pack" can exploit asymmetric information and anticipate an abnormal short-term gain on the Schedule 13D filing).[196] In this

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[194] See Bebchuk, Brav, and Jiang, supra note 8, at 27-31. They do not deny the increase in leverage, but argue that it has produced gains for shareholders (or at least has not harmed operating performance).

[195] See The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report at 9 (July, 2012) (available at http://www.gov.uk/government/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf); The Aspen Institute, "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management" at 2-3 (2009) (available at http://www.aspeninstitute.org).

[196] In describing short-term hedge fund interventions in which the activists buy before the Schedule 13D's filing and sell within nine months later as "relatively riskless," we do not deny that there are some risks: a possible takeover can be blocked by the antitrust laws, for example, or by other legal obstacles. Nothing is riskless. But this just underscores why most hedge fund activists seem to prefer to make short-term interventions.

environment, activists have little need to engage in longer-term reform or restructuring, but can seek simply to exit the target after the market's response to the Schedule 13D and move on to the next activist intervention;

(2) A full accounting of the impact and costs of activism must focus on firms not targeted, but still deterred. This has not been done to date. The danger exists that the general deterrent effect of hedge fund interventions is to discourage longer-term investment horizons and, more specifically, investment in research and development. Even indisputable evidence that shareholders gain from activist interventions would not resolve what their impact was at other firms not targeted. Given the volume of recent interventions, some impact is inevitable.

The new evidence may intensify the long-standing debate between proponents of a "board-centric" model of corporate governance and the majority of academics who favor a "shareholder-centric" model. We will sidestep that debate, because we believe the greater need is to focus research on how the composition of the firm's shareholders (i.e., "transient" versus long-term) affects its decision making.[197] Arguably, traditional institutional investors favor collective monitoring to increase aggregate shareholder wealth, while activist hedge funds pursue private trading gains and in so doing, may disserve the American economy by discouraging research and development. That thesis is plausible, but, we concede, not yet proven. Moreover, even if it is true, a policy response to it does not fall within the SEC's normal jurisdiction.

Thus, for the time being, we can only conclude that there is reason for concern (and possibly alarm), but more evidence still must be developed before any conclusion that hedge fund activism poses a threat to the American economy can be reached with confidence. Conversely, the claim that event studies showing stock price gains on a hedge fund's filing of a

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[197] See sources cited in the text and notes at notes 89 to 93.

Schedule 13D prove that activism creates real, long-term value rests on a shaky foundation. What is clear, however, is that their hedge fund activism may dissuade many corporate managers from investing in research and development. Future research needs to focus more specifically on where activism causes real changes in firm value and where it does not.

For the immediately foreseeable future, new regulatory initiatives appear unlikely. Over this interim period, courts will be recurrently faced with defensive efforts that use private ordering to slow down the process and buy time for target managements. Given the current state of knowledge, we believe such efforts can often be justifiable (depending, as always, on their specific facts and circumstances).

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