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HEDGE FUNDS IN CORPORATE GOVERNANCE AND CORPORATE CONTROL

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Hedge funds have become critical players in both corporate governance and corporate control. In this Article, Professors Kahan and Rock document and examine the nature of hedge fund activism, how and why it differs from activism by traditional institutional investors, and its implications for corporate governance and regulatory reform. The authors argue that hedge fund activism differs from activism by traditional institutions in several ways: it is directed at significant changes in individual companies (rather than small, systemic changes), it entails higher costs, and it is strategic and ex ante (rather than incidental and ex post). The reasons for these differences may lie in the incentive structures of hedge fund managers as well as in the fact that traditional institutions face regulatory barriers, political constraints, or conflicts of interest that make activism less profitable than it is for hedge funds. But the differences may also be due to the fact that traditional institutions pursue a diversification strategy that is difficult to combine with strategic activism.

Although hedge funds hold great promise as active shareholders, their intense involvement in corporate governance and control raises two potential problems: the interests of hedge funds sometimes diverge from those of their fellow shareholders, and the intensity of hedge fund activism imposes substantial stress that the regulatory system may not be able to withstand. The resulting concerns, however, are relatively isolated and narrow, do not undermine the value of hedge fund activism as a whole, and do not warrant major additional regulatory interventions.

The sharpest accusation leveled against activist funds is that activism is designed to achieve a short-term payoff at the expense of long-term profitability. Although the authors consider this a potentially serious problem that arguably pervades hedge fund activism, they conclude that a sufficient case for legal intervention has not been made. This conclusion results from the uncertainties about whether short-termism is, in fact, a real problem and how much hedge fund activism is driven by excessive short-termism. But most importantly, it stems from the authors' view that market forces and adaptive devices adopted by companies individually are better designed than regulation to deal with the potential negative effects of hedge fund short-termism, while preserving the positive effects of hedge-fund activism.

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INTRODUCTION

Hedge funds[1] have become critical players in both corporate governance and corporate control. Recently, hedge funds have pressured McDonald's to spin off major assets in an IPO;[2] asked Time Warner to change its business strategy;[3] threatened or commenced proxy contests at H.J. Heinz,[4] Massey Energy,[5] KT&G,[6] infoUSA,[7] Sitel,[8] and

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[1] For purposes of this Article, and in general, hedge funds are funds exempt from regulation under the Investment Company Act that invest primarily in publicly traded securities or financial derivatives. *See* U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 3 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf (defining the term "hedge fund").

[2] *See* Jesse Eisinger, *Hedge-Fund Man at McDonald's*, WALL ST. J., Sept. 28, 2005, at C1 (noting pressure by Pershing Square, a hedge fund, on McDonald's to sell company-owned restaurants); Steven Gray, *Big Shareholder of McDonald's Urges Asset IPO*, WALL ST. J., Nov. 9, 2005, at A6 (reporting Pershing Square's response to McDonald's rejection of its proposal).

[3] *See* Julia Angwin, *Icahn Confirms Time Warner Challenge*, WALL ST. J., Aug. 16, 2005, at A3 (detailing Carl Icahn's alliance with three other investors to "agitate for changes" at Time Warner); Andrew Ross Sorkin & Richard Siklos, *Icahn Tries To Form a Team to Take On Time Warner*, N.Y. TIMES, Aug. 10, 2005, at C1 (describing a plan by Icahn to "form a faction with enough leverage to spin off Time Warner Cable, and possibly other divisions").

[4] *See* Janet Adamy & David Reilly, *Heinz Says Investor's Company Plans To Nominate 5 Directors*, WALL ST. J., Mar. 4, 2006, at B2 (reporting that Trian Partners had nominated five directors to run for the board of H.J. Heinz Co.).

[5] *See Investment Company Wants Representation on Massey Board*, ASSOCIATED PRESS, Mar. 17, 2006, *available at* Factiva, Doc. No. APRS000020060317e23h002ea (noting Third Point LLC's plan to nominate two candidates for Massey's board to "present stockholders' perspectives on management direction," executive compensation, and other issues).

[6] *See* Seon-Jin Cha, *Icahn Group Demands Access to KT&G Books*, WALL ST. J., Mar. 15, 2006, at C4 (reporting and analyzing the proxy contest between a group of investors led by Carl Icahn and KT&G management); Laura Santini, *Icahn Group Lands KT&G Board Seat*, WALL ST. J., Mar. 17, 2006, at C4 (describing the Icahn group as having "won more support than expected" during the proxy contest).

[7] *See InfoUSA Tells Shareholders To Ignore Hedge Fund*, REUTERS, May 4, 2006, *available at* Factiva, Doc. No. LBA0000020060504e254001vp (discussing the proxy contest between infoUSA's founder and Dolphin, a Connecticut-based hedge fund).

[8] *See JANA Partners LLC Announces SITEL Board Nominees and Intention To Replace Additional Board Members*, PR NEWSWIRE, Nov. 23, 2005, *available at* Factiva, Doc. No. PRN0000020051123e1bn0050s (noting Jana Partners' nomination of three director candidates for SITEL's board).

GenCorp;[9] made a bid to acquire Houston Exploration;[10] pushed for a merger between Euronext and Deutsche Börse;[11] pushed for "changes in management and strategy" at Nabi Biopharmaceuticals;[12] opposed acquisitions by Novartis of the remaining 58% stake in Chiron,[13] by Sears Holdings of the 46% minority interest in Sears Canada,[14] by Micron of Lexar Media,[15] and by a group of private equity firms of VNU;[16] threatened litigation against Delphi;[17] and pushed for litigation against Calpine that led to the ouster of its top two executives.[18]

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[9] *See* Clint Swett, *Shareholder Revolt Rocks GenCorp*, SACRAMENTO BEE, Apr. 1, 2006, at A1 (reporting Pirate Capital's victory in a proxy battle to elect its slate of directors to GenCorp's board).

[10] *See* Marietta Cauchi, *Jana Partners Sets Energy Bid in Unusual Move for Hedge Fund*, WALL ST. J., June 13, 2006, at A18 (reporting the bid by Jana for Houston Exploration).

[11] *See* Nick Clark & Vivek Ahuja, *Hedge Fund Forces Euronext Merger Vote*, FIN. NEWS ONLINE US, Apr. 5, 2006, http://www.financialnews-us.com/?page=ushome&contentid=531748 (discussing Euronext's acquiescence to The Children's Investment Fund's request for a vote); Posting to Hedge Fund Street, Hedge Funds Push for Merger of Deutsche Boerse & Euronext, http://www.fundstreet.org/2005/11/index.html (Nov. 23, 2005) (noting the proposed merger and providing the historical context).

[12] Robert Steyer, *Hedge Funds Take Aim at Nabi*, THESTREET.COM, Apr. 26, 2006, http://www.thestreet.com/stocks/biotech/10281755.html.

[13] *See* David P. Hamilton, *Shareholder Insurrection Infects Novartis's $5.1 Billion Chiron Bid*, WALL ST. J., Apr. 3, 2006, at C3 (detailing the challenges ValueAct's activism presented to the then-proposed merger between Novartis and Chiron); *ValueAct Capital Refuses To Meet with Chiron Directors Except To Discuss Ways To Increase Shareholder Value Beyond $45*, BUS. WIRE, Mar. 15, 2006, *available at* Factiva, Doc. No. BWR0000020060315e23f0041v (noting ValueAct's continued opposition to the merger).

[14] *See* Gary Norris, *Sears Holdings Says It Will Own 100% of Sears Canada Despite Hedge Fund*, CBC.CA, Apr. 7, 2006, http://www.cbc.ca/cp/business/060407/b040783.html (detailing Sears Holdings' attempt to take Sears Canada private and Pershing Square's opposition to the transaction).

[15] *See* Jeff Chappell, *Hedge Fund Investors Question Lexar-Micron Deal*, ELECTRONIC NEWS, Apr. 7, 2006, http://www.edn.com/article/CA6323076.html?partner=enews (reporting the concerns of a consortium of hedge funds, including Icahn Associates Corporation and Elliott Associates, L.P., that the merger paid an insufficient price for Lexar).

[16] *See* Jason Singer, *Knight Presses VNU Overhaul Plan*, WALL ST. J., Apr. 7, 2006, at C4 (describing Knight Vinke Asset Management's opposition to the transaction).

[17] *See* Jeffrey McCracken, *Delphi Ripped for Bankruptcy Case*, WALL ST. J., Mar. 17, 2006, at A10 (discussing an attempt by David Tepper, the head of Appaloosa Management, to form an equity committee in the Delphi bankruptcy case).

[18] Rebecca Smith & Henry Sender, *Executives' Ouster Shows Growing Hedge-Fund Clout*, WALL ST. J., Dec. 1, 2005, at A1 (detailing the battle between Calpine's management and dozens of hedge funds over bankruptcy strategy).

Even though most hedge funds are not activist,[19] the ones that are have captured attention. Martin Lipton, the renowned advisor to corporate boards and veteran of the takeover wars of the 1980s, lists "attacks by activist hedge funds" as the number one key issue for directors.[20] The *Wall Street Journal*, the newspaper of record for executives, bankers, and investment professionals, calls hedge funds the "new leader" on the "list of bogeymen haunting the corporate boardroom."[21] *The Economist* has run a special report on shareholder democracy focusing on activism by hedge funds,[22] and several European governments are considering regulations designed to curb hedge fund activism.[23]

What should we make of this spate of shareholder activism by hedge funds? Are hedge funds the "Holy Grail" of corporate governance—the long sought-after shareholder champion with the incentives and expertise to protect shareholder interests in publicly held firms? Or do they represent darker forces, in search of quick profit opportunities at the expense of other shareholders and the long-term health of the economy?

In this Article, we analyze and evaluate the implications of the rise of hedge funds for corporate governance and corporate control. In Part I, we examine and categorize a variety of presumptively "happy stories"—that is, examples of different kinds of activism where hedge

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[19] *See infra* Part I.C.

[20] Client Memorandum from Martin Lipton, Wachtell, Lipton, Rosen & Katz, Key Issues for Directors (Dec. 6, 2006) [hereinafter Key Issues for Directors] (on file with authors); *see also* Client Memorandum from Martin Lipton, Wachtell, Lipton, Rosen & Katz, Attacks by Activist Hedge Funds (Mar. 7, 2006) [hereinafter Attacks by Activist Hedge Funds] (on file with authors) (presenting a checklist for clients to avoid disruptions caused activist hedge funds); Client Memorandum from Martin Lipton et al., Wachtell, Lipton, Rosen & Katz, Be Prepared for Attacks by Hedge Funds (Dec. 21, 2005) [hereinafter Be Prepared for Attacks by Hedge Funds] (on file with authors) (noting an "environment of attacks by hedge funds" and advising companies on how to deal with it).

[21] Alan Murray, *Hedge Funds Are New Sheriffs of Boardroom*, WALL ST. J., Dec. 14, 2005, at A2; *see also* Jesse Eisinger, *Memo to Activists: Mind CEO Pay*, WALL ST. J., Jan. 11, 2006, at C1 ("The shareholder activists with the most clout these days are hedge-fund managers . . . .").

[22] *Battling for Corporate America*, ECONOMIST, Mar. 11, 2006, at 69, 69-71.

[23] *See* Edward Taylor, *German Official Wants To Put Hedge Funds on G-8's Agenda*, WALL ST. J., Sept. 1, 2006, at C4 (reporting that the German finance minister wanted to discuss the transparency of hedge funds, a concern shared by managers worried about activist funds); Edward Taylor & Alistair MacDonald, *Hedge Funds Face Europe's Clippers*, WALL ST. J., May 23, 2006, at C1 (describing regulations being considered by Germany and the Netherlands).

funds have no apparent conflict of interest. We argue that this hedge fund activism differs, quantitatively and qualitatively, from the more moderate forms of activism that traditional institutional investors engage in.

In Part II, we analyze why hedge funds are so much more active than other institutional investors. We show that hedge funds have better incentives, are subject to fewer regulatory impediments, and face fewer conflicts of interest than traditional institutions, such as mutual funds and pension funds, which have never lived up to the hopes of their partisans. But the activism of hedge funds may also be due to the fact that many follow a different business strategy than traditional institutions. This strategy involves taking high stakes in portfolio companies *in order to* become activist, rather than diversifying and becoming involved (if at all) only ex post when companies are underperforming, thus blurring the lines between betting on and determining the outcome of contests.

In Part III, we turn to potential problems generated by hedge fund activism. We first examine the "dark side" of activism—instances where the interests of activist hedge funds conflict with those of their fellow shareholders—to see whether regulatory intervention is warranted. We then discuss other problems that arise from the stress that hedge funds put on the governance system.

In Part IV, we turn to the most severe attack leveled against hedge funds: that hedge fund activism increases the pressure for short-term results over more valuable long-term benefits. We accept that short-termism by hedge funds can aggravate short-termism in the executive suite. But we nevertheless conclude that, at this point, no regulatory intervention is warranted because: it is unclear to what extent hedge fund activism is driven by excessive short-termism; hedge funds usually need the support of other, less short-term oriented constituents to affect corporate policy; and, to the extent short-termism generates a problem, adaptive devices adopted by corporations are a better way to address it than regulation.[24]

[24] We do not address the question of whether additional regulation is needed to protect hedge fund investors from either investment risk or unscrupulous managers. While important and timely, this question is beyond the scope of this Article.

I. WHAT'S GOING ON OUT THERE? SOME ILLUSTRATIVE, HAPPY STORIES

Hedge funds are emerging as the most dynamic and most prominent shareholder activists. On the bright side, this generates the possibility that hedge funds will, in the course of making profits for their own investors, help overcome the classic agency problem of publicly held corporations by dislodging underperforming managers, challenging ineffective strategies, and making sure that merger and control transactions make sense for shareholders. In so doing, if one looks at the bright side, hedge funds would enhance the value of the companies in which they invest for the benefit of both their own investors and their fellow shareholders. In the first Section of this Part, we examine and categorize the different ways in which hedge funds, without any apparent conflicts of interest, have confronted managers. This Section illustrates the potential bright side of hedge fund activism.

But the bright-side story of hedge funds—of large and sophisticated investors standing up to management for the benefit of shareholders at large—has an element of déjà vu. Twenty years ago, similar stories were told about another set of large and sophisticated investors: mutual funds, pension funds, and insurance companies—or "institutional investors," as they became known.[25] While, on the whole, the rise of these traditional institutional investors has probably been beneficial, they have hardly proven to be a silver bullet.

Are there reasons to think that the newly prominent hedge funds will be more effective? In Section B of this Part, we start answering this question by comparing the activism of hedge funds to the activism of traditional institutions. We show that hedge fund activism differs in degree and type from activism by traditional institutions.

In the final Section of this Part, we place hedge fund activism in the context of hedge fund investment strategies more generally. Because only a small portion of hedge fund assets are devoted to shareholder activism, activism does not dominate what hedge funds do.

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[25] *See generally* Anat R. Admati et al., *Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium*, 102 J. POL. ECON. 1097 (1994); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

Hedge funds, however, dominate certain modes of activism and—if that activism is profitable and more hedge funds' assets become devoted to it—the extent of hedge fund activism could quickly increase.

A. *Hedge Funds as Activists*

1. Corporate Governance Activism

Hedge funds have increasingly tried to influence the business strategy and management of corporations. This activism takes a variety of forms, from public pressure on a portfolio company to change its business strategy, to the running of a proxy contest to gain seats on the board of directors, to litigation against present or former managers.

One of the better known (and more entertaining) activist hedge funds is Third Point, which has about $4 billion under management.[26] Its list of recent targets includes Ligand, Salton, Western Gas Resources, Massey Energy, Potlatch, Intercept, Warnaco, Penn Virginia, and Star Gas Partners.[27] Star Gas, to pick one of the targets, is a heating oil distributor in which Third Point acquired a 6% stake.[28] In addition to severely criticizing then-CEO Irik Sevin's management of the company, Third Point attacked him personally: "It is time for you to step down from your role as CEO and director so that you can do what you do best: retreat to your waterfront mansion in the Hamptons where you can play tennis and hobnob with your fellow socialites."[29] The governance practices of Star Gas were apparently not ideal. Third Point openly wondered:

> [H]ow is it possible that you selected your elderly 78-year-old mom to serve on the Company's Board of Directors and as a full-time employee providing employee and unitholder services? We further wonder under what theory of corporate governance does one's mom sit on a Company board. Should you be found derelict in the performance of your execu-

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[26] *James Kelly Joins Third Point as President and Chief Operating Officer*, PR NEWSWIRE, Sept. 7, 2005, *available at* Factiva, Doc. No. PRN0000020050907e197003s1.

[27] Innisfree M&A Inc., Presentation to Skadden, Arps, Slate, Meagher & Flom LLP, at slide 15 (Apr. 23, 2006) [hereinafter Innisfree Presentation] (on file with authors).

[28] *Third Point Demands that Star Gas CEO, Irik Sevin, Resigns and Returns Keys to Company Car*, PR NEWSWIRE, Feb. 14, 2005, *available at* Factiva, Doc. No. PRN0000020050214e12e00dqm.

[29] *Id.*

> tive duties, as we believe is the case, we do not believe your mom is the right person to fire you from your job.[30]

The tactic worked. Bowing to the pressure generated by Third Point, Sevin resigned one month later.[31]

The exploits of Barington Capital Group provide another good example. In June 2003, a syndicate of investors led by Barington nominated three directors to the board of Nautica Enterprises, the sportswear company. At the time, it held about 3.1% of Nautica stock.[32] Shortly thereafter, the company indicated that it was discussing a possible sale.[33] Barington subsequently convinced Institutional Shareholder Services, a proxy voting advisory service, to recommend that its clients vote for two director candidates nominated by Barington.[34] By July 2003, Barington's tactics had worked: Nautica agreed to be acquired by VF Corporation for $587 million,[35] and Barington dropped its proxy fight.[36] The following July, Barington turned to Steven Madden, the shoe retailer, and urged it to explore "strategic discussions with potential acquirers."[37] Barington, which had accumulated a 7.7% stake, sent outside directors a strongly worded letter demanding that Steven Madden hire a more seasoned CEO, reduce change in control compensation, reduce conflicts of interest on the board, and use its excess cash to buy back shares and pay dividends.[38]

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[30] *Id.*

[31] Ron Orol, *Fortress GenCorp*, THEDEAL.COM, Mar. 24, 2005, http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1111624424652. Whether this was too little too late is an interesting but separate question. After a brief uptick, Star Gas's stock price continued to decline.

[32] Suzanne Kapner, *Board Move Lifts Nautica 21 Percent*, N.Y. POST, June 12, 2003, at 41.

[33] Suzanne Kapner, *Nautica Rises 11% on News of Suitor*, N.Y. POST, June 21, 2003, at 20.

[34] *Institutional Shareholder Services Recommends Election of Barington Companies Group Nominees*, PR NEWSWIRE, July 2, 2003, *available at* Factiva, Doc. No. PRN0000020030702dz72000k6.

[35] Greeta Sundaramoorthy, *Nautica Accepts $587m VF Bid*, FIN. TIMES (London), July 8, 2003, at 26.

[36] *Barington Companies Group Reacts Favorably to Proposed Acquisition of Nautica Enterprises by VF Corporation—Withdraws Proxy Solicitation*, PR NEWSWIRE, July 7, 2003, *available at* Factiva, Doc. No. PRN0000020030707dz770011s.

[37] Tania Padgett, *A Proxy Fight Is Brewing for Steven Madden*, NEWSDAY (N.Y.), Dec. 30, 2004, at A45.

[38] *Barington Capital Group Sends Letter to Outside Directors of Steven Madden Ltd. Calls for the Board To Replace CEO Jamieson Karson and To Make Other Changes To Enhance Share-*

By February 2005, the Steve Madden board agreed to spend $25 million in 2005 for share repurchases and dividends and to meet with representatives of Barington on a regular basis in order to avoid a proxy fight.[39]

Carl Icahn, familiar to some from the takeover battles of the 1980s, has returned to the headlines by starting a hedge fund, buying blocks in companies and pressuring them to change.[40] For example, he teamed up with Jana Partners to take a position in Kerr-McGee and push for change.[41] The outcome was a restructuring in which Kerr-McGee sold off its chemicals unit and its North Sea oil fields.[42] Icahn has more recently put pressure on Blockbuster, where he gained a board seat;[43] Time Warner, where the company agreed to add some independent directors to its board and to increase the size of its share repurchase program;[44] KT&G, where the group he led gained board representation;[45] and Motorola, where he is seeking board representation.[46]

Other examples, many involving household names, abound. Targets of corporate governance activism include McDonald's, where Pershing Square has sought a spin-off of its real estate assets;[47] Wendy's, where Trian Partners has provoked an asset spin-off and gained board

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holder Value, PR NEWSWIRE, Dec. 13, 2004, *available at* Factiva, Doc. No. PRN0000020041213e0cd00d4a.

[39] *Steven Madden, Ltd. and the Barington Capital Group Reach Agreement—Company Will Allocate $25 Million to Share Repurchase and/or Dividends in 2005*, PR NEWSWIRE, Feb. 2, 2005, *available at* Factiva, Doc. No. PRN0000020050202e12200bvv.

[40] Susan Pulliam & Martin Peers, *Once a Lone Wolf, Carl Icahn Goes Hedge-Fund Route*, WALL ST. J., Aug. 12, 2005, at A1.

[41] *News in Brief: Americas: Moody's Warns Kerr-McGee*, THEDEAL.COM, Mar. 4, 2005, http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1107993117669 (noting pressure from Icahn and Jana Partners, who both sought seats on the Kerr-McGee board).

[42] Patricia Koza, *Kerr Pursues Revamp*, THEDEAL.COM, Aug. 8, 2005, http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1123524351195.

[43] Henny Sender, *Hedge Funds: The New Corporate Activist*, WALL ST. J., May 13, 2005, at C1.

[44] Matthew Karnitschnig, *Time Warner, Icahn Reach Accord*, WALL ST. J., Feb. 18-19, 2006, at A3.

[45] Santini, *supra* note 6.

[46] Li Yuan & Christopher Rhoads, *Icahn Bid Adds to Woes Dogging Motorola's CEO*, WALL ST. J., Jan. 31, 2007, at A1.

[47] Eisinger, *supra* note 2.

seats;[48] Heinz, where Trian has nominated five directors to the twelve-member board;[49] Pep Boys—Manny, Moe & Jack, where Barington has sought to induce the company "to sell itself or replace its CEO";[50] and Delphi Corp., where Appaloosa Management has sought board seats and the creation of (and representation on) an official equity committee to represent shareholder interests in the company's Chapter 11 proceeding.[51]

In the course of their general corporate governance activities, hedge funds often get involved in various legal disputes with the targets of their activism. While these disputes are usually an adjunct to broader activism—as when Jana Partners sued SourceCorp to invalidate changes in the company's bylaws in light of an impending proxy contest,[52] or when Mason Capital tried to block the recapitalization of Kaman, arguing that it violated the Connecticut antitakeover statute[53]—litigation is sometimes an essential part of the activist strategy. Take, for example, Cardinal Value Equity Partners, which

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[48] James Politi, *Wendy's Agrees Deal with Trian*, FIN. TIMES (London), Mar. 3, 2006, at 15.

[49] Janet Adamy, *Heinz Investors To Seek Board Seats*, WALL ST. J., Apr. 25, 2006, at A17.

[50] Suzanne McGee, *US Shareholder Friendly Rankings*, DAILYII, Apr. 14, 2006, http://www.dailyii.com/article.asp?ArticleID=1025799.

[51] McCracken, *supra* note 17; *see also* Karen Richardson, *New Way To Play Distressed Firms: Acquire the Stock*, WALL ST. J., May 1, 2006, at C1 (reporting that Xerion Capital helped form a shareholder committee, which succeeded in increasing the sale price of Riverstone Networks' assets in Chapter 11 from $170 to $210 million). For other instances of hedge fund governance activism, see Joseph T. Hallinan & Dennis K. Berman, *Knight Ridder Goes up for Sale, but a Bidding War Is Unlikely*, WALL ST. J., Nov. 15, 2005, at A3 (noting that under pressure from hedge fund Private Capital Management and the company's largest shareholder, Knight Ridder put itself up for sale); Alan Murray, *Backlash Against CEOs Could Go Too Far*, WALL ST. J., June 15, 2005, at A2 (observing that hedge funds ratcheted up pressure on the Morgan Stanley board to remove its CEO); Sender, *supra* note 43 (discussing hedge fund activism at OfficeMax, Woolworths, and Wendy's); *Steel Partners Asks Board of BKF Capital Group To Redeem Poison Pill, Use Excess Cash To Up Dividend and Buy Back Stock, Add Representatives of Institutional Stockholders to Board Steel Partners Says Board Needs To Improve Operating Profits and Reduce Expenses*, PR NEWSWIRE, Dec. 16, 2004, *available at* Factiva, Doc. No. PRN0000020041216e0cg00ahw (discussing efforts by Steel Partners to influence the board of BKF capital group); *Steel Partners Serves Notice to BKF Capital Group, Inc. That It Intends To Nominate Three Individuals for Election to BKF's Board at BKF's 2005 Annual Meeting of Stockholders*, PR NEWSWIRE, Feb. 14, 2005, *available at* Factiva, Doc. No. PRN0000020050214e12e00e79 (revealing Steel Partners' plans to nominate director candidates for BFK's board).

[52] *Jana Partners Sues SourceCorp*, DALLAS BUS. J. (online edition), July 6, 2005, http://dallas.bizjournals.com/dallas/stories/2005/07/04/daily20.html.

[53] Mason Capital, Ltd. v. Kaman Corp., No. 3:05CV1470, 2005 WL 2850083, at *1 (D. Conn. Oct. 31, 2005); *see also Judge Rules in Favor of Kaman's Proposed Recapitalization; Enjoins Closing Until December 1*, PR NEWSWIRE, Oct. 31, 2005, *available at* Factiva, Doc.

Take, for example, Cardinal Value Equity Partners, which owned about 1.5 million shares in Hollinger International. When allegations of self-dealing and other improper transactions by Conrad Black, Hollinger's CEO, and other members of Hollinger's management surfaced, Cardinal brought a lawsuit in Delaware to obtain records and corporate documents.[54] Six months later, in December 2003, Cardinal brought a derivative lawsuit for breach of fiduciary duty against Hollinger's board of directors.[55] Cardinal subsequently agreed to stay the action until an internal investigation of the alleged misconduct was finished.[56] By May 2005, Cardinal had negotiated a $50 million settlement with the directors not directly implicated in the self-dealing, with Hollinger continuing to pursue the self-dealing claims against Black and some of his associates in a separate litigation.[57] Cardinal, moreover, has continued to pressure Hollinger's board and recently criticized its failure to remove some of the settling directors from its ranks.[58]

Tellingly, hedge funds have even sought appointment as lead plaintiffs in securities fraud class actions under the Private Securities Litigation Reform Act.[59] What makes these efforts noteworthy is that, even though hedge funds are often among the investors with the largest losses, their appointment as lead plaintiffs is fraught with problems. Because hedge funds often engage in short selling, they face issues of reliance that may render them "inadequate" class representatives. A short strategy is based on the assumption that the

No. PRN0000020051031e1av004v9 (reporting the ruling in favor of Kaman); *Kaman and Mason Agree To End Litigation Concerning Recapitalization*, PR NEWSWIRE, Nov. 3, 2005, *available at* Factiva, Doc. No. PRN0000020051103e1b3004pv (announcing an agreement between the two firms to end the suit).

[54] Liz Vaughan-Adams, *Hollinger Investor Seeks Access to Internal Records*, INDEPENDENT (London), July 9, 2003, at 19.

[55] Jim Kirk, *Hollinger Board Never Said No, Suit Alleges*, CHI. TRIB., Jan. 3, 2004, at 1.

[56] Dominic Rushe & John O'Donnell, *Lord Black 'Looted $300m'*, SUNDAY TIMES (London), Jan. 4, 2004, § 3, at 1.

[57] Press Release, Hollinger Int'l, Hollinger International Inc. Announces Settlement by Certain of Its Current and Former Independent Directors of Claims Asserted in Derivative Action Filed by Cardinal Value Equity Partners, L.P. (May 3, 2005) (on file with authors).

[58] Richard Siklos, *Rebuked, Even Sued, a Board Remains in Place*, N.Y. TIMES, Sept. 26, 2005, at C1. For examples of other instances where Cardinal engaged in litigation, see *In re Pure Resources Shareholder Litigation*, C.A. No. 19876, 2002 Del. Ch. LEXIS 116 (Del. Ch. Oct. 9, 2002); Associated Press, *Cardinal Value Sues InfoUSA CEO*, HIGHBEAM RES., Feb. 24, 2006, http://www.highbeam.com/doc/1P1-118948139.html.

[59] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

current market price is inaccurate. This provides evidence that a short-selling hedge fund did not rely on the integrity of the market price, as required under the fraud on the market theory on which most securities fraud class actions are based. Indeed, as a result of this conflict, courts have often, though not uniformly,[60] rejected the appointment of hedge funds as lead plaintiffs.[61]

2. Corporate Control Activism

Hedge funds have been particularly active in transactions involving potential changes in corporate control. This activism broadly falls into three categories. First, as shareholders of the potential acquirer, hedge funds have tried to prevent the consummation of the transaction. Second, as shareholders of the potential target, hedge funds have tried to block the deal or improve the terms for target shareholders. Third, hedge funds have themselves—sometimes on their own, sometimes as part of a group—tried to acquire companies.

a. *Blocking Acquirers*

Perhaps the best-known example of a hedge fund blocking an acquirer involves the proposed acquisition by Deutsche Börse (DB) of the London Stock Exchange (LSE). Having tried and failed to ac-

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[60] *See, e.g.*, *In re* Tyson Foods, Inc. Sec. Litig., No. 01-425-SLR, 2003 U.S. Dist. LEXIS 17904, at *10-20 (D. Del. Oct. 6, 2003) (certifying the class in a securities fraud suit and rejecting challenges to a hedge fund as a representative—challenges based on the alleged unsuitability of hedge funds to serve in that role); Danis v. USN Commc'ns, Inc., 189 F.R.D. 391, 396 (N.D. Ill. 1999) (rejecting a challenge to a hedge fund's typicality based on short sales, because the fund also sustained losses on long positions).

[61] *See, e.g.*, Camden Asset Mgmt., L.P. v. Sunbeam Corp., No. 99-8275-CIV-MIDDLEBROOKS, 2001 U.S. Dist. LEXIS 11022, at *54-56 (S.D. Fla. July 3, 2001) (denying class certification in a class action brought by a fund that hedged its investment in convertible debentures, because individual issues of reliance were held to predominate); *In re* Critical Path, Inc. Sec. Litig., 156 F. Supp. 2d 1102, 1109-10 (N.D. Cal. 2001) (holding that a hedge fund, which had shorted stock, was an inadequate class representative in a fraud on the market class action because short strategy is premised on inaccuracy of current market price); *In re* Bank One S'holders Class Actions, 96 F. Supp. 2d 780, 784 (N.D. Ill. 2000) (rejecting a hedge fund as a lead plaintiff that had "engaged in extensive daytrading, first shorting Bank One stock (presumably because it was regarded as overvalued at market price) and then buying to cover the short position"). In an interesting development, Chancellor Leo Strine forced a hedge fund to serve as a defendant class representative in *Regal Entertainment Group v. Amaranth, LLC*, 894 A.2d 1104 (Del. Ch. 2006). The effect of this—and presumably why the hedge fund resisted—is that any settlement must be approved by the court and, moreover, that the class representative cannot settle separately.

quire LSE in 2000, DB announced a new bid in December 2004.[62] This quickly spurred Euronext, a competing exchange, to announce its interest in LSE.[63]

DB's problems started in mid-January, when The Children's Investment Fund Management (TCI),[64] a London-based hedge fund that had assembled more than a 5% stake in DB, announced its opposition. TCI argued that using DB's cash hoard to buy back shares "would be far superior in value creation."[65] Although the bid did not require shareholder approval, TCI held a large enough stake to call an extraordinary general meeting to dismiss DB's supervisory board.[66] Around the same time, Atticus Capital, a US-based fund which then controlled around 2% of DB's shares, joined TCI in opposing the bid.[67] By February, DB shareholders holding about 35% of its stock (including several mutual funds), prompted by TCI and Atticus, were planning to confront DB.[68] TCI started looking for a candidate to replace Rolf Breuer as DB's chairman, and came up with Lord Jacob Rothschild,[69] who, as it happens, was the father of the president of Atticus.[70]

In early March, DB's CEO, Seifert, came to London to meet with the largest dissident shareholders, only to have the offer of a meeting

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[62] Patrick Jenkins & Norma Cohen, *Deutsche Börse Courts LSE for European Exchange Union*, FIN. TIMES (London), Dec. 14, 2004, at 23.

[63] Norma Cohen, *LSE War Looms as Euronext Confirms Intent*, FIN. TIMES (London), Dec. 21, 2004, at 22.

[64] So named because 50% of TCI's annual management fee is paid to The Children's Investment Fund Foundation, which funds development projects focused on children in developing nations. Martin Waller, *Fund Says Opposition to Börse's LSE Bid Is Mounting*, TIMES (London), Jan. 18, 2005, at Bus. 43.

[65] Richard Wray, *Börse Rebel Threatens To Derail LSE Bid*, GUARDIAN (London), Jan. 17, 2005, at 21.

[66] To call a meeting, TCI would have to register its shares with BaFin and hold them for three months. Damian Reece, *Börse Could Bid Pounds 1.7 bn for LSE, Says Deutsche*, INDEPENDENT (London), Jan. 27, 2005, at 48.

[67] Norma Cohen, *Deutsche Börse 'Empire Building'*, FIN. TIMES (London), Jan. 17, 2005, at 19.

[68] Louise Armitstead, *Shareholders Revolt in Bid to Topple Seifert*, SUNDAY TIMES (London), Feb. 20, 2005, at Bus. 1; *see also* Julia Kollewe, *Fidelity Joins Börse Shareholder Revolt*, INDEPENDENT (London), Feb. 25, 2005, at 37 (indicating that Fidelity held more than a 4.5% stake).

[69] Louise Armitstead, *Rothschild To Lead Battle for Börse Rebels*, SUNDAY TIMES (London), Feb. 27, 2005, at Bus. 1.

[70] Grant Ringshaw, *Rothschilds Unite in Attack on Seifert*, SUNDAY TELEGRAPH (London), Feb. 27, 2005, at City 1.

refused.[71] With more than 40%, and as much as 60%, of the shares opposing the bid (depending on reports), DB abandoned its bid in early March and promised to develop a plan to distribute the cash.[72] As the participants celebrated the victory, the division of labor between hedge funds and traditional institutional investors became clear. As the representative of one institutional investor said, "The hedge funds have done a marvelous job. No matter how we feel about companies, traditional managers simply cannot move as fast to achieve our aims. We were right behind [the hedge funds], but we couldn't have done it without them."[73] In May 2005, Seifert resigned after DB's chairman was ordered by the supervisory board "to change the composition of the Supervisory and Executive Boards in order to reflect the new ownership structure of the Company."[74]

Other instances where hedge funds have sought to block an acquisition in their role as the shareholders of the potential acquirer include Carl Icahn's efforts to prevent Mylan Laboratories from acquiring King Pharmaceuticals;[75] Knight Vinke, which followed Templeton in opposing VNU's proposed acquisition of IMS Health;[76] Duquesne Capital Management, which opposed the proposed acquisition of Public Service Enterprise Group by Exelon;[77] OrbiMed Advisors, which succeeded in blocking the acquisition of EOS by Pharmacopia;[78] and

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[71] Norma Cohen & Patrick Jenkins, *Deutsche Börse Withdraws LSE Offer*, FIN. TIMES (London), Mar. 7, 2005, at 1.

[72] *Id.*; *see also Deutsche Boerse Bows to the Might of Investment Funds*, AGENCE FRANCE PRESSE, Mar. 7, 2005, *available at* Factiva, Doc. No. AFPR000020050307e1370096q (describing DB's actions as "effectively throwing in the towel in the face of fierce and long resistance to the deal on the part of private equity firms"); Danny Fortson, *Deutsche Bvrse* [sic] *Drops LSE Hunt*, THEDEAL.COM, Mar. 7, 2005, http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1107993123143 (noting DB's plan to "redistribute funds to investors").

[73] Louise Armitstead, *Saved by the Growing Power of Hedge Funds*, SUNDAY TIMES (London), Mar. 13, 2005, at Bus. 14 (alteration in original).

[74] Press Release, Deutsche Börse AG, Changes to the Boards of Deutsche Börse AG (May 9, 2005), *available at* http://deutsche-boerse.com/dbag/dispatch/en/listcontent/gdb_navigation/investor_relations/60_News/20_Ad_hoc_Announcements/Content_Files/10_adhoc/db_ad-hoc_090505.htm.

[75] *See infra* Part III.A.3.

[76] Dennis K. Berman & Jason Singer, *VNU's Largest Shareholders Deride Plan To Buy IMS Health*, WALL ST. J., Oct. 1-2, 2005, at B3.

[77] Bloomberg News, *Exelon Merger Criticized*, CHI. TRIB., May 13, 2006, § 2, at 1.

[78] *Pharmacopia and EOS Call Off Merger*, S.F. BUS. TIMES (online edition), Jan. 18, 2002, http://sanfrancisco.bizjournals.com/sanfrancisco/stories/2002/01/14/daily52.html.

Pirate Capital, Omega Advisors, and Jana Partners, which collectively opposed Mirant's offer to acquire NRG.[79]

b. *Blocking Targets*

As shareholders of target companies, hedge funds have actively opposed several proposed acquisitions and have often succeeded in improving the terms of the transaction. A recent example involved Novartis's attempt to acquire the 58% of Chiron that it did not already own. Novartis initially offered $40 per share to the Chiron shareholders. An independent committee of Chiron negotiated this price up to $45 per share, a 23% premium over Chiron's pre-offer share price.[80] One month after the agreement was announced, ValueAct Capital, a hedge fund and the third largest shareholder of Chiron, sent a "stinging" letter to Chiron's CEO announcing its opposition.[81] This started a shareholder revolt, with mutual fund Legg Mason, the second largest shareholder of Chiron, joining ValueAct's opposition, and Institutional Shareholder Services recommending a vote against the deal.[82] To get the transaction through, Novartis had to raise its offer to $48 a share,[83] increasing the premium from 23% to 32%.

The fate of the Chiron-Novartis deal is not unusual. Other examples of hedge funds opposing acquisitions include Masonite International, where Eminence Capital and Greystone Management Investment succeeded in raising the price from C$40.20 to C$42.25;[84] ShopKo, where Elliott Management derailed a proposed acquisition

[79] Emma Trincal, *Mirant Up on Activist Agitation*, THESTREET.COM, June 21, 2006, http://www.thestreeet.com/markets/hedgefunds/10293003.html.

[80] Press Release, Novartis Int'l AG, Novartis Announces Agreement To Acquire Remaining Stake in Chiron (Oct. 31, 2005), *available at* http://hugin.info/134323/R/1018774/160041.pdf.

[81] Hamilton, *supra* note 13.

[82] *Id.*

[83] David P. Hamilton, *Novartis Raises Chiron Bid, Virtually Sealing Deal*, WALL ST. J., Apr. 4, 2006, at A2.

[84] *See Eminence Capital Presents Letter to Masonite Board of Directors*, PR NEWSWIRE, Jan. 27, 2005, *available at* Factiva, Doc. No. PRN0000020050127e11r002jq (expressing discontent with the initial C$40.20 per share offer); Press Release, Masonite Int'l Corp., Masonite Shareholders Approve Proposed Acquisition by KKR, (Mar. 31, 2005), *available at* http://www.masonite.com/Globalpdf/pdfs/MasonitePressMarch31.pdf (announcing approval of the sale to KKR by 91.8% of nonsenior management shareholders after the higher price was offered).

for $24 a share;[85] MONY, where Highfields led the opposition to the company's acquisition by AXA;[86] Molson, where Highfields forced Coors to improve the sale terms;[87] VNU, where Knight Vinke Asset Management opposed the company's acquisition by a consortium of private equity firms;[88] Lexar Media, where Carl Icahn and Elliott Associates opposed a merger with Micron;[89] Sears Canada, where Pershing Square tried to hold out against a bid by Sears—itself a company run by hedge fund manager Eddie Lampert—to freeze out the minority shareholders;[90] Titan International, where Jana Partners thwarted the company's proposed acquisition by a private equity firm;[91] and MCI, which faced the threat of a proxy contest by Deephaven Capital to derail an acquisition by Verizon.[92]

When hedge funds are dissatisfied with the terms of an acquisition and unable to obtain better terms, they also resort to litigation. In particular, hedge funds have filed statutory appraisal actions, in which shareholders receive a court-determined fair value instead of the merger consideration. Take the acquisition of Emerging Communications (ECM) by its majority shareholder, Innovative Communications, for $10.25 per share.[93] Greenlight Capital, a hedge fund, held about 500,000 shares in the company. After the acquisition was announced, it increased its stake and sought appraisal for 750,300 shares.[94] As is commonplace in minority freeze-out mergers, a plain-

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[85] *ShopKo Agrees to $29 a Share Offer from Sun Capital*, BUS. J. MILWAUKEE (online edition), Oct. 19, 2005, http://www.bizjournals.com/milwaukee/stories/2005/10/17/daily17.html.

[86] *See infra* Part III.A.2.

[87] Innisfree Presentation, *supra* note 27, at slide 6.

[88] Singer, *supra* note 16.

[89] Chappell, *supra* note 15.

[90] Norris, *supra* note 14.

[91] Press Release, Titan Int'l, Inc., Titan International, Inc. Announces Termination of Proposed Buyout (Apr. 12, 2006), *available at* http://www.titan-intl.com/newsdirectory/041206.html.

[92] Dennis K. Berman & Almar Latour, *Major MCI Holder Starts Proxy Fight To Thwart Verizon*, WALL ST. J., June 15, 2005, at B3. For additional accounts of hedge funds interfering with acquisition bids, see, for example, Jason Singer, *With Rising Clout, Hedge Funds Start To Sway Mergers*, WALL ST. J., Jan. 25, 2005, at A1.

[93] *In re* Emerging Commc'ns, Inc. S'holders Litig., No. 16415, 2004 Del. Ch. LEXIS 70, at *2 (Del. Ch. May 3, 2004).

[94] Greenlight held shares in ECM before the merger was announced, but increased its stake by 264,700 shares between the announcement and the merger vote. In its Schedule 13D, filed ten days later, Greenlight disclosed its intention to seek appraisal rights. Greenlight Capital, L.L.C., General Statement of Beneficial Ownership (Schedule 13D) (Sept. 28, 1998), *available at* http://www.secinfo.com/dsN7p.74d.htm#1stPage.

tiff's law firm also filed a fiduciary duty action.[95] The latter form of action often is settled for a relatively modest recovery (if any).[96] But, in this case, when a settlement was proposed that provided for no additional payments to shareholders and $115,000 in legal fees,[97] Greenlight, which had also acquired litigation rights for over 2 million ECM shares, objected.[98] Both the appraisal and the fiduciary duty action proceeded to trial, and the court determined that the fair value of an ECM share was $38.05. Greenlight was awarded that amount plus compounded interest in its appraisal shares, as well as damages of $27.80 per share—the difference between the fair value and the merger consideration—in the fiduciary duty action.[99]

Other instances of hedge funds exercising appraisal rights include Gabelli Asset Management's 2004 appraisal action against Carter Wallace,[100] Prescott Group's appraisal against Coleman,[101] and the pending appraisal action brought by Icahn and others in Transkaryotic Therapies, where hedge funds had tried, but failed, to block the acquisition and decided to pursue appraisal instead of accepting the merger consideration.[102]

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[95] *In re Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *3.

[96] *See In re* Cox Commc'ns Inc. S'holders Litig., 879 A.2d 604, 622 (Del. Ch. 2005) (noting that the plaintiffs' lawyers in a shareholder litigation were "pragmatic" in "temper[ing] their fee requests" to seek a "relatively small percentage of the 'benefits'"); Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1833 (2004) (finding that settlements in squeeze-out cases provided for small recoveries).

[97] Stipulation and Agreement of Compromise and Settlement at 10, Erickell Partners v. Emerging Commc'ns, Inc., No. 16415-NC (Del. Ch. Jun. 27, 2000).

[98] *In re Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *3-4.

[99] *Id.* at *155. ECM has appealed the judgment to the Delaware Supreme Court, where the case is pending. Tim Fields, *ICC-LLC, Emcom File for Chapter 11*, VIRGIN ISLANDS DAILY NEWS (online edition), Aug. 2, 2006, http://www.virginislandsdailynews.com/index.pl/article_home?id=17594677.

[100] Press Release, GAMCO Investors, Inc., Gabelli Clients Realize a More Than 40% Premium in Settlement of Carter-Wallace Appraisal Litigation (Nov. 1, 2004), *available at* http://www.gabelli.com/news/GBL_110104.html.

[101] Prescott Group Small Cap, L.P. v. The Coleman Co., No. 17802, 2004 Del. Ch. LEXIS 131 (Del. Ch. Sept. 8, 2004).

[102] *See* Latham & Watkins, Hedge Fund Activist M&A Investing, Presentation to the 2006 Proxy Season Symposium, at Slide 11 (Nov. 1, 2005) (on file with authors) (noting that "more than one third of Transkaryotic shares, including Icahn and other hedge funds, have exercised their appraisal rights" after the acquisition by Shire Pharmaceuticals).

c. *Making Bids*

Unlike traditional institutional investors, hedge funds not only urge portfolio companies to be acquired by third parties, but also make attempts to acquire these companies themselves. These bids can be part of a strategy to improve the governance or capital structure of these companies or to put the target in play. In other instances, however, hedge funds have emerged as controlling shareholders of large industrial corporations.

As an example of an acquisition offer that induced corporate governance changes, consider GenCorp. GenCorp owned more than 12,000 acres of undeveloped land in Sacramento, an asset that attracted the interest of various investors.[103] In November 2004, Steel Partners, a hedge fund, announced that it was interested in acquiring GenCorp for $17 per share.[104] When the board rejected Steel Partners' advance, the fund threatened a proxy contest.[105] By February 2005, GenCorp and Steel Partners had agreed that Steel Partners would cast its votes in favor of GenCorp's nominees, a representative of Steel Partners could attend board meetings, the board would appoint a new independent director with expertise in corporate governance (identified in consultation with Steel Partners), and the board would then consider corporate governance changes proposed by Steel Partners.[106]

ShopKo, a retail and pharmacy store chain, provides another illustration of this approach. ShopKo had agreed to be acquired by Goldner Hawn, a private equity firm, for $24 per share. But Elliott Associates, a hedge fund with a major stake in ShopKo, opposed the proposed deal. Together with Sun Capital, a private equity firm, and some other investors, Elliott made a counter bid of $26.50. After an auction, the Elliott group succeeded in acquiring ShopKo for $29 a share.[107]

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[103] Gene G. Marcial, *GenCorp's Earthly Assets*, BUS. WK., Jan. 24, 2005, at 100.

[104] *Steel Partners Offers To Acquire the Outstanding Shares of GenCorp Inc. in Letter to Board*, PR NEWSWIRE, Nov. 11, 2004, *available at* Factiva, Doc. No. PRN0000020041111e0bb003ff.

[105] Ron Orol, *GenCorp Rejects $700M Offer*, THEDEAL.COM, Nov. 15, 2004, http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1099927556612.

[106] Dale Kasler, *GenCorp Reaches Truce with Firm That Made Hostile Bid*, SACRAMENTO BEE, Feb. 17, 2005, at D1.

[107] *ShopKo Agrees to $29 a Share Offer from Sun Capital*, *supra* note 85.

Finally, take Kmart. Kmart filed for bankruptcy in February 2002. When it emerged from Chapter 11 in May 2003,[108] its largest shareholder was the hedge fund ESL, run by Edward Lampert. ESL owned about 50% of the company, having acquired $2 billion in financial claims (for somewhere around $200 million) that were converted into stock in the reorganization.[109] At the time Kmart emerged from bankruptcy, its stock opened at $15 per share and drifted downward.[110] But by July 2004, Kmart's stock was at $76 per share and Lampert, who had taken over the management of Kmart, was the toast of the town.[111] By unlocking the value of Kmart's real estate through selling off stores, Kmart accumulated a "$2.2 billion cash hoard."[112] By November 2004, Lampert answered the market's question of what he was going to do with all that money: Kmart and Sears agreed to merge.[113] The news of the deal pushed Kmart stock up to $109 per share, and Sears shares rose as well.[114]

Additional examples of hedge funds making bids include Appaloosa Management, which made a bid for Beverly Enterprises;[115] High-

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[108] To emerge from Chapter 11 in fifteen months is very quick for a major bankruptcy, and can be explained by the incentives put in place for management. *See* Douglas G. Baird & Robert K. Rasmussen, Reply, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 698 (2003) (attributing Kmart's atypical emergence from Chapter 11 to Lampert's control over the appointments to the board of directors and his stake in the reorganized business).

[109] Christopher Byron, *Short-Sell Scramble; Investors Are Betting That Kmart Won't Bounce Back*, N.Y. POST, May 19, 2003, at 37; *Week in Review: Kmart out of Bankruptcy*, CRAIN'S DETROIT BUS., May 12, 2003, at 34.

[110] Yural Rosenberg, *The Man Behind the Deal*, CNN MONEY, Nov. 17, 2004, http://money.cnn.com/2004/11/17/news/newsmakers/lampert.

[111] Becky Yerak, *Exec Lifts Kmart's Stock into Blue Yonder*, CHI. TRIB., July 11, 2004, at C1.

[112] Robert Berner, *Turning Kmart into a Cash Cow*, BUS. WK., July 12, 2004, at 81, 81.

[113] Constance L. Hays, *Kmart Takeover of Sears Is Set; $11 Billion Deal*, N.Y. TIMES, Nov. 18, 2004, at A1.

[114] *Id.* Prior to its investment in Kmart, ESL had owned a large block of Sears stock—a block which had increased to 15% by the time the merger was announced. *See Merger at the Mall*, ECONOMIST.COM, Nov. 17, 2004, http://www.economist.com/agenda/displayStory.cfm?story_id=3397862.

[115] Peter Moreira, *Four Funds Bid for Beverly*, THEDEAL.COM, Jan. 27, 2005, http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1106611780237. In response to the bid, the board of Beverly decided to auction the company, which was ultimately acquired by another bidder. *See Beverly Enterprises Receives Higher Bid*, WALL ST. J., Aug. 22, 2005, at C5; Peter Loftus, *Beverly Enterprises Agrees to Bid by Fillmore Despite Better Offer*, WALL ST. J., Nov. 22, 2005, at C4; Peter Loftus, *Beverly Enterprises To Be Acquired by Investor Group for $1.63 Billion*, WALL ST. J., Aug. 18, 2005, at A5.

fields, which made a bid to acquire Circuit City;[116] ValueAct, which repeatedly attempted to acquire Acxiom;[117] and Jana Partners, which made a bid for Houston Exploration.[118]

B. *Activism by Traditional Institutions Compared*

Over the last twenty years, traditional institutional investors—specifically public pension funds and mutual funds—have also engaged in shareholder activism. The mode of this activism, however, differs in important respects from activism by hedge funds.

Activism by traditional institutions generally falls into two categories. Starting in the mid-1980s, and continuing to a limited extent until today, traditional institutions have made shareholder proposals under Rule 14a-8. These proposals are usually precatory resolutions that relate to various aspects of the corporate governance rules, such as poison pills, confidential voting, and board structure. Most of these proposals were introduced by public pension funds—including CalPERS, various New York pension funds, and the State of Wisconsin Investment Board—and by TIAA-CREF.[119] Since the mid-1990s, however, institutions have increasingly engaged in private negotiations to get boards to make governance changes voluntarily and have only resorted to formal proposals in some of the instances where boards failed to do so.[120]

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[116] Michael Barbaro, *Circuit City Rejects Hedge Fund's Cash Bid*, WASH. POST, Mar. 8, 2005, at E5; *see also* Gary McWilliams, *Circuit City Rejects Takeover Bid, Won't Consider Any Other Offers*, WALL ST. J., Mar. 8, 2005, at A8 (reporting the bid by Highfields for Circuit City and noting the increasing interest among hedge funds in pursuing takeovers).

[117] Richard H. Levey, *ValueAct Redoubles Acxiom Takeover Effort*, DIRECT (online edition), Oct. 4, 2005, http://directmag.com/news/valueact-acxiom-takeover-100505.

[118] Cauchi, *supra* note 10.

[119] For discussion of these proposals, see generally Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293 (1999); Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275 (2000); Jonathan M. Karpoff et al., *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 J. FIN. ECON. 365 (1996); Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227 (1996).

[120] *See* William T. Carleton et al., *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335, 1336 (1998) (emphasizing "the importance of private negotiations between institutions and corporations"); Gillan & Starks, *supra* note 119, at 279 ("[I]nstitutional investors began having more direct negotiation with company management and less reliance on proxy proposals."); Stuart L. Gillan & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, J. APPLIED FIN., Fall/Winter 2003, at 4, 10 (noting that institutional shareholders had shifted away

Seeking governance changes through (actual or threatened) shareholder proposals has largely been the domain of public pension funds.[121] Other than TIAA-CREF, mutual funds have not themselves been active in this strategy, whether initially or after failed private negotiations. Mutual funds have, however, voted in favor of proposals introduced by others. In addition, mutual funds have adopted policies to vote against certain changes in governance rules that entrench the current board if such changes are proposed by the board of directors, and these funds have sometimes withheld votes (i.e., abstained) in director elections.[122]

These activities differ from activism by hedge funds in a variety of ways. They are directed to changes in the corporate governance *rules*, rather than to specific aspects of a company's business or management (such as share buy-backs, spin-offs, mergers, or the composition of the board of directors). In addition, the effect of the policy changes sought is usually minor, either because the subject matter is not very important,[123] because the shareholder resolution is precatory (and a favorable vote is thus not binding), or because a board, even if it agrees to adopt the proposed policy, is free to change it later. To the extent that the "activism" takes the form of merely voting in favor of proposals by others (or against proposals made by the company's board), it represents a rather passive form of "activism." Finally, a group of portfolio companies tends to be targeted at the same time,[124] and often with respect to the same governance changes.

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from their previous tactic of shareholder proposals toward "negotiating directly with corporate management").

[121] More recently, union-affiliated pension funds have increasingly sponsored shareholder proposals. Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1019-20 (1998).

[122] *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 834 tbl.5 (1993) (categorizing institutional investors' proxy voting policies). Public pension funds—but not mutual funds—have also increasingly applied to become lead plaintiffs in securities fraud class action lawsuits. Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Era After the PSLRA*, 106 COLUM. L. REV. 1489, 1507 (2006). Securities fraud class actions, however, are at the periphery of corporate governance and control activities.

[123] *See, e.g.*, Roberta Romano, *Does Confidential Voting Matter?*, 32 J. LEGAL STUD. 465, 506 (2003) (concluding that confidential voting proposals are immaterial).

[124] *See, e.g.*, Press Release, CalPERS, CalPERS Focus List Targets Six Underperforming Companies (Apr. 19, 2006), *available at* http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2006/april/focus-list.xml (illustrating CalPERS's practice of compiling an annual "Focus List" to channel its activism).

Viewed charitably, this mode of activism is designed to achieve small changes in multiple companies at little expense, but it is unlikely to result in big changes in specific companies. The prominent role of proxy advisory firms like Institutional Shareholders Services (ISS) is consistent with this focus on small, low cost, systemic changes.

The second category of activities by traditional institutions consists of "behind-the-scenes" discussions with company management and board members.[125] From what has become known about these activities after the fact, it appears that they seek the same modest changes in governance rules as do shareholder proposals. For example, Carleton, Nelson, and Weisbach, who obtained access to the private correspondence between TIAA-CREF and portfolio firms, report that the changes sought involved confidential voting, board diversity, and limitations on targeted stock placements.[126] Known instances of institutions seeking more far-reaching changes are rare and often involve unusual fact patterns.[127]

As to activities that have remained nonpublic, we, of course, do not know their scale and scope. But we consider it unlikely that such activities resemble the activism of hedge funds. It is implausible that institutions could often succeed in achieving major changes through behind-the-scenes discussions without their efforts becoming public.[128] After all, if management is not receptive to the proposed changes, the

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[125] *See, e.g.*, Carleton et al., *supra* note 120 (analyzing the influence of TIAA-CREF over corporate governance through private negotiations); Gillan & Starks, *supra* note 120, at 11-12 (discussing "behind the scenes" activism and providing examples of its use by TIAA-CREF and CalPERS).

[126] Carleton et al., *supra* note 120, at 1346 tbl.2; *see also* Allen R. Myerson, *The New Activism at Fidelity*, N.Y. TIMES, Aug. 8, 1993, § 3, at 15 (discussing letters that Fidelity sent to one hundred companies opposing certain executive pay plans); Alan Murray, *At AIG, a First Glance at 'Good Governance'*, WALL ST. J., May 17, 2006, at A2 (noting that public pension funds induced governance changes at AIG, including separating the posts of chairman and CEO, increasing the number of independent board members, and "[r]equiring independent board members to meet in 'executive session'").

[127] For example, Fidelity had one of its employees appointed as CEO of Colt Telecom. Gillan & Starks, *supra* note 120, at 10. But Colt was unusual in that it was founded by Fidelity, was close to bankruptcy, and Fidelity held 54% of its stock. *See Colt Names Fidelity's Akin To Replace CEO Manning*, BOSTON BUS. J. (online edition), July 24, 2002, http://boston.bizjournals.com/boston/stories/2002/07/22/daily33.html.

[128] *Cf.* Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1030 (1994) (observing that institutions considering "more activist efforts to influence corporate policy . . . do not appear convinced that the game is worth the candle"); Leon Lazaroff, *Hedge Fund Activist Turns Up Heat*, CHI. TRIB., Nov. 27, 2005, § 5, at 7 (quoting an investor as saying, "rarely do you hear a mutual fund manager make a sound," as an indication of passivity among institutional investors).

institution must either give up or go public. And if management knows that institutions are reluctant to go public, it has little incentive to accede to the request for change. Moreover, the leverage that institutions can exercise behind the scenes is limited. If an institution wanted to coordinate its pressure with those of other institutions, it could become engaged in a solicitation or in the formation of a "group" within the meaning of the Securities Exchange Act, which often would require a public filing.[129] The scarcity of such filings and the absence of any reports to the contrary suggest that traditional institutions do not coordinate their behind-the-scenes pressure. We are skeptical whether uncoordinated pressure by a single institution will often result in meaningful change.

This being said, traditional institutions have recently, in the wake of hedge fund activism, become somewhat more active in matters involving corporate control. Thus, as discussed above, Franklin Mutual Advisers, an investment adviser for mutual funds and other accounts, has joined forces with a hedge fund and other investors in making a bid for Beverly Enterprises.[130] Additionally, mutual funds have supported the efforts of hedge funds to block the acquisition of the London Stock Exchange by Deutsche Bank, of Chiron by Novartis, of MONY by AXA, and of IMS Health by VNU.[131] And we suspect that there are additional examples where traditional institutions have expressed support for hedge funds in private communications with management. Hedge funds, it thus appears, have not just been activist themselves; they have also been a catalyst for activism by traditional institutions conducted jointly with, or in the wake of, hedge funds.[132]

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[129] *See* Securities Exchange Act of 1934 §§ 13(d)(3), 14(a), 15 U.S.C. §§ 78m(d)(3), 78n(a) (2000) (imposing disclosure obligations on "groups" of shareholders). By contrast, the tendency of hedge funds to conduct their activism in public reduces the need for public disclosure of any coordination. *See infra* Part III.B.1.

[130] *See supra* note 115 and accompanying text.

[131] *See supra* notes 62-88 and accompanying text. This kind of activism is relatively novel for mutual funds. *See* Ann Carrns, *Putnam Cites Price in Plan To Vote Against WaMu's Providian Deal*, WALL ST. J., Aug. 2, 2005, at C3 (quoting a bank analyst as describing the public opposition to acquisition by a mutual fund as "a little bit unusual").

[132] *See* Client Memorandum from Andrew R. Brownstein & Trevor S. Norwitz, Wachtell, Lipton, Rosen & Katz, Shareholder Activism in the M&A Context (May 15, 2006) [hereinafter Shareholder Activism in the M&A Context] (on file with authors) ("Even traditional long-term institutional investors are on occasion becoming more outspoken than they have been in the past. The fusion of aggressive hedge fund activism and the power of large institutional holders is a potent formula that can energize an activist campaign."). The willingness of traditional institutions to become involved in activism with hedge funds may be enhanced by the adoption of Regulation FD,

C. *Hedge Fund Activism in Perspective*

In assessing the many instances where hedge funds have adopted an activist posture in corporate governance and control transactions, one has to keep in mind that only a minority of hedge funds pursue shareholder activism. Some hedge funds do not own many equity securities because they pursue macroeconomic strategies or because they invest primarily in debt securities.[133] And even most hedge funds that focus on equity securities are not activist, because they pursue quantitative strategies, because they value their relationship with management, or for other reasons.[134] Indeed, according to a recent estimate by J.P. Morgan, only 5% of hedge fund assets, or about $50 billion, are available for shareholder activism.[135]

Our point in discussing hedge fund activism is thus not that shareholder activism is predominant among hedge funds. It is not. Our point is rather that hedge funds—to the virtual exclusion of traditional institutional investors—dominate certain modes of shareholder activism. The fact that only a minority of hedge funds engages in such activism makes this point, if anything, even more noteworthy.

But the fact that, at present, only a minority of hedge funds is engaged in shareholder activism is important for another reason as well. It indicates that there is a large untapped fund of money that could quickly become available for activism. If activist strategies are profitable—more so than the other investment strategies hedge funds pursue—it would not take much for the capital devoted to activism to

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which made it harder for management to retaliate against institutional investors by engaging in selective disclosure of information. *See* 17 C.F.R. § 243.100 (2006) (preventing selective disclosure by requiring the immediate public disclosure of any material nonpublic information intentionally disclosed by the issuer); *see also* Black, *Shareholder Passivity Reexamined*, *supra* note 25, at 602 (hypothesizing that mutual funds may be passive because of a fear of such retaliation).

[133] For a table detailing the assets under management by various hedge fund strategies, see The Barclay Group, Hedge Fund Industry—Assets Under Management, http://www.barclaygrp.com/indices/ghs/mum/HF_Money_Under_Management.html (last visited Mar. 26, 2007).

[134] *See, e.g.*, Richard Dobbs & Timothy Koller, *Inside a Hedge Fund: An Interview with the Managing Partner of Maverick Capital*, MCKINSEY ON FINANCE (McKinsey & Co.), Spring 2006, at 6, 9-10, (quoting Lee Ainslie, the managing partner of Maverick Capital, who explains that his fund puts a "premium on the value of our relationships with management teams").

[135] J.P. MORGAN, GLOBAL MERGERS AND ACQUISITIONS REVIEW 89 (2006) (on file with authors).

double or even quadruple overnight.[136] Thus, whatever the extent of hedge fund activism today, it may become much larger—or much smaller—tomorrow.

II. HEDGE FUNDS AS INSTITUTIONAL INVESTORS

The activities of hedge funds described in Part I give substance to the hope that hedge funds may act "like real owners" and provide a check on management discretion. But similar hopes were generated in the 1980s, when commentators noted that a significant shift in the shareholder profile of public corporations—from small individual shareholders to large institutional holders—had taken place.[137] The rise of institutional investors, starting in the early 1990s, generated a series of articles analyzing the potential implications of institutional shareholdings on corporate governance.[138]

In this Part, we analyze hedge funds against the backdrop of the analysis of traditional institutional investors. Our comparison focuses on open-ended mutual funds, both because mutual funds are the most important institutional investors, holding about 24% of all corporate equities,[139] and because they are economically closest to hedge funds. But we also discuss, more briefly, public pension funds, the third-largest category of traditional institutions, which hold 10.5% of corporate equities.[140]

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[136] Unlike mutual funds, which must abide by the investment policies described in their registration statement or obtain shareholder approval for a change, *see* Investment Company Act of 1940 § 8(b)(2), 15 U.S.C. § 80a-8(b)(2) (2000), hedge funds can quickly change their policies to respond to new profit opportunities.

[137] According to the Federal Reserve Board, the percentage ownership of corporate equities by households declined from 70% in 1975 to 56% in 1984, while ownership by pension funds, insurance companies, and mutual funds increased from 25% to 37%. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, 1975-1984, at 82 tbl.L.213 (2006), *available at* http://www.federalreserve.gov/RELEASES/z1/current/annuals/a1975-1984.pdf. This trend has continued, with the ownership by households declining to 28% in the Third Quarter of 2006 and ownership by insurance companies, pensions, and mutual funds increasing to nearly 55%. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, THIRD QUARTER 2006, at 90 tbl.L.213 (2006) [hereinafter FLOW OF FUNDS ACCOUNTS], *available at* http://www.federalreserve.gov/releases/z1/20061207/z1.pdf.

[138] *See, e.g.*, Black, *Agents Watching Agents*, *supra* note 25; Rock, *supra* note 25.

[139] According to the Federal Reserve, mutual funds in the Third Quarter of 2006 held $4597 of $19,306 billion (24%) of corporate equities. FLOW OF FUNDS ACCOUNTS, *supra* note 137, at 90 tbl.L.213.

[140] *Id.* Private pension funds, the second largest holder, owned another 12.8% of corporate equities. *Id.* We do not further discuss corporate pension funds for several

A. *Mutual Funds and Monitoring*

1. The Pluses: Size and Expertise

Compared to individual investors, mutual funds enjoy a major advantage as corporate monitors: they are large. The average size of an equity mutual fund was $218 million in 1990 and $964 million in 2004.[141] The largest mutual funds manage assets in the tens of billions of dollars.[142] In comparison, the average capitalization of stocks is $25 billion in the S&P 500 Index[143] and $2.8 billion in the S&P MidCap Index.[144]

Due to their size, mutual funds enjoy significant economies of scale that arise in two ways. For one, they will tend to own a greater number of shares of an individual company than individual investors do. To the extent that governance activities entail company-specific costs, these costs can be spread over a larger investment. Moreover, mutual funds will tend to own shares in a larger number of companies than individual investors do. To the extent that governance activities entail costs that are common for several companies, these costs can be spread over a larger number of investments.

2. The Minuses: Regulation, Incentive Problems, and Conflicts

Mutual funds also suffer from a number of disadvantages that impede their ability to act as effective monitors. These disadvantages fall into three categories: regulatory constraints, inadequate incentives, and conflicts of interest.[145]

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reasons: they hold fewer assets than mutual funds, the literature on institutional investors has expressed skepticism about whether corporate funds will be activist, and corporate funds, unlike public funds, have not been activist.

[141] *See* INV. CO. INST., 2005 INVESTMENT COMPANY FACT BOOK 61 tbl.3, 63 tbl.5 (45th ed. 2005).

[142] For example, Vanguard's S&P 500 Index fund has assets of $121.2 billion. Vanguard, Vanguard 500 Index Fund Investor Shares, http://flagship2.vanguard.com/VGApp/hnw/FundsHoldings?FundId=0040&FundIntExt=INT (last visited Mar. 26, 2007).

[143] Standard & Poors, S&P 500 (Dec. 31, 2006), http://www2.standardandpoors.com/spf/pdf/index/500factsheet.pdf.

[144] Standard & Poors, S&P MidCap 400 (Dec. 31, 2006), http://www2.standardandpoors.com/spf/pdf/index/400factsheet.pdf.

[145] *See generally* Black, *Agents Watching Agents*, *supra* note 25, at 873-76 (examining the factors influencing institutional investors' effectiveness as monitors); Rock, *supra*

a. *Regulatory Constraints*

Mutual funds are subject to a number of regulatory constraints that can affect their ability and incentives to monitor portfolio companies. For one, mutual funds are subject to special disclosure requirements not applicable to other types of investors. Specifically, mutual funds must file semiannual lists showing the amounts and values of the securities they own.[146] This makes it harder for mutual funds to accumulate positions in portfolio companies without such companies, and the market at large, becoming aware of their activities.

In addition, in order to qualify for significant tax benefits, mutual funds must comply with the diversification requirements in subchapter M of the Internal Revenue Code. Accordingly, 50% of the assets of a mutual fund are subject to the limitations that the fund may own no more than 10% of the outstanding securities of a portfolio company, and that the stock of any portfolio company may not constitute more than 5% of the value of the assets of the fund.[147] Moreover, in order to advertise themselves as "diversified"—the preferred mode for most funds[148]—funds must further satisfy the diversification requirements of the Investment Company Act. Under the Act, 75% of the assets of a mutual fund are subject to the above limitation that the fund may own no more than 10% of the outstanding securities of a portfolio company and that the stock of any portfolio company may not constitute more than 5% of the value of the assets of the fund.[149] These diversification requirements, in principle, limit the ability of funds to take large positions in a single company, though the constraints they pose may not be binding for larger mutual funds.

Open-end mutual funds, by definition and by statute, must also stand ready to redeem their shares at the request of any shareholder

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note 25 (analyzing the interaction between collective action and agency costs in influencing institutional shareholder activism).

[146] Investment Company Act of 1940, § 29(e), 15 U.S.C. §80a-29(e) (2000). In addition, under a recently passed regulation, mutual funds must disclose how they voted any shares of their portfolio companies. 17 C.F.R. § 270.30b1-4 (2006); *see also* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003) (describing the purpose of the regulation).

[147] Roe, *supra* note 25, at 20.

[148] Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1474 (1991).

[149] Roe, *supra* note 25, at 19-20 (summarizing the restrictions placed on mutual funds by 15 U.S.C. § 80a-5(b) (2000)).

at short notice.[150] The redemption price of these shares is based on the fund's net asset value. These requirements make it difficult for mutual funds to have illiquid investments, such as restricted securities, as illiquid investments cannot be readily transformed into cash when fund shareholders want to redeem their shares and cannot be easily valued. In light of this limitation, the staff of the SEC issued a guideline limiting the aggregate holdings of a mutual fund in illiquid investments to no more than 15% of the fund's net assets.[151]

Finally, regulations make it difficult for mutual funds to base the fee paid to the fund management company on the performance of the fund. Performance fees must be symmetrical, such that if fees are higher than normal after a good year, they must also be lower than normal after a bad year.[152] But even symmetrical pay-for-performance fees are rendered impracticable by the requirement that performance fees be based on a period of at least one year. Thus, if a fund has a stellar performance in one month, fund managers will likely earn an increased performance fee for the following eleven months. This, of course, creates incentives for investors to sell their shares at the end of the first month, when they have fully benefited from the stellar performance in that month but only paid one-twelfth of the associated performance fee, and discourages investors from buying shares in a fund after a strong month, as they have to pay eleven-twelfths of the performance fee without getting the benefit of the stellar performance.

b. *Incentives To Monitor*

Activism of the variety described in Part I is not cheap. Fund managers first have to identify a company that would benefit from activism and develop a strategy for the company that would raise its share price. Then fund mangers have to pressure the company's management to adopt that strategy. All of this consumes significant resources, both in-house and from hiring outside advisors.

For mutual funds, the incentives to expend resources on such activism are limited to begin with.[153] The lack of incentives is particu-

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[150] Investment Company Act of 1940 § 5(a)(1), 15 U.S.C. § 80a-5(a)(1) (2000).

[151] Eleanor Laise, *Mutual Funds Delve into Private Equity*, WALL ST. J., Aug. 2, 2006, at D1.

[152] Investment Advisers Act of 1940, § 205(b)-(c), 15 U.S.C. § 80b-5(b) to (c) (2000). Hedge fund advisors are typically exempt from registration and from § 205 under the so-called "private adviser" provision of 15 U.S.C. § 80b-3(b)(3) (2000).

[153] *See* Rock, *supra* note 25, at 472-76 (discussing the collective action problem inherent in mutual fund shareholder activism).

larly pronounced for managers of indexed funds. The job of index fund managers is to replicate the performance of the index. An index fund thus competes with other funds replicating the same index principally on the basis of fund expenses. As activism is costly and raises the fund's expenses (or lowers the managing company's profits), index fund managers will be reluctant to engage in activism.

There is often a similar shortage of incentives for diversified mutual funds. As previously discussed, regulatory barriers make it difficult for mutual funds to charge performance-based fees. As a result, 97% of all funds, accounting for 92% of all mutual fund assets, charge fees based on a flat percentage of the fund's assets under management.[154] Asset-based fees, however, provide only small direct incentives to engage in costly activism. The median stock fund in 2004 charged investors total expenses of 1.45% of assets, of which roughly half were management fees.[155] Thus, for example, when a manager of a $1 billion mutual fund earns additional profits of $100 million (a 10% return), total annual fees increase by $1.45 million and management fees increase by about $750,000. Of course, a portion of these increased fees covers increased expenses associated with running a larger fund, and fees do not increase at all to the extent that investors withdraw some of the profits. To get a sense of how much a fund management company benefits from the increased profits, assume that $1 million of the $1.45 million in total increased fees constitutes profits for the fund managers and that investors keep any profits in the fund for three years before withdrawing them. Applying a 5% discount rate, the $100 million in fund profits would then generate $2.85 million in additional profits for the fund management company—amounting to a very modest implicit performance fee of 2.85%. Even this rough estimate probably overstates the implicit performance fees because most larger funds utilize "breakpoints," where the marginal percentage fee declines as fund assets increase.[156]

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[154] *See* Jesse Eisinger, *Pay-for-Performance Bedevils Mutual Funds*, WALL ST. J., Apr. 13, 2005, at C1 ("Only 3% of mutual funds charge performance fees. Such funds . . . make up less than 8% of the . . . assets in mutual funds.").

[155] *See Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors: Hearing Before the Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Governmental Affairs*, 108th Cong. 189, 193 (2004) (prepared statement of Jeffrey C. Keil, Vice President, Lipper Inc.) [hereinafter Lipper Testimony] (providing data on management fees and total expenses in 1992 and 2002-2003); John Waggoner, *Many More Stock Funds Lower Management Fees After Scandal in 2003*, USA TODAY, Dec. 5, 2005, at 5B (observing a reduction in average fund fees from 1.50% to 1.45% in 2004).

[156] Lipper Testimony, *supra* note 155, at 190.

Even for the few funds that charge explicit performance fees, incentives are not much stronger. In order to avoid the problem of strategic timing of withdrawals and contributions described above, the mutual fund performance fees that do exist are relatively flat. Fidelity's Magellan Fund, for example, charges a performance adjustment of 0.02% of assets for each percentage point of outperformance or underperformance relative to the S&P 500 Index, up to a maximum of plus or minus 0.2%.[157] This is the equivalent of an annual performance fee of 2% of the fund's profits (as long as the profits are within the range where the performance adjustment is made).[158]

Mutual funds, of course, also can benefit from good performance indirectly. Studies have shown that funds that outperform their peers generally attract inflows of new assets. A recent study by Stephen Choi and one of the authors of this Article, for example, finds that a 1% abnormal positive performance by a fund (relative to other funds with the same investment objective) is associated with increased inflows of roughly 1% over the following year, while a 1% abnormal negative performance is associated with outflows of about 0.6% over a year.[159] Increased inflows, of course, generate management and other asset-based fees. The implicit performance fee generated indirectly by the effect of positive performance on inflows is, thus, roughly of the same magnitude as the implicit performance fee generated directly by asset-based fees.

In one important respect, however, the incentive effect of performance on net assets via inflows differs from the incentive effect of performance on net assets via profits. While the latter is a function of the fund's absolute performance, the former turns on a fund's performance *relative to other funds with similar investment objectives.*[160] Activ-

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[157] Fidelity Magellan Fund, Management Contract Between Fidelity Magellan Fund and Fidelity Management & Research Company (Exhibit 5(a) to Form N-1A), at ¶ 3(c) (May 22, 1998).

[158] FIDELITY INVESTMENTS, PROSPECTUS, FIDELITY MAGELLAN FUND 21 (May 30, 2006), *available at* http://personal.fidelity.com/products/funds/mfl_frame.shtml?316184100.

[159] *See* Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals* 3 (N.Y. Univ. Law & Econ. Working Papers, Paper No. 43, 2006), *available at* http://lsr.nellco.org/nyu/lewp/papers/43 (providing an overview of the literature analyzing the effect of past performance on fund flows); *see also* Richard A. Ippolito, *Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry*, 35 J.L. & ECON. 45, 55, 67 (1992) (explaining investor responses to fund performance).

[160] *See* Fisch, *supra* note 128, at 1020 ("Their [mutual funds'] performance is evaluated not in absolute terms, but based on whether they are able to generate a higher rate of return than the competition or than the market."); Jeffrey Ubben & David Haarmeyer, *With Activism Comes Accountability*, INSTITUTIONAL INVESTOR'S ALPHA,

ism, however, will increase a fund's relative returns only to the extent that the fund has a higher stake in the portfolio company (relative to the fund size) than competing funds do *and* the costs of activism to the fund are less than the profits from that differential. For any given portfolio company, this means that funds with a below-average stake in the company (relative to fund size) have no incentives—or indeed negative incentives—to take action to increase that company's value, and funds with an above-average stake have only attenuated incentives to expend resources on activism.[161]

Table 1: Top 10 Magellan Holdings Relative to S&P 500 Index[162]

Company	Magellan Investment (in %)	Vanguard 500 Index (in %)	Difference	Dilution of Magellan's Incentices
GE	4.1	3.4	0.7	83%
Microsoft	3.0	2.6	0.4	87%
Exxon Mobil	3.0	2.9	0.1	97%
Citigroup	2.7	2.2	0.5	81%
AIG	2.7	1.5	1.2	56%
Home Depot	2.2	0.8	1.4	36%
Bank of America	2.2	1.7	0.5	77%
Viacom	2.1	0.5	1.6	24%
Pfizer	2.0	1.8	0.2	90%
Tyco Int'l	1.9	0.6	1.3	32%
All 10 stocks	25.9%	18%	7.9	69% (weighted)

For example, Table 1 above lists the ten largest stock holdings—as of March 31, 2005—of the Fidelity Magellan Fund and the compara-

July/Aug. 2006, at 60, 60 ("[P]erformance of traditional money managers is measured on a relative, not an absolute, basis.").

[161] *See* Rock, *supra* note 25, at 472-73 (discussing the collective action problem that forms in this context). And even funds with an above-average stake relative to fund size have incentives to expend material resources only if the stake is significant in absolute terms.

[162] *See* Fidelity Magellan Fund, Certified Shareholder Report (Form N-CSR) (May 27, 2005); Vanguard Index Funds, Certified Shareholder Report (Form N-CSR) (Feb. 25, 2005).

ble holdings in these companies—as of December 31, 2004—of the Vanguard 500 Index Fund.

The last column of the table indicates the degree to which the Magellan Fund's incentives to monitor are diluted by the fact that any increase in the value of these shares would not also raise the S&P 500 index. As the table shows, the degree of dilution is significant even for the largest holdings of the fund. For smaller holdings, the degree of dilution is likely to be even higher.[163]

c. *Conflicts of Interest*

Mutual funds also suffer from conflicts of interest between fund managers and fund beneficiaries that inhibit their activities as monitors of portfolio companies.[164] Many mutual fund management companies are affiliated with—and are, in effect, subsidiaries of and controlled by—another financial institution, such as an investment bank or an insurance company. For example, of the twenty largest mutual fund complexes in 2003, nine had such affiliations.[165] Managers of such funds may be reluctant to antagonize present or future clients of their parent company with their governance activities. Indeed, the ef-

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[163] For example, for the ten companies in the Magellan Fund's "Consumer Staples" industry group, which account for 7.9% of the fund assets, the weighted average dilution is 78%. As further discussed below, the degree of dilution in incentives is endogenous as it is a function of a fund's investment portfolio, which itself will be a function of the fund's desire to engage in activism. *See infra* Part II.C.5. For purposes of this Section, however, we use a fund's portfolio as a starting point to determine the incentive to engage in activism given the portfolio choice.

[164] *See* Black, *Shareholder Passivity Reexamined*, *supra* note 25, at 595-608 (examining the conflicts of interest that affect institutional shareholders); Rock, *supra* note 25, at 469-72 (noting the divergent interests that give rise to this conflict); John C. Bogle, Op-Ed., *Individual Stockholder, R.I.P.*, WALL ST. J., Oct. 3, 2005, at A16 (noting the conflicts that can be created by large corporate clients at financial institutions that manage both pension plans and mutual funds). Conflicts are regarded as particularly pronounced in defined benefit plans, where fund assets are usually managed by designated corporate pension fund managers. The managers of a corporate pension fund are appointed by the executives of the corporation that sponsors the pension plan. These executives are believed to pressure pension fund managers to cast pro-management votes. Accordingly, corporate pension funds have not become active in corporate governance and are not regarded as likely to do so. Black, *Shareholder Passivity Reexamined*, *supra* note 25, at 596-98.

[165] The list of funds was derived from a study sent by Fidelity to the SEC. Letter from Eric D. Roiter, Senior Vice President and Gen. Counsel, Fidelity Mgmt. & Research Co., to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n (Mar. 18, 2004), *available at* http://www.sec.gov/rules/proposed/s70304/fidelity031804.htm (including a study by Geoffrey H. Bobroff and Thomas H. Mack assessing the potential impact of independent board chairs on mutual fund performance).

fect of such affiliations on governance activism may be both more subtle and more pervasive. Consider, for example, a mutual fund affiliated with an investment bank. The mutual fund managers will, ex ante, often not know which portfolio companies have hired, or are about to hire, the investment bank as an underwriter or financial advisor. And, ex post, the investment banker, for public relations and legal reasons,[166] would not want to interfere directly with the governance activism of the mutual fund when an investment banking client becomes the target of such activism. Thus, the easiest and safest way to avoid any problems is for affiliated mutual funds not to engage in governance activism *at all*.[167] This way, mutual fund managers do not have to distinguish between portfolio companies that are investment banking clients and those that are not, and investment bankers do not have to worry about mutual fund managers interfering with their business.

Of course, many mutual fund companies, including the two largest—Fidelity and Vanguard—are not affiliated with other financial institutions. But even unaffiliated mutual fund managers, especially the larger ones, face potential conflicts. For many mutual fund complexes, the management of corporate pension plans is an important source of revenues.[168] Governance activism could lead to a loss of such business, not just with respect to the activist fund, but for the complex as a whole.[169] John Bogle, the founder and former head of

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[166] The potential pitfalls facing a mutual fund are illustrated by the publicity that resulted when Deutsche Asset Management, an affiliate of Deutsche Bank, switched its votes from "against" to "for" the merger of Hewlett-Packard and Compaq, after it learned that Deutsche Bank provided investment banking advice to HP. *See* Press Release, U.S. Sec. & Exch. Comm, SEC Brings Settled Enforcement Action Against Deutsche Bank Investment Advisory Unit in Connection with Its Voting of Client Proxies for Merger Transaction; Imposes $750,000 Penalty (Aug. 19, 2003), *available at* http://www.sec.gov/
news/press/2003-100.htm.

[167] *Cf.* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, J. FIN. ECON. (forthcoming 2007) (manuscript at 18), *available at* http://www.london.edu/assets/documents/PDF/davis_kim_05.pdf (finding that voting by mutual funds appears to be independent of whether the fund has client ties with the portfolio company, but noting that funds with multiple clients are generally more likely to vote in favor of management).

[168] *See, e.g.*, Gretchen Morgenson, *Investors vs. Pfizer: Guess Who Has the Guns?*, N.Y. TIMES, Apr. 23, 2006, § 3, at 1 (noting Pfizer's influence as a client to several of its institutional shareholders).

[169] *See, e.g.*, Black, *Shareholder Passivity Reexamined*, *supra* note 25, at 602 (observing that Armstrong World Industries transferred its employee savings plan business from

Vanguard, even suggested that merely voting against management could "jeopardize the retention of clients of 401(k) and pension accounts."[170] And Don Phillips, a managing director of Morningstar, attributes the reluctance of funds to support shareholder proposals to rein in executive pay to their "desire to solicit business from corporations."[171] As in the case of affiliated funds, the effect of such conflicts on governance activism may be to deter strong activism on a broader scale. It is certainly easy to imagine a mutual fund complex concluding that having the reputation as a governance troublemaker is not conducive to being picked as manager for corporate pension plans and that the profits to be made from managing these pension plans would exceed those from governance activism.

To assess the significance of these conflicts of interest, one must compare them to the affirmative incentives a fund would have, absent any conflicts, to engage in activism. As discussed in the previous section, activism is costly, and fund management companies only profit modestly from any fund profits generated by activism. Thus, in our view, even modest conflicts of interest can easily dissuade a fund management company from pursuing an activist strategy and induce it to rely instead on less conflict-prone strategies—such as quantitative research or fundamental value analysis—to generate excess returns.

d. *Concluding Remarks*

The actual activities of mutual funds are consistent with our analysis. Mutual funds have shied away from the more costly and more confrontational modes of activism. They have not instigated proxy contexts or led the charge in pushing for changes in business strategy and management. Most mutual funds have not even made shareholder proposals, and, until recently, mutual funds have rarely been active in opposing or triggering corporate control transactions. If they engage in behind-the-scenes communications—and we doubt that they do so extensively—these communications are largely *just that*: efforts to coax management to change its ways, without much

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Vanguard to Fidelity after Fidelity stopped opposing a then-proposed Pennsylvania antitakeover law that Armstrong supported).

170 *See* William Baue, *Biting the Hand That Feeds: Mutual Fund Ties to Corporate Clients Can Affect Proxy Voting*, SOCIALFUNDS.COM, Mar. 10, 2005, http://www.socialfunds.com/news/article.cgi/article1659.html (quoting a letter from Bogle to the SEC, but also noting that a Fidelity spokesperson disclaimed any link between voting and clients).

171 Jennifer Levitz, *Do Mutual Funds Back CEO Pay?*, WALL ST. J., Mar. 28, 2006, at C1.

follow-up if management is not amenable. Despite this passive tendency, by capitalizing on their economies of scale, mutual funds have developed general policies that have led them to support some governance proposals brought by other shareholders, withhold votes from some board nominees, and oppose some governance proposals made by the board.

B. *Public Pension Funds and Monitoring*

Like mutual funds, public pension funds enjoy significant economies of scale. The average member of the Council of Institutional Investors, an organization of large public pension funds as well as union and corporate pension funds, has assets exceeding $23 billion.[172] The concerns about the ability of public pension funds to act as effective corporate monitors differ from those related to mutual funds. Public pension funds must make quarterly disclosures of their public equity securities holdings.[173] But, unlike mutual funds, public pension funds are not subject to specific diversification requirements[174] or regulatory constraints on performance fees, face predictable liquidity requirements, and have no business ties with portfolio companies that would be jeopardized by activism.

The problem for public pension funds, rather, is that they are political entities and, thus, subject to political constraints and conflicts of interest. The makeup of their boards of trustees is governed by state law and differs from fund to fund. Generally, these boards consist of some combination of gubernatorial appointees, elected politicians who serve *ex officio*, and officials elected by fund beneficiaries.[175] For example, the trustees of CalPERS, the nation's largest public fund, include six members elected by beneficiaries, three political appointees, and four members who serve ex officio.[176] The New York State Common Retirement Fund, the second largest public fund, has the State

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[172] *See* Council of Institutional Investors, About the Council, http://www.cii.org/about (last visited Mar. 26, 2007) (noting that it has "130 public, labor, and corporate pension funds with assets exceeding $3 trillion").

[173] For a discussion of disclosure requirements for institutional investors, see *infra* Part II.C.2.

[174] Public pension funds are subject to a prudent person standard for diversification. Romano, *supra* note 122, at 800. But given a fund's size, this would often not be an effective constraint on its ability to take large positions in portfolio companies.

[175] *Id.* at 823-25 & tbl.2.

[176] CalPERS, Structure & Responsibilities (May 12, 2005), http://www.calpers.ca.gov/index.jsp?bc=/about/organization/board/structure-responsibilities.xml.

Comptroller, a state-wide elected official, as its sole trustee.[177] As should be evident, public pension fund trustees lack significant financial incentives to maximize fund performance.

To be sure, public pension funds can hire professional managers compensated by performance-based fees.[178] The funds, however, are subject to political constraints in setting the size of these fees. As officials who are, as some commentators have noted, "accountable for their decisions to politicians or the press,"[179] state pension officials avoid calling negative publicity to their activities. The adverse publicity generated by the pay packages of the managers of Harvard University's endowment provides some indication of the nature of these constraints. Though Jack Meyer, Harvard's top investment manager, "produced stellar investment results," alumni complained that the pay of Meyer and of some of his top managers was inappropriately high.[180] Meyer and some of his employees ultimately left Harvard to start a hedge fund.[181] By private sector standards, however—and certainly by hedge fund standards[182]—Meyer's pay package ($7 million in 2004) and those of his top two managers ($35 million each in 2003 and $25 million each in 2004)[183] were laughably small, considering that Harvard's endowment of $22 billion would have been more than $12 billion smaller had Meyer earned median returns.[184] Consistent with the tendency illustrated by the Harvard endowment example, empirical evidence has shown that the compensation of public pension fund administrators is less frequently based on performance—and is less

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177 N.Y. State & Local Ret. Sys., About Us, http://www.osc.state.ny.us/retire/about_us (last visited Mar. 26, 2007).

178 CalPERS pays performance-based fees to some of its external managers. *See* CalPERS, *External Manager Fees Report*, *in* ANNUAL INVESTMENT REPORT, YEAR ENDED JUNE 30, 2005, http://www.calpers.ca.gov/invest/investmentreport-2005/investment_operations/external-manager-fees.asp.

179 Kevin J. Murphy & Karen Van Nuys, Governance, Behavior, and Performance of State and Corporate Pension Funds 14 (Sept. 1994) (unpublished manuscript), *available at* http:// http://www-rcf.usc.edu/~kjmurphy/Pensions.pdf.

180 Charles Stein, *Harvard's High-Paid Star Investor Leaving*, BOSTON GLOBE, Jan. 12, 2005, at A1.

181 Peter Grant & Rebecca Buckman, *Fatter Pay Lures University Endowment Chiefs*, WALL ST. J., June 27, 2006, at C1.

182 For a discussion of hedge fund manager compensation, see *infra* Part II.C.3.

183 Stein, *supra* note 180.

184 Charles Stein, *Harvard's $12 Billion Man*, BOSTON GLOBE, Oct. 17, 2004, at D1. *See generally* Grant & Buckman, *supra* note 181 (discussing Meyer's departure from Harvard and the problem of low endowment compensation compared to the private sector).

performance sensitive when it is—than that of private-plan administrators.[185]

Given the potential pitfalls of high pay packages, a politically safer course for pension fund boards that are willing to pay steep performance-based fees would be to entrust funds to an outside entity rather than to hire in-house managers. This, of course, is exactly what public pension funds do when they manage the indexed portion of their portfolio in-house and invest some of their other assets in private equity funds, venture capital funds, and hedge funds.[186]

Political constraints can also inhibit public pension funds from pursuing some of the more aggressive activist strategies employed by hedge funds. It is one thing for public pension funds to sponsor shareholder resolutions demanding greater board accountability, to act as lead plaintiffs in securities lawsuits, or even to demand governance changes in underperforming companies. It is quite another for them to tell a CEO how to run her business—by opposing major strategic acquisitions, demanding asset spin-offs, or recommending a different business strategy—and then threaten a proxy contest if management fails to cooperate. Public pension funds simply lack the legitimacy to push beyond relatively uncontroversial "motherhood and apple pie" issues. Unlike CEOs or hedge fund managers, these funds do not have to go out to the market to compete for investment capital; their managers have little financial stake in their success; they are not subject to market penalties for failure; they are run by politicians, bureaucrats, and union representatives; and as political entities, they are subject to political pressure not to overstep their bounds.

Compounding these political constraints are political conflicts of interest. Pension fund trustees who are gubernatorial appointees or elected politicians may be tempted to pursue political ends, rather than work to maximize investment returns. In her 1993 article on pension fund activism, Roberta Romano details several instances of pension fund trustees pursuing political goals rather than profits. In 1992, for example, the Illinois state treasurer and trustee of the state

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[185] *See* Tracie Woidtke, *Agents Watching Agents?: Evidence from Pension Fund Ownership and Firm Value*, 63 J. FIN. ECON. 99, 104 (2002) (providing a statistical comparison of compensation structure for private and public pension fund administration).

[186] *See, e.g.*, Press Release, CalPERS, CalPERS Taps Blackstone Alternative Asset Management as Advisor to $1 Billion Hedge Fund Program (May 15, 2001), *available at* http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2001/may/tapsblackstone.xml (noting that the CalPERS board agreed to establish a $1 billion hedge fund program in October 2000).

pension fund threatened not to make future investments in a leveraged buyout fund unless the fund's operator preserved jobs in an Illinois plant it was selling to its employees.[187] The same year, "Elizabeth Holzman, New York City comptroller and a trustee for the city's pension funds, publicized her active approach to corporate governance" in her campaign for the Democratic nomination for New York's senate seat.[188] As related by Romano, both the New York and the California state pension funds have come under political pressure to tone down (and indeed did tone down) their governance activities.[189] More recently, Alan Hevesi, the very active New York State Comptroller[190] and sole trustee of the $115 billion New York State Common Retirement Fund,[191] has been criticized both for pursuing political goals[192] and for having the fund hire law firms that made large contributions to his campaign.[193]

Trustees elected by fund beneficiaries are usually union representatives, who also have objectives that may conflict with their fiduciary duty to maximize investment returns.[194] For example, CalPERS, the largest and, traditionally, most active public pension fund, has come under increased criticism for the presence of union representatives on its board and the pro-union stance it has taken in various labor dis-

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[187] Romano, *supra* note 122, at 797 n.6, 807.

[188] *Id.* at 822.

[189] *Id.* at 815-20. For another example of such pressure, see Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1141 n.39 (1991) (discussing the political fallout when Wisconsin's pension fund submitted a proposal critical of management to General Motors as it was considering expanding a plant in Wisconsin).

[190] *See* Arden Dale, *New York Fund Sues Merck, Citing Vioxx, Stock Drop*, WALL ST. J., Dec. 1, 2004, at B8 (noting that Hevesi is considered an "activist comptroller" and detailing the investor suits he has filed).

[191] New York State Office of the State Comptroller, Pension Investment and Cash Management, http://www.osc.state.ny.us/pension/index.htm (last visited Mar. 26, 2007).

[192] *See* Editorial, *Pension Fund Blackmail*, WALL ST. J., Mar. 31, 2005, at A10 (arguing that Hevesi was using his clout as pension fund trustee to aid John Kerry).

[193] *See, e.g.*, Editorial, *Comptrolling Legal Authority*, WALL ST. J., Apr. 1, 2005, at A10; Karen Donovan, *Legal Reform Turns a Steward Into an Activist*, N.Y. TIMES, Apr. 16, 2005, at C1; Editorial, *Hevesi by the Letter*, N.Y. SUN, Apr. 12, 2005, at 10; *see also* Woidtke, *supra* note 185, at 127-28 (concluding that public pension fund activism is motivated more by political and social goals than by firm performance).

[194] *Pension Fund Blackmail*, *supra* note 192 ("[T]he AFL-CIO and its friends are now using pension funds to advance their political agenda."); *see also* Michael Schroeder, *Council of Institutional Investors Is Set To Focus on Morgan Stanley*, WALL ST. J., Apr. 13, 2005, at A15 (noting that labor representatives have sought trustee positions in order to "bolster union power to influence corporate management").

putes.[195] When public pension funds do not pursue political or labor goals, the relatively low pay and incentives of public pension fund executives raise the specter that their governance activities are designed more for self-promotion than to enhance returns.[196]

The political constraints and conflicts of public pension funds not only make the funds less likely to engage in certain kinds of activism, but these constraints can also make public funds less effective when they do become active. To the extent that others perceive public pension fund activism to be politically motivated or as serving the promotional interests of fund executives, they are less likely to support public funds when they do become active. Without such support, however, activism is less likely to affect changes in the portfolio companies. This, again, suggests that public funds will be most effective when their activism is perceived to be least affected by political or personal motives—such as uncontroversial "apple pie" issues—and, thus, will be inclined to limit their activism to those issues.

The actual activities of public pension funds correspond to these incentives and constraints. Consistent with their lack of business relations with target companies and the political interests of some trustees, public pension fund activism is somewhat more open and confrontational than activism by mutual funds: public funds make more shareholder proposals, publish lists of target companies, and apply to become lead plaintiffs in securities class actions. But the choice of targets—companies that have been underperforming or have been accused of major fraud—and the substance of the activism—such as calling for greater board accountability and opposing excessive CEO compensation—insulate the fund from political backlash. Additionally, because they lack the requisite incentives and credibility to do so, public funds have steered clear of demanding specific changes in

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[195] *See* Editorial, *Calpers and Cronyism*, WALL ST. J., Oct. 18, 2004, at A18 (discussing the political and union ties of CalPERS board members and accusing the board of basing investment decisions on political goals of labor and the Democratic party); Jim Carlton & Jonathan Weil, *Ouster Isn't Expected To Alter Calpers Policy*, WALL ST. J., Dec. 2, 2004, at C3 (noting that CalPERS has been criticized for "meddling in political and labor-union issues with little connection to improving shareholder returns"); Jonathan Weil & Joann S. Lublin, *Gadfly Activism at Calpers Leads to Possible Ouster of President*, WALL ST. J., Dec. 1, 2004, at A1 (explaining CalPERS's controversial actions in interceding on behalf of the striking employees of a portfolio company).

[196] *See* Romano, *supra* note 122, at 822 & n.102 (suggesting that veteran activist Dale Hanson, former head of CalPERS, may have been so motivated); Black, *Shareholder Passivity Reexamined*, *supra* note 25, at 599 ("[Public fund managers] may become active shareholders partly to generate good publicity for themselves.").

strategy or management, have not engaged in proxy contests, and, so far, have not even joined forces with hedge funds in opposing or triggering corporate control transactions.

C. *Hedge Funds and Monitoring*

1. Size

Since hedge funds are largely unregulated, significantly less data is available about them than about other institutional investors. However, the available evidence suggests that hedge funds enjoy significant economies of scale. According to one estimate, there are approximately 8000 hedge funds with aggregate assets under management of over $1 trillion.[197] These figures indicate that the average hedge fund has assets of about $100 million, while the largest hedge funds have assets of over $10 billion.[198] Although smaller than the comparable figures for mutual funds and pension funds, these figures probably understate the effective assets of hedge funds. Unlike mutual funds and pension funds, hedge funds regularly use leverage and invest in derivatives, enabling them to take positions that are much larger than those of mutual funds with similar net assets. According to an industry report, 15% of hedge funds use a leverage ratio in excess of 2—meaning that the total dollars invested are more than twice the total equity—and another 35-55% use leverage at a lower ratio.[199]

2. Regulatory Constraints

Hedge funds are not subject to any specific regulatory constraints. They must, however, comply with rules applicable to investors generally. These constraints include the disclosure requirements under section 13(d) of the Securities Exchange Act,[200] which requires disclosures by persons who own more than 5% of the equity securities of a public company, and the short-swing profit rules under section

[197] *Hedge Funds and the SEC: Still Free*, ECONOMIST, July 1, 2006, at 68.

[198] Institutional Investor Magazine's Alpha Names Farallon Capital Mgmt the World's Largest Hedge Fund Firm in Their Annual Hedge Fund 100, PR NEWSWIRE, May 27, 2005, *available at* Factiva, Doc. No. PRN0000020050527e15r002ml.

[199] *See* WILLIAM P. OSTERBERG & JAMES B. THOMSON, FED. RESERVE BANK OF CLEVELAND, THE TRUTH ABOUT HEDGE FUNDS 2 (1999), http://www.clevelandfed.org/Research/commentary/1999/0501.pdf.

[200] Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (2000).

16(b),[201] which are applicable to officers, directors, and 10% shareholders of a company.[202]

In addition, all institutional investment managers—including hedge fund managers—are subject to the disclosure requirement of section 13(f) of the Securities Exchange Act.[203] Under that provision, certain investment managers (including mutual fund, pension fund, and hedge fund managers) must make disclosures about their holdings on a quarterly basis. However, the disclosure requirements under section 13(f) differ from those applicable to mutual funds in two important respects. First, and most significantly, only holdings of registered equity securities—so-called "13(f) securities"—need to be disclosed. These 13(f) securities include traded shares and options listed on an exchange. Importantly, however, holdings of other options and derivatives need not be disclosed in one's 13(f) filings. As a result, hedge funds can use derivatives to accumulate large economic positions in portfolio companies without disclosure, unless they become subject to the disclosure requirements under section 13(d). In addition, no disclosures at all must be made if one's holdings of 13(f) securities are less than $100 million. Thus, small and even medium-sized hedge funds can avoid making any disclosures as long as a sufficiently large percentage of their holdings are in debt securities or in nonlisted equity derivatives.

Hedge funds also have a greater ability to invest in illiquid assets than do mutual funds. While mutual funds are required to redeem shares on short notice, and SEC guidelines limit the percentage of assets that mutual funds can hold in illiquid investments, hedge funds are not subject to any similar regulatory requirements. Contractually, hedge fund investors have more limited withdrawal rights than mutual fund investors. Traditionally, hedge fund investors could make withdrawals only after an initial lock-up period of six months. More recently, some hedge funds have extended the initial lock-up period to two years or longer.[204] Once the initial lock-up period has expired,

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[201] § 16(b).

[202] § 16(a).

[203] § 13(f).

[204] *See, e.g.*, Jenny Anderson, *Ex-Chairman of S.E.C. Set To Start Hedge Fund*, N.Y. TIMES, Sept. 13, 2005, at C1 (reporting that investors in a new hedge fund only can redeem initial funds after two years, and thereafter only annually); Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, WALL ST. J., Nov. 10, 2005, at C1 (noting that several hedge funds have adopted a two-year lock-up period, in part to avoid SEC registration requirements). The increased lock-up may contribute to hedge

further restrictions apply. In particular, hedge funds usually require advance notice for withdrawals and sometimes permit withdrawals only at specific points in time, while also imposing limits on the amounts an investor can withdraw at any point.[205] In addition, hedge funds may refuse a withdrawal request if the withdrawal would be harmful to other investors in the fund or may "pay" a requested withdrawal "in-kind," rather than in cash.[206] These provisions combine to make hedge funds much less sensitive than mutual funds to sudden liquidity shocks.[207]

3. Incentives To Monitor

As discussed above, traditional institutional investors suffer from impaired incentives to monitor portfolio companies. The incentives for hedge funds to monitor portfolio companies differ in several important respects from those of traditional institutions. First, hedge fund managers are highly incentivized to maximize the returns to fund investors. The standard hedge fund charges a base fee equal to 1-2% of the assets under management and a significant incentive fee, typically 20% of the profits earned.[208] This fee structure gives hedge fund managers a very significant stake in the financial success of the fund's investments. These stakes are even higher when, as is frequently the case, a hedge fund manager has invested a significant portion of her personal wealth in the hedge fund.[209]

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fund activism. Rachel McTague, *Two-Year Lock-Up for Hedge Funds Seen as Promoting Activist Strategies*, BNA SEC. L. DAILY, Mar. 29, 2006, *available at* LEXIS.

[205] *See, e.g.*, Henny Sender, *Citadel Pulls Up Its Withdrawal Bridge, As Hedge Funds Aim To Block the Exits*, WALL ST. J., Jan. 13, 2006, at C1 (noting that Citadel charged a penalty on an investor that wanted to withdraw more than 3% of its money).

[206] Telephone Interview with Nathan Fischel, Managing Member, DAFNA Capital Management LLC, in L.A., Cal. (Jan. 2, 2006).

[207] Hedge funds also have a greater ability to take on debt than mutual funds. Under the Investment Company Act, mutual funds are required to have a three-to-one asset-to-debt ratio. Investment Company Act of 1940 § 18(f), 15 U.S.C. § 80a-18(f) (2000). As most mutual funds have no debt to speak of, this regulatory constraint is unlikely to be binding. Hedge funds are not similarly limited and, by all accounts, often are far more leveraged.

[208] *See* Interview with Anonymous Hedge Fund Manager (Jan. 30, 2006). This fee is usually structured to incorporate a high-water mark, but not a claw back. That is, if a fund produces losses, these losses have to be made up before any incentive fee is payable (this is the high-water mark requirement), but if a fund makes profits and earns an incentive fee, the fee does not have to be returned if the fund suffers subsequent losses (hence, no claw back).

[209] E-mail from David Haarmeyer to Marcel Kahan, George T. Lowy Professor of Law, N.Y. Univ. Sch. of Law (Apr. 4, 2006) (on file with authors).

Secondly, many hedge funds strive to achieve high absolute returns, rather than returns relative to a benchmark.[210] In particular, the industry standard 20% incentive fee is usually based on a fund's absolute performance. And while a few funds use a hurdle rate before the incentive fee is payable, this hurdle rate is generally a rate based on the yield of debt securities, not based on the performance of a market index or an index of hedge funds with similar investment objectives.

Thus, unlike mutual funds, hedge funds benefit directly and substantially from achieving high absolute returns. For successful managers, the resulting profits can be extraordinarily high. The average take-home pay for the top twenty-five hedge fund managers in 2003 was $207 million, and the lowest paid manager in that group still earned a respectable $65 million.[211] These figures increased in 2004, when the average manager earned $251 million and the lowest paid manager received $100 million.[212]

Of course, hedge fund managers, like mutual fund managers, also care about retaining existing investors and attracting new ones through their performance. But even to the extent that hedge fund performance is, for this purpose, assessed relative to a benchmark or to other hedge funds with comparable strategies, their incentives are diluted to a lesser extent than those of mutual funds. This is because hedge fund portfolios resemble the relevant index much less than those of mutual funds. Reliable data on hedge fund holdings are not available since hedge funds need only disclose their holdings in equity securities and listed options, and not any other derivatives. We are thus unable to calculate the percentage of dilution in hedge fund incentives in the manner we calculated Magellan's dilution in incentives.[213] But the hedge fund managers we talked to confirmed that hedge fund investments are definitely much more eclectic and less correlated with a market index, or with investments of another hedge fund with a similar investment style, than those of mutual funds.[214] As

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[210] Fin. Servs. Auth., *Hedge Funds: A Discussion of Risk and Regulatory Engagement* 10 (Fin. Servs. Auth. Discussion Paper 05/4, 2005), *available at* http://www.fsa.gov.uk/pubs/discussion/dp05_04.pdf.

[211] Stephen Taub, *The Bucks Stop Here*, INSTITUTIONAL INVESTOR, Aug. 2004, at 47, 47.

[212] Stephen Taub, *Alpha's Top 25*, INSTITUTIONAL INVESTOR'S ALPHA, May-June 2005, at 15, 15.

[213] *See supra* Table 1.

[214] Interview with Anonymous Hedge Fund Manager, *supra* note 208.

one manager put it: eclecticism "is what we are selling."[215] As a result, hedge funds need not worry much about competitor funds free riding on their governance activism and getting higher returns with lower costs.

Even if the activism of one hedge fund boosts the returns of activist hedge funds generally, the result may not be all that bad. Investors use returns of funds with a certain investment style to determine the amount of money they invest in this sector of funds. If activism by one hedge fund boosts the returns of activist hedge funds generally, more money will flow into this sector, thereby benefiting all activist funds.[216]

4. Conflicts of Interest

Hedge funds suffer from fewer conflicts of interest between fund managers and fund investors than traditional institutional investors. First, most hedge funds are independent investment vehicles and are not affiliated with any other institution. Of the twenty largest hedge funds in 2004, only one was affiliated with another financial institution, such as a bank or insurance company.[217] By contrast, as reported above, of the twenty largest mutual fund complexes in 2003, nine were so affiliated.[218] Furthermore, anecdotal evidence suggests that even hedge funds that are affiliated with other financial institutions do not shy away from taking actions that are antagonistic to investment banking clients of their affiliates. Recently, for example, the Highbridge Fund, majority-owned by J.P. Morgan, accumulated an over 25% stake in convertible bonds of Saks Inc. and then sent a "notice of default" when Saks breached a covenant by failing to file financial statements with the SEC—even though Saks has an investment banking relationship with J.P. Morgan.[219] Indeed, some concern recently has been ex-

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[215] *Id.* Hedge funds specializing in merger arbitrage may be an exception in this regard, since their investments are highly correlated with those of other hedge funds specializing in merger arbitrage.

[216] Moreover, investors in hedge funds tend to be highly sophisticated. As a result, they may tend to use more complex evaluation criteria and channel their investment to the funds that took the lead in activism, and not those that were free riders.

[217] Interview with Anonymous Hedge Fund Manager, *supra* note 208.

[218] *Supra* note 165 and accompanying text.

[219] Mike Esterl & Henny Sender, *Highbridge Fund Sent Default Note to Retailer Saks*, WALL ST. J., June 20, 2005 at C5 (suggesting that Highbridge had bet on Saks stock declining by taking a short position).

pressed that investment banks sacrifice the interests of other clients in order to cultivate and retain lucrative hedge fund business.[220]

In addition, unlike mutual funds, hedge funds do not manage companies' defined-contribution plans. Accordingly, they do not have to be concerned that activism will result in a loss of fund management business. In sum, hedge funds are, to a much greater extent than mutual funds, free from the most significant potential sources of conflicts of interest.[221]

To be sure, hedge funds may still face some conflicts of interest to the extent that they want to attract contributions by defined-benefit corporate pension funds that are run by management-appointed trustees. Mutual funds, of course, would also face similar conflicts. But we believe that, at least for hedge funds, these conflicts tend to be minor. First, hedge funds may not be all that interested in capital from private pension funds. If private pension funds, together with public pension funds, account for more than 25% of the capital of a hedge fund, the hedge fund becomes subject to regulations under ERISA[222]—a fate unattractive to a sector that is otherwise largely unregulated. More importantly, however, we do not think that corporate pension funds have been, or will become, a substantial source of direct funds for hedge funds. Historically, corporate pension funds have not been significant contributors to hedge funds. Rather, hedge funds have obtained most of their capital from wealthy individuals and

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[220] *See, e.g.*, *Hedge Funds and Capital Markets: Hearing Before the Subcomm. on Securities and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (May 16, 2006) (statement of Susan Ferris Wyderko, Director, Office of Investor Education and Assistance, SEC) *available at* 2006 WLNR 8468099 (discussing potential dangers of such "side-by-side" management); *see also* Michael Forman, *FSA Bloodhounds Pursue Hedge Funds*, SEC. INDUSTRY NEWS, May 16, 2005, at 11 (announcing an FSA review of the relationships between hedge funds and large investment banks in the U.K.).

[221] *Cf.* Mara Der Hovanesian & Nanette Byrnes, *Attack of the Hungry Hedge Funds*, BUSINESSWEEK ONLINE, Feb. 20, 2006, http://www.businessweek.com/print/magazine/content/06_08/b3972103.htm (noting that hedge funds, unlike mutual funds, are not trying to sell money management services to companies).

[222] 29 C.F.R. § 2510.3-101(f) (2006); *see also* Client Publication, Shearman & Sterling LLP, *Hedge Fund Compliance with ERISA 25% Limit* (Sept. 2004), *available at* http://www.shearman.com/files/Publication/0527637a-386d-4edd-b83b-b4babc648872/Presentation/PublicationAttachment/a8795ffd-7839-4515-8787-d058684f9ae2/eceb_092004.pdf (providing a brief overview of the applicability of the 25% limit to hedge funds). Under the recently passed Pension Protection Act of 2006, investments in hedge funds by foreign and governmental plans no longer count towards the 25% limit. § 611(f), Pub. L. No. 109-280, 120 Stat. 780.

institutions such as foundations or university endowments.[223] More recently, corporate (as well as public) pension funds have started to make investments in hedge funds.[224] While we lack precise data, we do not believe that corporate pension funds are a major source of capital for hedge funds at this time. And, given the declining importance of corporate defined-benefit plans,[225] we are skeptical that they ever will become one. Finally, even to the extent that corporate pension funds invest in hedge funds, they tend to do so through funds-of-funds rather than directly.[226] Hedge fund managers do not know the identity of the investor in a fund-of-funds, and investors in a fund-of-funds do not always know to which hedge funds their money flows. The presence of funds-of-funds thus serves to further insulate hedge funds from pressure by corporate pension funds.

Whatever residual conflicts of interest may remain must be compared to the affirmative incentives to enhance investor returns. As explained, hedge fund management firms and individual managers derive substantially greater benefits from increased fund returns than do mutual fund management firms and managers. As a result, any conflict of interest is more likely to be resolved in favor of hedge fund investors. On the whole, therefore, we do not believe that conflicts of interests are likely to interfere with activism by hedge funds, and, even if such interference does occur, it occurs much less than in the case of public pension funds and mutual funds.

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[223] *See, e.g.*, Jason Singer, *Ivy Leave: Yale Parts Ways with Hedge Fund*, WALL ST. J., Mar. 29, 2006, at C1 (indicating that 25.7% of Yale's endowment is invested in hedge funds).

[224] The Hennessee Group recently estimated that public and private pension funds combined account for 9% of the sources of capital to hedge funds. Hennessee Group LLC, Hedge Fund Industry Growth (Jan. 2005), http://www.magnum.com/hedgefunds/articles/2005/050101.pdf.

[225] In 1995, private pension funds held corporate equities of nearly $1.3 trillion, amounting to 15% of the total market value of corporate equities. By 2005, private pension funds held corporate equities of approximately $2.4 trillion, amounting to 9% of the total market value of corporate equities. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, 1995-2005, at 67 tbl.L118, 82 tbl.L213 (2006), *available at* http://www.federalreserve.gov/RELEASES/z1/Current/annuals/a1995-2005.pdf.

[226] Jane B. Kenney et al., *The Hedge Fund 100*, INSTITUTIONAL INVESTOR'S ALPHA, June 2003, at 40, 40 ("Much of the new pension money enters the market through funds of hedge funds.")

5. Activism and Stakes

In the end, the incentives for a fund to engage in activism depend on its stake in a portfolio company.[227] In this regard, it is noteworthy that activist hedge funds usually accumulate stakes in portfolio companies *in order to engage in activism*. There are numerous examples of hedge funds taking stakes whose values depend on firm actions, and then taking action to determine the outcome—everything from trying to influence strategy and running proxy contests, to instigating litigation and threatening to vote against mergers.

In this regard, hedge funds differ markedly from mutual funds and public pension funds. Mutual fund and public pension fund activism, if it occurs, tends to be incidental and ex post: when fund management notes that portfolio companies are underperforming, or that their governance regime is deficient, they will sometimes become active.[228] In contrast, hedge fund activism is strategic and ex ante: hedge fund managers first determine whether a company would benefit from activism, then take a position and become active. Hedge fund activism represents a blurring of the line between risk arbitrage and battles over corporate strategy and control.

This suggests that the differences in activism between hedge funds and other institutions may be, at least in part, endogenous. Because (activist) hedge funds pursue activism as a profit-making strategy, they take economic positions in portfolio companies that enable them to engage in, and make profits from, activism. In contrast, traditional institutions do not pursue activism as a profit-making strategy; thus they do not take positions for this purpose and, accordingly, engage in less activism.[229] Put differently, the difference in activism is, in part, due to the fact that hedge funds and traditional institutions pursue different profit strategies.

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[227] In addition, hedge funds may structure their portfolios so that they profit from activism in various ways. As discussed below, for example, it is likely that Highfields stood to profit from a defeat of the MONY-AXA merger both through its holdings of MONY shares and through its holdings of ORANs. *See infra* Part III.A.2. On the plus side, this can allow hedge funds to increase their returns from successful activism, thereby overcoming rational apathy or free riding.

[228] *See, e.g.*, Smith, *supra* note 119, at 231-32 (describing the criteria for target selection used by CalPERS).

[229] *See* Ubben & Haarmeyer, *supra* note 160, at 60 (noting that traditional money managers own small positions in many companies and have poor performance incentives, whereas activist investors invest in a small number of companies and have powerful incentives).

Viewed from this perspective, the relevant question becomes why (some) hedge funds pursue activism as a strategy, while (most) traditional institutions do not. The answer to this question may lie, in part, in the fact that traditional institutions face regulatory barriers, political constraints, and conflicts of interest that make activism less profitable for them than it is for hedge funds.

But the difference in strategies may also be due to the fact that mutual funds view and market themselves as vehicles for diversification, which enables their investors to gain broad exposure to markets at low costs. To be a successful activist, it is probably helpful for a fund to engage in activism as a principal strategy—activism presumably entails learning, with funds that have done more of it becoming better at it, and funds with an activist reputation more easily attracting support from other investors and inducing management changes. An activist strategy, however, does not mesh well with a diversification objective, because strategic activism is relatively expensive and requires a fund to take comparatively large positions in relatively few companies. Hedge funds, in contrast, do not see themselves as vehicles for diversification; they engage in targeted hedges, rather than diversification, to eliminate unwanted risk.[230] More narrowly tailored strategies—such as activism—are thus more appropriate for hedge funds than for mutual funds.[231]

III. PROBLEMS GENERATED BY HEDGE FUND ACTIVISM: CONFLICTS AND STRESS FRACTURES

Although hedge funds hold great promise as active shareholders, their intense involvement in corporate governance and control also

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[230] Perhaps more importantly, hedge funds have less of a need to diversify because investors in hedge funds, unlike many investors in mutual funds, are already substantially diversified through their other holdings. Put differently, hedge fund investors have a greater tolerance for risk generated by their hedge fund investment than mutual fund investors have with respect to their mutual fund investment.

[231] Even nonactivist hedge funds tend to pursue narrowly tailored investment strategies such as merger arbitrage and convertible bond arbitrage. Of course, some "multistrategy" hedge funds pursue broader (or a combination of narrower) strategies, and some mutual funds—such as sector funds—offer lesser diversification benefits. Indeed, some mutual funds, such as Mutual Beacon Fund, are even relatively activist. FRANKLIN TEMPLETON INVESTMENTS, A GUIDE TO INVESTMENT STYLE 9 (2006), http://www.profinvest.ca/clients/Feature_Articles/Investment_Styles_-_Franklin_Templeton.pdf (describing the investment strategies used by the Mutual Series of funds, including "activist" investments in distressed securities). On the whole, however, the mutual fund sector is dominated by funds with broadly diversified portfolios, while the hedge fund sector is characterized by funds with narrowly tailored strategies.

raises some concerns. Hedge funds are set up to make money for their investors without regard to whether the strategies they follow benefit shareholders generally. For example, a hedge fund that owns shares in Company A may try to use that position to increase the value of another position, say in Company B, rather than to maximize the share price of Company A. Indeed, because hedge funds frequently engage in hedges and other sophisticated trading and arbitrage strategies, such conflicts of interest are likely to arise more frequently for hedge funds than for other institutional investors. We examine these "hedging-related conflicts" in Section A.

In addition to these direct conflicts, we also address a secondary problem related to hedge fund activism. Hedge funds combine high-powered incentives with great sophistication and access to vast pools of capital. Together, these can put great stress on the existing governance system. We examine some of these potential "stress fractures" in Section B.

We conclude this Part by commenting in Section C on the absence, so far, of a third set of problems: managers buying off activist hedge funds through the payment of greenmail or similar devices. We leave the most common, and potentially most serious, criticism leveled against hedge funds—that they, due to their short-term trading horizons, aggravate an already serious problem of "short-termism" in the executive suite—to be analyzed in Part IV.

In assessing the need for a regulatory response to these problems, there are several considerations. First, to what extent does the existing regulatory structure adequately address the concerns? Here, we consider whether the problems are of a familiar type, and whether the increased pressure on the system imposed by hedge funds overwhelms existing tools. When a problem is a standard corporate law problem, we presume that the existing regulatory structure is adequate, unless some specific aspect of hedge fund involvement changes the analysis. If, on the other hand, the problem is of a new type, new tools may be required.

If one concludes that the current structure is inadequate, one then needs to consider which of the various tools available is most appropriate. In this regard, there are three general categories of potential responses. One can rely on market forces (e.g., competition among hedge funds or reputation), employ self-help (e.g., charter amendments or contracts), or resort to regulation.

While the specific response depends on the precise nature of the problem, it is critical to bear in mind that hedge fund activism is not static. Hedge funds are among the most nimble market actors, with a track record of coming up with new strategies, some of which are designed to exploit imperfections in the very responses developed to the old strategies. Moreover, hedge funds are not only clever, but quick. Therefore, in choosing a mode of response, speed and flexibility are very important. This suggests that market forces and self-help are better designed to deal with these problems than regulation. The reason is twofold. First, private actors generally can react more quickly than regulators. Second, private actors have a greater ability to learn from each other to devise a proper response.

As we will see, many of the problems discussed in this Part are familiar and classic corporate law problems. Despite the increased pressure applied by hedge funds, our general view is that the traditional solutions (perhaps with increased enforcement), supplemented by market responses and, possibly, some additional disclosure requirements, should suffice. We are not indifferent to the possibility of illegal or improper behavior; rather, our view is that the current regulatory structure can handle it, with minor exceptions.

A. *The Dark Side: Hedging-Related Conflicts*

1. Buying (Control) vs. Selling (Shares)

As the earlier anecdotes show, hedge funds are sometimes potential buyers, as opposed to sellers. When a hedge fund is a potential buyer of a company in which it has a stake, its interests clearly diverge from those of its fellow shareholders. The hedge fund wants to buy at the lowest possible price, while the other shareholders want to sell at the highest possible price. A hedge fund's activities may not be so much directed at making sure that the target is sold at the highest price, but rather at increasing the likelihood that the hedge fund succeeds in its acquisition attempt.

This is a very old problem in corporate law that is analyzed under the rubric of the duty of loyalty. While hedge funds' interests diverge from general shareholder interests when they are seeking to buy control, this conflict is obvious, with management and other shareholders aware of it and on guard against it. Moreover, hedge funds will generally have no control over the target company they are trying to buy. We therefore believe that no special response is necessary.

2. Conflicts in Merger Votes

A more subtle conflict can arise in control transactions when a hedge fund owns other securities, the value of which depends on whether the transaction is consummated. Such conflicts featured prominently in the proposed acquisition of MONY (a publicly traded life insurance company) by AXA (a large French financial conglomerate), where hedge funds both favoring and opposing the deal had conflicts of interest.[232] Highfields—a hedge fund holding nearly 5% of MONY—led the opposition by MONY shareholders, running a full-page ad in the *Wall Street Journal* "urging MONY shareholders to reject the sale,"[233] convincing Institutional Shareholder Services, a proxy advisory firm, to recommend a "no" vote on the deal,[234] and establishing a website to aid MONY shareholders in exercising their appraisal rights.[235]

But Highfields's interests were not pure. In order to finance its cash acquisition of MONY, AXA had issued convertible debt securities—known as "ORANs"—to its shareholders. These debt securities were to convert into AXA shares on completion of the acquisition, but could be redeemed at face value plus interest if the acquisition was not completed by December 21, 2004. Given the relative values involved, the ORANs would be significantly more valuable if the AXA-MONY deal went through. Highfields held a large short position in ORANs, a position that would become more valuable if the merger

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[232] *See In re* MONY Group, Inc. S'holder Litig., 853 A.2d 661, 668 (Del. Ch. 2004) ("[P]ersons who hold long positions in ORANs stand to gain a large profit on that investment if the MONY/AXA merger is consummated. Conversely, arbitrageurs who sell ORANs short stand to gain if that same merger is not completed.").

[233] Sara Hansard, *MONY Delays Vote as Dissidents' Effort Gains Steam*, INVESTMENTNEWS, Feb. 23, 2004, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20040223/SUB/402230718/-1/INIssueAlert04. Highfields even mailed a letter to shareholders urging them to vote "no" on the merger. Highfields had originally intended to enclose a duplicate of the corporate proxy card so that shareholders, should they choose, could easily cast a "no" vote, but MONY succeeded in obtaining an injunction preventing this additional step, despite Highfields' argument that it was an exempt solicitation under Rule 14a-2(b)(1). MONY Group, Inc. v. Highfields Capital Mgmt., L.P., 368 F.3d 138, 141-45 (2nd Cir. 2004).

[234] Hansard, *supra* note 233 ("ISS said the sale price 'is outside the boundary of reasonableness when compared to precedent transactions coupled with open-market opportunities to sell above the offer price.'").

[235] *Highfields Capital Establishes Web Site for MONY Shareholders Exercising Appraisal Rights*, PR NEWSWIRE, Mar. 31, 2004, *available at* Factiva, Doc. No. PRN0000020040331e03v00bkp (describing the creation of Highfields's website: www.demandfairvalue.com).

did not close.[236] Other hedge funds favoring the merger, in turn, were long on ORANs and apparently purchased MONY stock at a premium in order to vote for the merger.[237] Eventually, after a postponement of the shareholder meeting (which allowed shareholders who bought stock after the previous record date to vote) and much litigation, the MONY merger squeaked through, with 53.8% of the outstanding shares voting in favor.[238]

In a world in which more than half of all equities are held by institutional shareholders, such conflicts are pervasive. But, while pervasive, they are not necessarily bad. Index funds, for example, will own shares on both sides of many mergers between public companies. In such cases, their financial interest is to maximize the value of their portfolios. Thus they should approve a merger if it is value enhancing, without regard to the magnitude of the premiums paid to shareholders, even if shareholders of individual firms, qua shareholders, might prefer higher premiums. In contrast to index funds, which simply find themselves on both sides, hedge funds potentially exacerbate the pervasive conflicts because they choose to invest in both sides of a deal and acquire stakes *in order to* influence the outcome.

Corporate law has long lived with, and tolerated, conflicts of interest in voting by shareholders. Hedge funds may be more likely to have such conflicts than traditional institutional investors, and may even choose to create such conflicts, but the conflicts in the context of hedge funds pale compared to the conflicts of controlling shareholders in freeze-outs, whose votes will usually be outcome-determinative. And controlling shareholders are entitled to vote their shares in their (conflicted) self-interest, unencumbered by any fiduciary duties to minority shareholders.[239]

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[236] *In re MONY Group*, 853 A.2d at 668.

[237] Innisfree Presentation, *supra* note 27, at slide 11; *see also In re MONY Group*, 853 A.2d at 669 (describing the trading activity surrounding the merger). In a presentation to the MONY board, CSFB, the Board's independent financial advisor, "noted that as of the Board meeting, anyone long ORANs would receive an approximate 46% profit if the merger was consummated, compared to a 2.4% profit if it was not." *Id.* at 671 n.29.

[238] Floyd Norris, *Holders of MONY Approve $1.5 Billion Sale to AXA*, N.Y. TIMES, May 19, 2004, at C4. The article also notes that "[e]ssential to approval may have been a block of 8.7 percent of the shares owned by Deutsche Bank," which was not disclosed until shortly before the vote. *Id.*

[239] *See* Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987) ("Clearly, a stockholder is under no duty to sell its holdings in a corporation, even if it is a majority shareholder, merely because the sale would profit the minority.").

Therefore, we see little need to impose stricter duties on hedge funds, or on voting conflicts more generally,[240] for several reasons: absent empty voting, the effect of conflicted votes is self-limiting;[241] conflicted funds are often on both sides of the contested issue and their votes thus cancel each other out;[242] the market is often aware of, and can respond to, these conflicts; all diversified shareholders—including all institutional investors—will often find themselves with similar conflicts; and the board of directors, which does have fiduciary duties, can take measures to counteract any dangers.

3. Empty Voting

A particularly extreme form of a hedging-related conflict arose in the proposed Mylan-King merger. In July 2004, Mylan Laboratories entered into a merger agreement with King Pharmaceuticals, whereby, subject to shareholder approval, Mylan would acquire King in exchange for Mylan shares. Perry, a hedge fund, was a large shareholder in King, with approximately seven million shares, and supported the merger. While the deal was seen as favorable to King, the market reaction to the merger for Mylan was negative, and some large shareholders of Mylan, including Carl Icahn, threatened to vote against it. As a result, approval of the merger by Mylan shareholders was in doubt.[243]

Perry then acquired 9.9% of Mylan's shares. At the same time, Perry apparently entered into "equity swaps" with Bear Stearns and Goldman Sachs that fully hedged its economic exposure to Mylan's share price. As a result, Perry acquired shares—and votes—in Mylan, which, because it had no economic stake in Mylan, it could vote purely on the basis of its interest as a King shareholder—thus in favor of the merger.[244] Indeed, this presumably was Perry's purpose.

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[240] We suspect that a more common occurrence is that hedge funds have economic interests that are disproportionate to their voting interest due to options or other derivatives that have a value that correlates with the stock price, but carry no voting rights.

[241] As long as the economic interest of a hedge fund corresponds at least to its voting rights, the hedge fund will suffer proportionally with other shareholders from any value decline.

[242] *See infra* Part III.A.3 (discussing conflicts in the Mylan-King merger vote).

[243] Robert Steyer, *New Player Joins Mylan-King Fray*, THESTREET.COM, Nov. 29, 2004, http://www.thestreet.com/stocks/robertsteyer/10196467.html.

[244] Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 828-29 (2006). The issues relating to

The divergence between the interests of Perry and those of other Mylan shareholders is evident. If the merger was good for King but bad for Mylan, as many Mylan shareholders apparently felt, Perry would still vote its sizeable position in Mylan in favor of the merger and could help push it through. As it happened, King had to restate its earnings, which caused Mylan management to terminate the merger agreement. The success and legal validity of Perry's strategy thus were not tested.[245]

"Empty voting," as this is called, is an example of an old problem—conflicts of interests created by exploiting the separation of legal and beneficial ownership—aggravated by modern financial innovation. Perry took advantage of modern financial instruments to acquire votes. While Perry's actions functionally appear to be a form of "vote buying," legally they do not seem to fall within the existing jurisprudential framework. Indeed, as Hu and Black explain, the existing regulatory structure does not prohibit it.[246] If empty voting turns out to be a significant problem—and it is not clear that it will—new measures will be required, either through regulation or by common law decision making.

That said, how exactly the law should be changed, if it should at all, is a highly complex question. The complexity has several sources: multiple mechanisms can generate empty votes; current legal rules do not treat these mechanisms equivalently; other problems related to compilation of broker votes interact with the concerns raised by empty voting; and, at present, neither the market, nor companies, nor regu-

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empty voting are extensively discussed in Hu & Black, *supra*, at 828-35; Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 779-80.

[245] Other, more traditional conflicts of interest in voting were also present. Icahn had a stake of about 10% in Mylan, both in terms of economic exposure and in terms of voting rights. But Icahn also had shorted 5.3 million shares of King stock. *See Icahn Wins as Mylan, King Deal Dies; Stewart Leaves "Big House" for House Arrest*, FORBES.COM, Mar. 4, 2005, http://www.forbes.com/2005/03/04/cx_gl_0304faceweek_print.html (explaining Icahn's position in the failed merger). Icahn could thus have an economic incentive to oppose the merger, even if the merger were in the interest of Mylan, as long as the market thought that the merger would be significantly more beneficial to King. In that event, Icahn would gain more from a defeat of the merger through his short position in King than he would lose on account of his long position in Mylan. Suppose Icahn shorted the King shares at $30 per share, that the shares would go up to $40 per share if the merger were completed, but down to $20 per share if the merger failed. Icahn would then profit from defeating the merger if his profits from shorting were greater than the increase in the value of his Mylan stake from completing the merger.

[246] Hu & Black, *supra* note 244, at 861-63.

lators have the information necessary to determine the presence and extent of empty voting schemes.

The development of a proper response is further complicated by the fact that companies and investors have an interest in determining the outcome of a vote speedily. Thus, any more intrusive legal regime that involves protracted litigation generates special problems in the context of voting rules. Moreover, it is unclear to what extent market responses (such as the increasing costliness of hedging strategies around critical votes) temper empty voting. For now, we agree with Henry Hu and Bernie Black that not enough is known about the extent of empty voting to prescribe anything more than an increase in disclosure of schemes generating empty votes.[247]

B. *Stress Fractures*

With billions of dollars available, and super-high-powered incentive compensation structures, hedge funds put stress on the existing governance structures. In doing so, they highlight and exacerbate existing structural weaknesses, albeit not necessarily in a manner that generates a conflict of interest with other shareholders. In this Section, we address two such potential weaknesses: undisclosed concerted action and overvoting.

1. Undisclosed Concerted Action

In many of the battles between managers and hedge funds described earlier, the shareholder base of companies can change almost overnight, with hedge funds sometimes ending up with more than 50% of the shares. Managers and their counsel have speculated that hedge funds act in concert, both in the acquisition of their shares and in the subsequent pressuring of management, without filing the required disclosure statements[248] under section 13(d) of the Securities Exchange Act.[249] Indeed, say some, there is a pervasive problem of SEC underenforcement of section 13(d).

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[247] *See id.*, *supra* note 244, at 864-86 (advocating disclosure as a means to curb empty voting because the information disclosed would expose a need for empty voting reform).

[248] *See* Be Prepared for Attacks by Hedge Funds, *supra* note 20 (noting the tendency of activist hedge funds "to execute purchases so as to avoid detection").

[249] 15 U.S.C. § 78m(d) (2000).

We do not know whether this is true or not. If there is, in fact, a problem of underreporting, it presents an interesting parallel to the events of the 1980s. When hostile tender offers first assumed prominence, management complained that hostile bidders and their allies operated behind the scenes to the disadvantage of shareholders and companies. Now one hears complaints that it is hedge funds (some run by the same raiders about whom managers complained in the 1980s) that are operating behind the scenes.

An important difference exists, however, between nondisclosure by raiders in the 1980s and any nondisclosure by activist hedge funds today. The acquisition of a 5% stake by a raider was highly material, market-moving information. By delaying a 13(d) filing, raiders and their allies could acquire additional shares at a substantially lower price. By contrast, hedge fund activism has much less of an immediate market impact. Moreover, hedge fund corporate governance activities are usually conducted publicly, with hedge funds issuing press releases long before they reach the 5% filing threshold under section 13(d).[250] Finally, hedge funds (unlike most raiders) must disclose their equity holdings quarterly under Section 13(f).[251] Thus, while hedge funds, like all other investors, ought to comply with 13(d), one wonders what all the fuss about a failure to disclose is about.

To be sure, a 13(d) filing can yield information that would otherwise not become public. Specifically, a 13(d) filing could reveal the presence of a conflict of interest, such as an empty voting scheme. Section 13(d) requires the disclosure of any contracts and other arrangements in which hedge funds dispose of their economic interests.[252] Indeed, it was this 13(d) requirement that forced Perry to reveal its hedging positions in the Mylan-King battle. Where such conflicts exist, they would have to be disclosed in a 13(d) filing. A failure to make the filing constitutes a serious problem, but it does not appear that such conflicts are common.

In addition, most poison pills incorporate the 13(d) concept of a group into the pill trigger. Thus, it may sometimes be the case that an undisclosed formation of a "group" would trigger the pill—to the serious harm of the participating hedge funds and, one assumes, to the

[250] *See, e.g.*, Yuan & Rhoads, *supra* note 46 (detailing, in a front page article, Carl Icahn's purchase of a 1.39% stake in Motorola).

[251] Securities Exchange Act of 1934 § 13(f), 15 U.S.C. § 78m(f) (2000).

[252] § 13(d)(1)(E), 15 U.S.C. § 78m(d)(1)(E) (2000). But section 13(d) does not have a per se requirement to disclose conflicts of interest.

delight of management and their lawyers.[253] In that case, however, management is in a good position to respond: it can argue that the hedge funds have formed a group, declare the pill triggered, dilute down the members of the alleged group, and wait to be sued. Given the incentives for management to pursue such cases, this does not seem to be an area to which the SEC need devote its limited enforcement resources.

Thus, the key issue is not the SEC's failure to bring enforcement actions, but the vagueness of the concept of "group" underlying section 13(d) and the poison pill. Rule 13d-5 provides that "[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership."[254] Thus, concerted conduct—but not parallel action—will trigger section 13(d)'s reporting obligations. The fact that a variety of hedge funds crowd into the shares of a company at the same time does not per se establish the formation of a group, any more than the mere fact that competing manufacturers raise their prices at the same time establishes a price-fixing agreement in violation of section 1 of the Sherman Act.[255] Proving that parallel conduct is concerted action is difficult, both in the antitrust and in the 13(d) context.

In this regard, hedge fund activism may raise a somewhat novel problem. Until recently, the issue of unaffiliated parties acting in parallel to influence a public company—and the accompanying evidentiary ambiguity concerning whether a group has been formed—has not arisen that often. Rather than bring more enforcement actions, the SEC may want to provide regulatory clarification on the question of group formation.

2. Overvoting

The current voting technology is seriously flawed. Some argue that it is so flawed that in any reasonably close corporate vote—the

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[253] *See* Phyllis Plitch, *Lawyers See No Poison Pill To Feed Hedge Fund "Wolf Packs"*, CORP. GOVERNANCE (Dow Jones), Dec. 21, 2005, at 4 (discussing the limited ability of boards to deploy a pill against hedge funds).

[254] SEC Rule 13d-5(b)(1), 17 C.F.R. § 240.13d-5(b)(1) (2006).

[255] Theatre Enters., Inc. v. Paramount Film Distrib. Corp., 346 U.S. 537, 541 (1954) ("[T]his Court has never held that proof of parallel business behavior . . . itself constitutes a Sherman Act offense.").

number of which are increasing with more hedge fund involvement—it would be impossible to prove which side has prevailed.

Since 1973, to avoid the overwhelming record-keeping problems of paper shares, companies have used a book entry system with share certificates held by the Depository Trust Company (DTC). Individual brokerage houses each have accounts with DTC in which, under the standard arrangements between customers and their brokerage firms, holdings of customers are commingled in a single, fungible mass. DTC's records simply indicate that Merrill Lynch, for example, has 20,000 shares of Firm X, without indicating how many shares specific customers of Merrill hold. As Merrill Lynch's customers buy and sell, Merrill's net holdings will change and DTC's records will reflect this, but it is Merrill's responsibility to keep track of its customers' holdings.

When it comes time for the shareholders of Firm X to vote, the company will typically retain a firm, usually ADP, to handle the distribution of proxy materials, the solicitation of proxies, and the tabulation of the votes.[256] ADP receives a list of holdings, sorted by brokerage house, from DTC and a list of customers' accounts from the participant broker. It then sends out proxy materials, including proxy cards indicating the number of shares in a customer's account, to all who appear on brokers' lists. Customers fill out their cards, return them to ADP, and the results are then passed on to the firm.

This system breaks down when there is significant short selling, as is often the case when hedge funds are involved. Consider what happens when someone "shorts" a stock.[257] In a short sale, a brokerage house typically arranges for a short seller to acquire shares from a broker (sometimes itself) or bank that holds shares (in a fungible mass) for its custodial clients, subject to an obligation to return a share at some later date. The short seller then sells the shares to some third party, who will take full title and be entirely oblivious to the source of the shares.

Because a short sale involves an actual transfer of shares, it creates substantial difficulties in determining who has a right to vote shares,

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[256] ADP Investor Communications Services claims a 95% market share. ADP Investor Commc'n Servs., ADP Investor Communication Services Story, http://ics.adp.com/release11/public_site/about/ics_story.html (last visited Mar. 26, 2007).

[257] For an excellent account of the consequences of short selling, see Robert C. Apfel et al., *Short Sales, Damages, and Class Certification in 10b-5 Actions* 7-25 (Univ. Rochester, Bradley Policy Research Ctr., Fin. Research & Policy Working Paper No. FR 01-19, 2001), *available at* http://papers.ssrn.com/abstract=285768.

principally because tracing is not possible, and record keeping and communication are incomplete.[258] Suppose that Merrill has 20,000 shares of X in its DTC account, while Goldman has 30,000 shares in its account. A hedge fund (HF) "borrows" 5,000 shares from Merrill and, to go short, sells them to a customer of Goldman. Once that sale is completed, DTC records will show that Merrill has 15,000 shares of X while Goldman has 35,000 shares.

The problem is now clear: DTC's omnibus proxy will transfer the right to vote 15,000 shares to Merrill, and will inform ADP of this. But Merrill will give ADP a list of all its customers' holdings in Firm X for a total of 20,000 shares. ADP will then send out proxy materials according to the brokers' customer lists, with the result that it will send out proxy cards for more shares than are, in fact, entitled to vote. In this example, although Merrill and Goldman collectively hold only 50,000 shares, their customers will receive proxy cards representing 55,000 shares. Because the shorted shares are often not attributed to specific customer accounts, it is unclear which customers are entitled to vote. If fewer than 15,000 Merrill shares are voted, this problem is shoved under the table by pretending that the Merrill customers who returned proxies were all entitled to vote and some of those who did not return proxies were not entitled to vote anyhow. But if proxies for more shares are returned than are entitled to vote—because the level of short-selling was high and the abstention rate was low—it is unclear what should be done.

There are several possible effects of this system for collecting votes. First, it may mean that some people who are shareholders are unable to vote their shares. Second, it may mean that others who may not, in fact, own any shares (because they have been lent out) will nonetheless be able to vote. Finally, it may result in a situation in which there is no answer to the question of who is entitled to vote.

The MONY/AXA deal, discussed above, is an example of a contested transaction that illustrates these problems. The controversial buyout was approved by a margin of 1.7 million votes out of a total of 50.1 million shares at a time when somewhere around 6.2 million shares had been shorted.[259]

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[258] Here we follow the excellent discussion of the complications attendant to short sales in Apfel et al. *Id.*

[259] Bob Drummond, *Corporate Voting Charade*, BLOOMBERG MARKETS, Apr. 2006, at 96, 96 (using the MONY/AXA deal as an example of a short sale's effects on corporate democracy).

Though the overvoting problem has been noted for a long time,[260] it is becoming more acute now because hedge fund activism makes close votes more likely and hedge funds engage in short selling at the time of votes. We discuss this problem in greater detail, and examine possible solutions, in a separate paper.[261]

C. *The Absence (So Far) of a Third Conflict: Paying Hedge Funds Off*

It is worth noting that we have not found any evidence for the existence of a third potential conflict between hedge funds and other investors: hedge funds and managers making a side deal, such as greenmail, in which the firm pays the hedge fund to go away. We are not aware of a single instance of hedge funds receiving greenmail, one of the 1980s' classic examples of "dark side" behavior. The absence of greenmail is interesting in its own right. One possible explanation is that greenmail got such a bad name during the 1980s that hedge funds are too embarrassed to touch it, or, perhaps more plausibly, that boards are too embarrassed to offer it. Alternatively, the absence of greenmail or similar devices may reflect the fact that there are so many hedge funds around that greenmail or similar devices will not provide firms with any protection and may well elicit even greater interest. Finally, it could be that accepting greenmail may not serve the long-term interests of activist hedge funds because it would undermine their credibility and their ability to obtain the support of other investors (which they may need to succeed in their activism) the next time around.

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[260] A 1991 House Report recommended that the SEC promulgate a rule to handle this situation, and, specifically, a rule that would prohibit brokers and dealers

> from soliciting proxy voting instructions from or giving proxies at the direction of beneficial owners for more shares than the net amount owned beneficially by each beneficial owner, as shown on the books and records of the broker or dealer, after subtracting the short security positions of each beneficial owner.

H.R. REP. NO. 102-414, pt. 1, at 33 (1991). More recently, the New York Stock Exchange has also identified this as a problem and is working on a solution. *See* Information Memorandum from the N.Y. Stock Exch. 1 (Nov. 5, 2004) (on file with authors) ("Several recent special examinations of member organizations' proxy departments have discovered significant areas of concern involving an apparent systemic over-voting of proxies and a general lack of effective supervision." (footnote omitted)).

[261] Marcel Kahan & Edward Rock, The Hanging Chads of Corporate Voting (Mar. 6, 2007) (unpublished manuscript, on file with authors).

IV. PERVASIVE SHORT-TERMISM?

Although many of the "dark side" problems identified in Part III have generated comment and controversy, the sharpest and most comprehensive criticism of hedge fund activism is that it exacerbates an already serious problem of "short-termism" in the executive suite. In this Part, we take that criticism seriously.

A. *A Real Problem?*

Hedge funds come close to being the archetypal short-term investor.[262] For some funds, holding shares for a full day represents a "long-term" investment. Short-termism may thus pervade much that hedge funds do, including their corporate governance and control activism. Leading opponents of hedge fund activism, such as Martin Lipton, argue that hedge fund short-termism could cause managers not to make crucial long-term investments.[263] And the German finance ministry set up a panel to assess the impact of, and consider regulation of, "short term profit-oriented foreign investors."[264] One's views about whether hedge fund activism, on the whole, is desirable or undesirable are likely to turn on one's stand on the short-termism problem.[265]

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[262] *See* Rita Raagas De Ramos, *Concerns over Hedge Funds Rise as Market Volatility Rises Globally*, WALL ST. J., June 15, 2006, at C5 (noting that hedge funds make up 40% to 50% of average daily trading volume in major financial markets).

[263] *See Battling for Corporate America*, ECONOMIST, Mar. 11, 2006, at 69, 69 ("Martin Lipton, a veteran Wall Street lawyer, [complained] that 'we have gone from the imperial CEO to the imperial stockholder.'"); Attacks by Activist Hedge Funds, *supra* note 20 (outlining a "checklist" for rebuffing hedge fund attacks). Even if they are short-term oriented, hedge funds' short-term strategies may perform valuable functions. For example, when hedge funds play their traditional role of arbitraging market inefficiencies, their pursuit of short-term profit will be one of the mechanisms that helps to bring the market price into alignment with the value of the firm. Thus, for example, when prices are too high because of excessive optimism, hedge funds can be expected to short the stock, thereby putting some necessary downward pressure on the price. Moreover, even if the interests of short-term and long-term investors may occasionally conflict, their interests will often coincide. To that extent, hedge funds, by furthering their own short-term interests, will also benefit long-term shareholders.

[264] Taylor & MacDonald, *supra* note 23, at C5 (internal quotation marks omitted).

[265] There is so far limited empirical evidence regarding the effect of activism on company value. *See* April Klein & Emanuel Zur, *Hedge Fund Activism* 35-36 (European Corp. Governance Inst. Fin. Working Paper No. 140/2006, 2006), *available at* http://ssrn.com/abstract=913362 (finding that a company's stock price increases when an activist hedge fund files a schedule 13D, but that accounting performance declines in the year following filing); Alon Brav et al., Hedge Fund Activism, Corporate Governance, and Firm Performance 21-24 (Sept. 22, 2006) (unpublished manuscript)

Looking at the specific activities of hedge funds, there is often an inherent ambiguity as to whether they sacrifice valuable long-term projects in favor of short term gains. Consider Deutsche Börse's (DB) failed attempt to acquire the London Stock Exchange (LSE), discussed earlier.[266] DB's CEO wanted to acquire the LSE and convinced the board that doing so was a good idea. Hedge funds that had acquired large stakes in DB disagreed. They maintained that the plan to acquire the LSE represented wasteful managerial empire building and that DB's cash reserves should instead be distributed to shareholders. Now, if the investment in acquiring the LSE was a valuable long-term project, then the involvement of the hedge funds would have had the effect of pushing the company toward the lower value outcome: an outcome worse for long-term shareholders than acquiring the LSE. If the hedge funds were right that the investment was simply a bad investment driven by delusions of grandeur, their opposition benefited both short-term and long-term shareholders.[267]

For the short-term trading horizon of hedge funds to generate a short-term investment outlook for hedge fund managers, the stock market must suffer from *myopia*: that is, it must undervalue long-term investments relative to short-term investments. If the market does not itself suffer from such a bias, then the interests of investors with short-term trading horizons will not conflict with those of investors with long-term trading horizons. In the case of the DB's attempt to acquire LSE, for example, a conflict between hedge funds with short-term

available at http://www.fdic.gov/bank/analytical/cfr/2006/oct/hedge_fund.pdf (finding abnormal stock price increases upon announcement of activism and no support for the assertion that activism destroys value or is short-term focused). Since hedge fund activism is a relatively recent phenomenon, these studies, by necessity, cannot measure the long-term effect of such activism.

[266] *See supra* Part I.A.2.a.

[267] This analysis nicely illustrates the different ways in which hedge fund involvement, when it crosses a critical threshold, can affect shareholders. Were hedge funds only to hold a small percentage of either DB or the LSE, and were the market to overvalue the transaction's worth to the companies, they could bet against the DB bid for the LSE by shorting DB stock. If they could be short for a long enough time, they would make money if it turned out that they were right that this was empire building and would lose money if it turned out that this was value enhancing. While, in the DB case, the hedge funds were likely right, there are other cases in which they bet against a complex strategy and lost. The clearest case seems to be the investment strategies surrounding the transaction between Lampert, Kmart, and Sears. When Lampert acquired control of Kmart, the stock was heavily shorted. Byron, *supra* note 109. But within a year, the stock had gone from $15 per share to $109 per share. *Supra* text accompanying notes 110-114. Had those with the short view held a controlling position, they may have blocked the strategy, to shareholders' detriment.

trading horizons and other investors with long-term horizons would exist only if the market myopically failed to incorporate the long-term benefits of acquiring LSE into the stock price of DB.

Whether and under what circumstances the market suffers from myopia has been the subject of substantial analysis and debate. Many managers, directors, private equity funds, investment bankers, and others involved in the management and sale of companies are convinced that the market is myopic. Others believe that the allegations of myopia are a foil for managerial failure to deliver results.[268] Academics have developed theoretical models showing that market myopia can result in a number of circumstances.[269] Much of the current research in finance starts from the assumption that capital markets are not perfectly efficient.[270] But the empirical evidence on the extent and magnitude of myopia is sketchy at best.[271]

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[268] *E.g.*, Barry Rosenstein, *Activism Is Good for All Shareholders*, FIN. TIMES, Mar. 10, 2006, at 17; *see also* Ubben & Haarmeyer, *supra* note 160, at 60 (arguing that it is important to distinguish between activists that are "short-term saber rattlers" and those that are "long-term value creators" and criticizing defenders of entrenched management for trying to tar all activists with the same brush).

[269] *See generally* Richard E. Kihlstrom & Michael L. Wachter, *Why Defer to Managers? A Strong-Form Efficiency Model* (Univ. Pa. Law Sch. Inst. for Law & Econ., Research Paper No. 05-19, 2005); Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148 (1990); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989); Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988). Although the common view is that market myopia leads to underinvestment in long-term opportunities, some have argued that it can lead to overinvestment as well. *E.g.*, Lucian Arye Bebchuk & Lars A. Stole, *Do Short-Term Objectives Lead to Under- or Overinvestment in Long-Term Projects?*, 48 J. FIN. 719 (1993).

[270] For a short survey of the prevailing theories on market efficiency, see Michael L. Wachter, *Takeover Defense When Financial Markets Are (Only) Relatively Efficient*, 151 U. PA. L. REV. 787, 801-04 (2003).

[271] Some of the studies focus on the effect on managerial myopia of institutional investors, which has been argued to have a shorter-term trading horizon than other investors. *See, e.g.*, Mary M. Bange & Werner F.M. De Bondt, *R&D Budgets and Corporate Earnings Targets*, 4 J. CORP. FIN. 153, 156 (1998) (finding that managers are less likely to manipulate R&D budgets to reduce discrepancies between analysts' forecasts and reported income when institutional investors own a higher stake); Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCT. REV. 305, 306-07 (1998) (arguing that institutions generally reduce myopic pressure, but that institutions with high turnover that engage in momentum trading encourage myopia); Sumit K. Majumdar & Anuradha Nagarajan, *The Impact of Changing Stock Ownership Patterns in the United States: Theoretical Implications and Some Evidence*, 82 REVUE D'ÉCONOMIE INDUSTRIELLE [INDUS. ECON. REV.] 39, 50 (1997) (Fr.) (concluding that institutional investors have a positive and significant effect on R&D spending); Sunil Wahal & John J. McConnell, *Do Institutional Investors Exacerbate Managerial Myopia?*, 6 J. CORP. FIN. 307, 311 (2000) (concluding that presence of institutional investors, regard-

Arguably, the phenomenal growth of private equity funds—whose basic business model includes taking companies private so that they can be reconfigured away from the short-term pressures on public companies—indicates that there may well be a serious problem of myopia. KKR, Blackstone, Carlyle, Apollo, and TPG all have raised, or are currently raising, new funds in excess of $10 billion.[272] Then again, the business model of private equity funds also includes providing high-powered incentives to managers and monitoring them

less of investment style, leads to more investment in long-term projects); Sumit K. Majumdar & Anuradha Nagarajan, *The Long-Term Orientation of Institutional Investors: An Empirical Investigation* 19 (Univ. of Mich. Sch. of Bus. Admin., Working Paper No. 9504-13, 1994), *available at* http://deepblue.lib.umich.edu/handle/2027.42/35883 (finding that institutions prefer to invest in firms with long-term orientation). Other studies focus on the effect of threatened hostile takeovers—which Lipton and others have suggested generates undesirable short-termism—on R&D expenses and similar measures of long-term investments. While one study suggests that, consistent with the short-termism hypothesis, R&D expenses might increase after the enactment of antitakeover legislation, two other studies found that R&D declines after the adoption of antitakeover provisions. *See* Mark S. Johnson & Ramesh P. Rao, *The Impact of Antitakeover Amendments on Corporate Financial Performance*, 32 FIN. REV. 659, 674 tbl.2 (1997) (finding that R&D expenses decline after the adoption of an antitakeover provision); Lisa K. Muelbroek et al., *Shark Repellents and Managerial Myopia: An Empirical Test*, 98 J. POL. ECON. 1108, 1114-15 (1990) (same). *But see* William N. Pugh & John S. Jahera, Jr., *State Antitakeover Legislation and Shareholder Wealth*, 13 J. FIN. RES. 221, 221, 226 tbl.1 (1990) (finding a marginal increase in returns following enactment of an antitakeover statute, which the authors link to long-term investment, such as R&D). Other studies look at other aspects of myopia. *See, e.g.*, Jeffrey Abarbanell & Victor Bernard, *Is the U.S. Stock Market Myopic?* 38 J. ACCT. RES. 221, 221-22 (2000) (concluding that "stock prices do not generally exhibit myopic behavior"); Anup Agrawal & Jeffrey F. Jaffe, *The Post-merger Performance Puzzle*, *in* 1 ADVANCES IN MERGERS AND ACQUISITIONS 7, 37 (Cary Cooper & Alan Gregory eds., 2000) (rejecting EPS myopia as an explanation for negative long-run stock returns after mergers); Federico Ballardini et al., Do Stock Markets Value Innovation? A Meta-Analysis 27 (2005) (unpublished manuscript), *available at* http://ssrn.com/abstract=717562 (finding that the market values $1 invested in R&D as much or more than $1 invested in tangible assets); Mei Cheng et al., Earnings Guidance and Managerial Myopia 2-3 (Nov. 2005) (unpublished manuscript), *available at* http://ssrn.com/abstract=851545 (finding that firms dedicated to giving quarterly earnings guidance engage in more myopic R&D investments); Craig W. Holden & Leonard L. Lundstrum, Costly Trade, Managerial Myopia, and Long-Term Investment 2-3 (March 28, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=809507 (finding that the introduction of long-term options (LEAPS) is associated with an increase in long-term investments).

[272] Peter Smith, *Texas Pacific Raises Record $14bn for New Fund*, FT.COM, Apr. 2, 2006 (noting that TPG has raised more than $14 billion for its latest fund, while Blackstone raised at least $13.5 billion, and Apollo Management and KKR each raised over $10 billion). More than $250 billion is estimated to have been raised by private equity funds in 2005. *Id.*

closely.[273] Whether private equity and activist hedge funds pursue complementary strategies for maximizing firm value (with both targeting managerial agency costs in a different fashion), whether they are competitors in the same markets (as private equity funds open hedge funds and hedge funds take companies private), or whether hedge funds aggravate market imperfections and thus drive firms into the arms of private equity remains unclear.

Short-termism thus presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism. The other dark side problems represent relatively isolated and narrow concerns that do not relate to hedge fund activism as a whole. Short-termism, by contrast, arguably pervades hedge fund activism, and the accusation that hedge funds induce managerial short-termism has become the main ammunition for hedge fund critics. At the same time, among the problems associated with hedge fund activism, the very existence of a short-termism problem is the least proven, its manifestations—if it does exist—are the most manifold, and potential solutions are the least evident.

B. *Potential Responses?*

Let us assume that hedge fund managers tend to prefer that companies engage in projects with short-term payoffs, even if there are projects with longer-term payoffs that are more valuable. Should the law intervene, and if so, how?

The answer to these questions depends on a number of factors. First, even if hedge funds have short-term biases, to what extent is hedge fund activism *driven by* excessive short-termism? Activist hedge funds are agents of change with specific goals that depend on the particular company. When the company is diversified, hedge funds often push for divestitures. When it is underperforming, they often push for the sale of the company or a change in management. When the company has excess cash on hand, they push for stock repurchases or dividends. When the company has assets on its balance sheet that can be monetized (e.g., real estate), they push to monetize those assets. When companies are pursuing capital-intensive investment plans, hedge funds sometimes oppose the plans and push for the cash to be returned to shareholders. In the control area, hedge funds sometimes

[273] *Private Equity's Successes Stir Up a Backlash That May Be Misdirected,* WALL ST. J., Jan. 31, 2007, at A9 (suggesting that improved incentives and reduced pressure to achieve quarterly earnings allow private equity firms to enhance value).

make bids, sometimes advocate or oppose deals from either side of the transaction, and often try to get better terms for the target. Is it always the case that, when a hedge fund gets involved, it is pushing for business strategies with a short-term payoff over strategies with a more valuable long-term payoff? Or is the short-term payoff preferred by hedge funds sometimes the more valuable one? And how often is hedge fund activism motivated by altogether different concerns, such as bad management, an ill-advised strategy, or an insufficient price in an acquisition?[274] Is the controversy really about different investment horizons, or does it instead reflect a substantive dispute over the appropriate course of action for the firm?

Second, how long is the horizon of managers?[275] A plausible argument can be made that it is managers, not just markets, that suffer from myopia these days. Many CEOs are close to retirement age and, even among younger CEOs, turnover is high. Executives' stock options continually vest and are exercised or hedged, if only to diversify their portfolio. Bonuses are often based on short-term performance goals. Is it sometimes management's failure to invest in valuable long-term projects that creates the opening for hedge fund activism?

Third, when and to what extent do hedge funds succeed in affecting corporate policy? Though hedge funds have become highly active in the corporate governance area, they generally have not become powerful enough to exercise control over the targets of their activism.[276] Rather, they purchase a sizeable, but far from controlling stake—rarely more than 5% to 10%—and then seek to influence corporate strategies.[277] Even when hedge funds commence a proxy contest, they usually seek only minority representation on the board. Ac-

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[274] *See, e.g.*, Janet Adamy, *Investor Peltz Urges Heinz To Shed More Lines, Pare Payments*, WALL ST. J., May 24, 2006, at C4 (reporting that a hedge fund asked Heinz to, among other things, sell its line of Italian baby food and use new forms of marketing to increase ketchup consumption).

[275] *See, e.g,* Jason Singer, *Carlyle Will Join Financiers' Moves into Hedge Funds*, WALL ST. J., Aug. 1, 2006, at C1 (reporting a trend among private equity funds to enter the faster-paced business of hedge funds).

[276] *See* Shareholder Activism in the M&A Context, *supra* note 132, at 1 ("In larger transactions [the success of hedge funds in blocking a deal] will often require that the activists' position be supported by more traditional institutional investors and ISS.")

[277] *See supra* Part I.A (describing the tactics of corporate governance activism); *see also* Plitch, *supra* note 253, at 4 (noting that hedge funds "typically acquire a stake of less than 10%"). Even when several hedge funds become active in a specific portfolio company, they generally do not control it. *See, e.g.*, Armitstead, *supra* note 68 (describing the ownership of the institutions that eventually blocked the purchase of the London Stock Exchange by Deutsche Börse).

tivist hedge funds often have a chair at the metaphorical table where corporate strategy is set, giving them an opportunity to present their views. In order to see their views prevail, however, hedge funds usually need the support of others[278]—which cannot be taken for granted.[279] These "others" include, in particular, corporate management, independent directors, traditional institutional investors with large stakes, and other large shareholders. To the extent that the largest shareholders are effectively indexers, a strategy that results in a short-term increase in share price (which benefits hedge funds), but a long-term loss (that hurts long-term shareholders), will not be attractive. More generally, over time, the degree of support that hedge funds receive will likely depend on whether long-term shareholders benefit.

Fourth, if the determination of corporate policy, once hedge funds are involved, depends on multiple constituents, how do these constituents interact? At present, it seems that hedge funds often act as a counterweight to the substantial power of management, with the consequence that the effective power partly shifts to other groups, such as independent directors and traditional institutional investors. Independent directors and large shareholders, of course, may sometimes make mistakes, but management is not infallible either. We are inclined to be optimistic about the resulting interaction, which often results in a compromise rather than an outright victory for either hedge funds or management.[280] But another possibility—though one that we have so far not witnessed—is that hedge funds will enter an unholy alliance, either by being bought off by management through the payment of greenmail or its functional equivalent, or by teaming up with other large shareholders to advance their respective parochial interests to the detriment of shareholders at large.

Given these questions, a sufficient case for legal intervention has not been made. Our conclusion partly results from the uncertainties: about whether short-termism is a real problem, about the nature of the problem, about how much it affects hedge fund activism, and

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[278] *See* Rosenstein, *supra* note 268 (characterizing hedge fund activism as "campaigns between [hedge funds and managers] for the support of the company's true owners, its shareholders").

[279] *See* Client Memorandum from Wachtell, Lipton, Rosen & Katz, Financial Institutions Developments 4 (Feb. 22, 2006) (noting success by some firms in persuading large institutional shareholders to support their boards).

[280] Hovanesian & Byrnes, *supra* note 221, at 2 (noting that there is "scope for the warring parties to find a mutually beneficial resolution").

about how hedge fund activism relates to potential managerial short-termism. This conclusion also partly results from our observations that, at present, hedge funds influence, but do not control, corporate policy, that they depend on the support of other shareholders, and that they have shied away from greenmail and other similar unsavory tactics.

But our conclusion also rests, to a large extent, on our view, which we have developed elsewhere, that companies (and the market more generally) will adopt what we have called "adaptive devices" to deal with the potential negative effects of hedge fund short-termism.[281] To see the shape of some of these devices, one need look no further than the "Hedge Fund Attack Response Checklist" mailed by Martin Lipton to the clients of his firm. In this widely circulated memo, Lipton recommends that companies prepare in advance for hedge fund activism by: periodically updating the board of directors, reviewing dividend policy, improving financial public relations, maintaining consistency in the company's strategic message, proactively addressing reasons for any shortfall in peer company benchmarks, maintaining regular and close contact with major institutional investors, and reviewing basic strategy with the board.[282] These are terrific ideas, not just to deal with activist hedge funds, but in general. If companies follow Lipton's advice, hedge funds will already have made significant positive contributions to the management of U.S. companies. Moreover, if hedge funds can succeed, despite companies taking these measures, we think that chances are reasonably high that they have identified a real problem.

One adaptive device missing from Lipton's list, but one that merits particular attention, is private equity. Vast sums are now available to take companies private, sums largely provided by the same (allegedly myopic) institutional investors who hold the shares of public

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[281] *See generally* Marcel Kahan & Edward B. Rock, *How I Learned To Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 872 (2002).

[282] Attacks by Activist Hedge Funds, *supra* note 20; *see also* Shareholder Activism in the M&A Context, *supra* note 132 (recommending that companies "be proactive in explaining the reasons for, and the benefits of, a transaction," ensure that the board's position is accurately understood, and engage in early and open communication with significant stockholders); *Hedge Fund and Institutional Shareholder Activism*, SEC UPDATE (Mayer Brown Rowe & Maw, New York, N.Y.), Apr. 21, 2006, at 1, 7, *available at* http://www.mayerbrownrowe.com/publications/article.asp?id=2703&nid=6 (recommending that companies review their dividend policies, proactively address reasons for any shortfall in performance, and maintain close contact with major investors).

companies and invest in hedge funds. As we have noted above, private equity can be an escape mechanism for companies that suffer from excessive short-term pressures in the public market.[283] If it is indeed hedge funds that contribute substantially to such short-term pressures, it is no small irony that hedge funds and traditional private equity funds are now converging.[284] In an increasing number of high-profile deals, hedge funds have taken on "the type of long-term control investing previously the domain of private equity funds."[285] If hedge funds are part of the problem because their activism exacerbates short-termism, they may also be part of the solution as they develop private equity expertise. This, by itself, shows how multifaceted hedge funds are as an investment vehicle, and should caution against adopting hasty regulation.

CONCLUSION

We are observing an evolutionary process in real time. Hedge funds—highly incentivized, mostly unconflicted, and largely unencumbered by regulatory constraints—have become the prime corporate governance and control activists. They pursue activism as a profit-making strategy and make investments in order to become activist, rather than as an afterthought to a failed portfolio investment. Thus, they blur the line between risk arbitrage and governance and control battles. The emergence of hedge funds and the role they play prove that there is money to be made from being an active shareholder.

One of the most intriguing developments we are starting to observe is the division of labor between hedge funds and more traditional institutional investors. Because hedge funds are typically relatively undiversified, they show little interest in agitating for systemic changes, such as anti-poison pill or staggered board campaigns. On the other hand, hedge funds engage in firm-specific agitation to a degree unheard of among traditional institutional investors, with tradi-

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[283] *See Hedge Fund and Institutional Investor Activism*, *supra* note 282, at 1 (noting that private equity funds are looking to take private targets of shareholder activism).

[284] *See* Singer, *supra* note 275 (noting that an increasing number of private equity firms are opening hedge funds); *cf. Groups' Report Recommends Moving Away from Short-Term Corporate Thinking*, 38 SEC. REG. & L. REP. 1315 (2006) (referencing a report by CFA Centre that accuses corporate managers of a "short-term obsession").

[285] Woodrow W. Campbell & Jennifer A. Spiegel, *Hybrid Vehicles*, THEDEAL.COM, June 17, 2005, *available at* http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1118184148575.

tional institutions sometimes tagging along. As a representative of one traditional institution said, in connection with the battle to stop Deutsche Börse's attempt to acquire the London Stock Exchange, "The hedge funds have done a marvelous job. No matter how we feel about companies, traditional managers simply cannot move as fast to achieve our aims. We were right behind [the hedge funds], but we couldn't have done it without them."[286]

But there is also a potential downside to activism. The interests of hedge funds sometimes diverge from those of their fellow shareholders, and activism creates stress fractures for the regulatory system. The most serious accusation leveled against activist funds, however, is that activism is designed to achieve a short-term payoff at the expense of long-term profitability. It is here that the challenge lies for boards, traditional institutional investors, and the market as a whole. If the proposals made by hedge funds are sometimes valuable and sometimes misguided, how good are we at figuring out which is which? While we do not pretend to know the answer to this question, we believe that market forces and adaptive devices adopted by companies individually in response to activism are better designed to help separate good ideas from bad ones than is additional regulation.

Hedge funds are here to stay. They are prominent in control transactions and elsewhere. Their influence is being felt, but their future is uncertain. As hedge funds grow, will they retain their separate identity (and get stronger) or will (some of them) morph into high-fee mutual funds? Will activist investment opportunities for hedge funds dry up as more money chases these opportunities, or will more hedge funds become activist in response to the profits to be earned? If smart hedge fund investors keep hedge fund managers honest, will an expansion of the investor base reduce the monitoring of hedge fund managers and make them worse agents for their investors?

Finally, one can predict a backlash, although the exact form it takes will depend on the nature of the scandal that leads to the regulatory intervention. We are already beginning to see a regulatory reaction at the SEC, with a (failed) attempt to adopt rules requiring the regulation of hedge fund advisers,[287] and preparation for such regulation in Europe. When the inevitable crisis occurs, there will be pres-

[286] *See* Armitstead, *supra* note 73.

[287] *See generally Hedge Funds and the SEC*, *supra* note 197, at 68 (reporting the federal appeals court decision striking down "an attempt by the Securities and Exchange Commission (SEC) to monitor the industry").

sure to regulate further. At this point, the most important admonition—obvious in a period of calm but less so after an explosion—is to regulate cautiously and carefully.