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Introduction to *Institutional Investor Activism: Hedge Funds and Private Equity, Economics and Regulation*

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Abstract

The increase in institutional ownership of recent decades has been accompanied by an enhanced role played by institutions in monitoring companies' corporate governance behaviour. Activist hedge funds and private equity firms have achieved a degree of success in actively shaping the business plans of target firms. They may be characterized as pursuing a common goal – in the words used in the OECD Steering Group on Corporate Governance, both seek 'to increase the market value of their pooled capital through active engagement with individual public companies. This engagement may include demands for changes in management, the composition of the board, dividend policies, company strategy, company capital structure and acquisition/disposal plans which are normally regarded as governance issues.' This article is the introductory chapter of *Institutional Investor Activism: Hedge Funds and Private Equity, Economics and Regulation* (Oxford University Press 2015). The book collects descriptive expositions and empirical analyses essential for an understanding of both varieties of interventionist shareholder. The twenty-one chapters detail these investors' strategic approaches, the financial returns they produce, the regulatory context in which they operate, and the policy questions raised by their activities.

Chapters

1. Introduction

Agency theory posits that separation of ownership and control opens up a governance deficit. The shareholder principals, it says, have a collective action problem that leaves them without an economic incentive to monitor their manager agents. The theory, in its original form, held out the hostile takeover as a cure. But, in practice, the hostile takeover has never filled the role described, its incidence constrained by regulatory and other costs. The world of mergers and acquisitions has evolved to favour friendly transactions, even as hostile offers continue to appear in small numbers. The classic problem of the Berle and Means corporation persists accordingly.

To be sure, agency theorists have inquired into alternative possibilities for making up the governance deficit. For example, two decades ago the exercise of transnational governance comparison led observers in the United States, inspired by German main banks and Japanese keiretsu, to look to holders of large blocks of stock to provide quality oversight on a going-concern basis. The blockholder, thus hypothesized as the solution to the governance problem, holds out two manifest advantages. First, it can monitor from an interior position, surmounting the information asymmetry problem that disables outside shareholder-monitors. Second, the blockholder, posited as an underdiversified, long-term investor, can monitor with a cooperative disposition, avoiding the costs and disruptions attending hostile engagement. But there also are problems. Separation of ownership and control holds out for shareholders the advantages of liquidity and easy exit through the trading market, even as it creates a manager–shareholder incentive problem. Blockholder governance implies reduced liquidity even as it addresses the incentive problem. As a result, blockholding poses its own incentive problem. A rational blockholder would be unlikely to give up the benefits of liquidity in order to extract gains from improved governance only to have to share those gains with the rest of a free-riding population of small shareholders who enjoy liquidity's benefits. A different sort of governance dysfunction follows—a rational blockholder will seek compensation for its governance contribution through self-dealing transactions, insider trading, or some other unshared mode of return.

Agency theory continues to look for means to circumvent these trade-offs. The search turns again and again to the sleeping giant of corporate governance: the institutional investor. Institutions hold an increasing percentage of shares outstanding and interest themselves in governance problems. Rational apathy respecting matters presented for shareholder approval, long a shareholder trait under the separation of control, no longer prevails amongst them. At the same time, however, sustained, active monitoring and affirmative governance input have not been the rule. Most institutions are passive, well-diversified investors. The same factors that complicate the incentives of blockholders come to bear more preclusively with these institutions. Active monitoring presupposes investment in information gathering and governance participation. Diversified mutual and pension fund managers have no incentive to make such investments because they bear the costs unilaterally and share the gains with the rest of a free-riding shareholder population.

These constraints determine and limit the modes of institutional investor governance engagement. Large repositories of corporate information and expertise do exist, but in the hands of intermediary firms that came into existence for the very purpose of providing passive institutional investors with the means of acquitting themselves of governance responsibilities.

Activists do exist among traditional investment institutions, but not institutions acting on pure financial incentives. Public sector pension funds and labour unions take the lead roles, acting through agents incentivised by prospects of reputational advancement. These actors target companies and challenge their managers with shareholder proposals and 'just vote no' campaigns. They thereby register their voice and affect outcomes, but from a secondary position and on an occasional basis. The cumulated governance activity is impressive, but none of it assures or very often results in constructive engagement by shareholders in the formulation of business policy at individual firms. As to that, collective action problems and the problems of separation of ownership and control persist.

There have long been two significant exceptions to the rule of institutional shareholder disability. Activist shareholders do appear, from time to time, to take significant stakes in companies and bargain with their managers towards the end of effecting productive changes in business policy. These actors, whose initial appearance dates back 150 years, intervene from outside corporate and financial power structures and operate out of small, independent, underdiversified investment entities. The second exception, of more recent vintage, is the private equity firm, an intermediary that raises capital for the purpose of buying publicly traded companies in friendly, negotiated transactions, for the purpose of profiting from redirection of their business policies. These too operate from small, independent, underdiversified investment entities. Since the turn of this century, we have seen unprecedented levels of activity from both of these exceptional types.

1.1 Hedge Funds as Activist Shareholders

The role of the hostile activist shareholder has been taken up by a set of hedge funds. This group targets and researches companies, takes large positions in their stock, criticizes their business plans and governance practices, and confronts their managers, demanding action enhancing shareholder value. When one hedge fund announces a 5 or 10% position in company, others can follow, forming a 'wolf pack' that sometimes has the voting power to force management to address its demands. The demands, in turn, likely include one or more actions assuring a quick return on investment—sale of the company at a premium, unbundling of the company through the sale or spin-off of a large division, or a large cash payment to the shareholders in the form of a special dividend or share repurchase. The hedge fund activists pack their biggest punch at small companies, in which their investments translate into large voting blocks. But they also have confronted giants like DuPont, Kraft, McDonald's, Proctor & Gamble, and Time Warner. The list of big targets has lengthened notably in recent years. In 2013, Apple, Sony, UBS, PepsiCo, Dell, and Microsoft all came under attack.

The activist hedge funds' financial power has increased steadily. According to Hedge Fund Research, funds in the activist sector had $12 billion at their disposal in 2003. In 2013, this stock of 'dry powder' had risen to $73 billion, amounting to a tangible outpouring of investor confidence in the sector. The continued investor support partially answers a question regarding the permanence of hedge fund activists' place on the governance stage, a question that only recently loomed large when activist intervention almost disappeared in the wake of the financial crisis of 2008 (Bratton 2010). Hedge fund activism rose after 2002, subsided after 2008, and then rose again. The first rise accordingly cannot be dismissed as a flash in the pan and a pro-cyclical aspect can be noted.

Money talks on Wall Street and respectability has followed for the activists. Where interveners in this mould were once dismissed as rogues and widely shunned, these funds have become the clients of the most prominent investment banks and law firms. More importantly, their model of governance engagement has proved robust. While hostile in approach, they rarely seek to take over their targets, distinguishing them from the hostile raiders of the 1980s. Today's activists pursue more focused, discreet governance agendas. They are flexible about the means to the end, joining target boards of directors and softening their hostile postures as the occasion demands.

The activist hedge funds' record of success is historically impressive. Prior to their appearance, activist institutional investors did not have much of an impact. Some studies showed that activist intervention caused the stock price to go up. But, unless the intervener proceeded to buy the company or trigger a takeover by a third party, there was little evidence of resultant change inside the target firm. Meanwhile, studies focused on activism by public pension funds showed no stock price effect at all. Nor did the activists have a favourable record of success with full-dress proxy contests for control. The hedge fund activists have changed this, causing stock prices to rise, directing changes in business policy, and entering boardrooms. One detects a palpable sense of frustration on the defensive side. With hostile tender offers, management's lawyers erected reliable protective walls in the form of poison pills and staggered boards. With activist hedge funds, the best the lawyers can counsel is good shareholder relations and constant monitoring.

Unsurprisingly, there are allegations of perverse practices and effects. Short-termism is the main complaint, relentlessly mooted by management and its legal representatives. Questions also come up regarding tactics. It is said that hedge funds use derivatives to evade reporting requirements imposed on large blockholders and manipulate voting outcomes. Regulatory reform initiatives have followed in response, and some changes have occurred, none of them as yet fundamental.

1.2 Hedge Funds as Activist Debtholders

Activist hedge funds also have played a role in the transformation of US bankruptcy reorganization. Traditionally, Chapter 11 reorganizations have been dominated by the distressed company's managers under a system that accorded them agenda control. The managers had exclusive power to present a plan of reorganization and took advantage of this, delaying presentation of a plan even as the company's creditors received no interest on their claims during the proceedings. The creditors, wanting above all to return their investments to paying status, tended to accede to unfavourable terms. Power shifted in the creditors' direction after 2000. Significantly, the shift happened without any structural reform of the system. Creditor classes picked up contractual tools that were already on the table, successfully deploying them to push management into a corner. New borrowing, termed 'DIP (debtor-in-possession) loans', is critical in many Chapter 11 proceedings. Under the US Bankruptcy Code, new loans can receive priority status. A bankruptcy declaration, accordingly, can imply an instant return to creditworthy status for the distressed company. After 2000, DIP lenders, with the concurrence of the bankruptcy courts, started using their debt contracts to impose timetables and performance metrics on the bankrupt company and its managers. As result, Chapter 11 reorganizations now move more quickly and more often conclude with asset sales rather than confirmed reorganization plans. New managers armed with new business plans are more likely to take over as the proceeding runs its course. In effect, a different separation of ownership from control—this one between creditors and incumbent managers—has been remedied.

Banks and other primary lenders are prominent among the newly empowered creditors. But activist hedge funds also sit at the table, playing complicated arbitrage strategies. The hedge funds are established Chapter 11 players. They first showed up in the 1980s, along with new trading markets in bankruptcy claims. Conservative lenders dump their paper into the claims trading markets where specialist hedge funds, termed 'vultures', pick up the paper at distressed prices. The hedge funds then aggressively use their claims positions to influence the outcomes of Chapter 11 proceedings, even looking to take control of the reorganized company. Questions arise regarding the desirability of hedge fund aggression in Chapter 11. At a minimum the hedge funds impart an uncooperative aspect to bankruptcy proceedings. More worrisome are accusations of obstructionist and manipulative tactics. Some think that the costs of hedge fund disruption are uncompensated by any value added. But the matter is far from clear, for others plausibly look to hedge fund activism as the mainspring of bankruptcy's new efficiencies.

1.3 Private Equity Funds

We turn now to a contrasting mode of activist government intervention, going private transactions conducted by private equity firms. We acknowledge that our application of the term 'activist' will strike many as inappropriate, for, with private equity, friendly and cooperative engagement with target management is the byword in contrast to the hedge fund interventions just described. We do not, however, delimit activism to hostile engagement. Private equity buyouts are governance interventions and anything but passive.

A buyout carries blockholding out to its logical conclusion. It completely removes the target firm from the equity trading market, entailing the utmost liquidity sacrifice on the blockholder's part. The limited partnership that conducts the buyout (the buyout fund) emerges with the majority equity stake, with the target's managers as the only minority shareholders. Significantly, the interposition of this separate entity as the holder of a majority block of the target firm's shares solves the blockholder incentive problem. The buyout fund is organized and promoted by a private equity firm, with the risk capital coming from the institutional investors who take its limited partnership shares. The private equity firm selects the going private target, effects the buyout, and undertakes the role of target firm monitor. The buyout fund's limited partnership agreement and other operative contracts allocate the risks and returns between the buyout firm and the outside institutional investors. Meanwhile, the buyout target emerges from the control transfer with a governance structure that approaches the agency ideal. Its incumbent managers get high-powered incentives as minority shareholders even as control moves to a highly incentivized shareholder-monitor. At the same time, an arm's-length contract governs relations between that control party and outside equity investors. Returns from monitoring are thus allocated up front.

Private equity firms made their first appearance thirty-five years ago. They played a prominent role in the 1980s mergers and acquisitions market, in particular as promoters of leveraged corporate restructurings. But the 1980s buyout boom was followed by a spectacular bust. Figure 1.1 shows the per capita percentage of private equity buyouts amongst public company acquisitions peak at 27% in 1988, only to slide in 1994 to less than 2% of a thin market. By all appearances, private equity had, by the mid-1990s, disappeared in tandem with the 1980s bust-up takeover.

It looked for a time as if the private equity business model had seen its best days. Holström and Kaplan, looking back to the 1980s in 2001, described a period of shock therapy that redirected management priorities in a more productive direction. Managers had needed the therapy because they had proved slow to adapt to changed conditions (Holström and Kaplan 2001). The newly enabled capital markets imposed responsive strategies instead. Management learned its lesson, in turn. In the 1990s, managers, incentivised by stock option compensation, voluntarily downsized their operations and unbundled conglomerates. As the shareholder value approach became dominant, the private equity buyout's moment seemed to have passed. Effective management and high leverage were no longer seen as inevitable concomitants. Now that the shock effectively had been administered, other, less drastic, incentive devices could do the job.

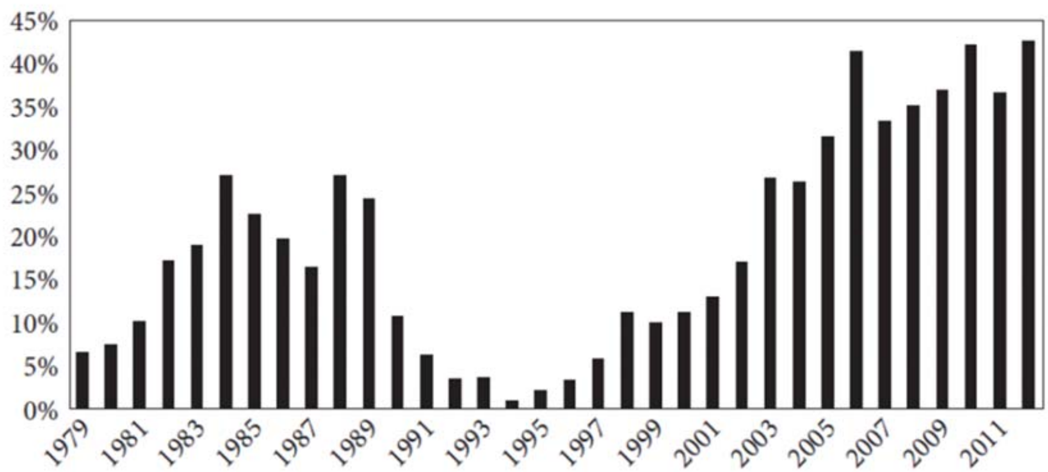

Figure 1.1 US going private transaction as a percentage of US public company acquisitions, 1979–2012

Source: Mergerstat.

But, as Figure 1.1 shows, buyouts came back to claim a per capita share of 41% of public company acquisitions in 2006. Buyouts then held their share of acquisitions in the diminished merger market that followed the financial crisis, reaching a highest-ever share of 42.6% in

2012. They did so in a shareholder value era, absent either a concomitant reappearance of hostile takeovers or a manifest need for a control shock. Their reappearance implies that, even in an era focused on best governance practices and shareholder value maximization, the incentive problems bound up in the separation of ownership and control retain economic salience.

Indeed, the fundamentals of the buyout business model have changed little across the period, even as there have been changes at the buyout firms themselves. In their original iteration, private equity firms were small shops that lacked the in-house expertise and information needed for direct management of portfolio companies. Hence, a going private transaction was, by definition, a 'management buyout'—the incumbent managers stayed on. Today it depends on the deal. Buyout transactions are still almost invariably friendly, but the incumbent managers no longer necessarily remain with the target; private equity buyers frequently assemble teams to replace them. Meanwhile, as private equity firms have grown, their funds' investment portfolios have become more varied, including energy and real estate and a range of financial assets. But buyouts themselves have changed little, with their leveraged purchase prices and post-closing cost-cutting and asset sales.

1.4 Funds—Structural Comparison

We have then three categories of activist intervention—the first entails the holding of non-controlling share blocks with the holder wielding the shareholder franchise, the second entails the holding of debt claims in a Chapter 11 reorganization proceeding with the holder wielding votes within a class of bankruptcy claimants, the third entails the outright purchase of the control in the mergers and acquisitions market. All of the activists are funds, funds falling into two categories.

Hedge funds and private equity funds share a common, largely unregulated space, at least in the United States. If one puts periodic reporting to government authorities to one side, they remain outside the bounds of federal regulation of mutual funds, other investment companies, and their advisors. They market participations through the unregulated vehicle of the private placement. In other national economies, both types of funds are subject to more significant modes of regulatory control, including reporting requirements and sometimes capital structure rules.

Organizational structures are similar worldwide. Contracts control. Both hedge and private equity funds are limited partnerships organized by management firms, with risk capital coming from the institutional investors who purchase limited partnership shares. The management firm selects, makes, and monitors the investments. The limited partnership agreement of the hedge or private equity fund, along with other operative contracts, allocates the risks and returns between the management firm and the outside investors. Portfolios are likely to be leveraged in both cases, but more steeply on the private equity side. Compensation to the management firm also runs along parallel lines, with the management firm taking up to 2% per year of committed capital and a 20% 'carry' respecting annual profits, subject to negotiated percentage reductions in the asset fee, negotiated limitations of the asset fee percentage to capital actually invested, and negotiated hurdles and clawbacks respecting the carry. Finally, both types of funds implicitly promise to deliver above-market returns, a task that becomes harder and harder as more funds pursue the same strategies.

Until recently, hedge and private equity funds could be distinguished by the characteristics of their investments. Private equity takes companies private, investing long term in their equity from a control position. Hedge funds, in contrast, play securities markets worldwide. Private equity firms possess expertise in company analysis. The typical hedge fund, in contrast, employs 'numbers guys' expert in complex market arbitrage. Different hedge funds concentrate on different market plays. Some specialize in securities of distressed firms. Others make directional bets on the movement of currency exchange or interest rates. Still others pursue convertible arbitrage, going long in a convertible bond and shorting the underlying common stock. Many follow market momentum, moving in groups in and out of different asset classes. Some have taken up risky lending, funding leveraged buyouts and firms in bankruptcy reorganization, and trading in junk bonds and credit derivatives.

The activist hedge funds derive from a subset of the sector that invests in equities in the classic, value investor mode. These funds maintain concentrated portfolios and, in some cases, avoid the hedged or multi-strategy approaches followed by other funds, with their managers tending to be former investment bankers or research analysts rather than quantitative experts. They do the research and know their targets well, much like the private equity firms. Some of their managers even profess to be followers of Graham and Dodd, the mid-twentieth-century financial writers whose work remains a fundamental text of value investment. But their activist interventions break with the Graham and Dodd tradition. The leading value exponent, Warren Buffett, invests long term and stays patient, following the same cooperative strategy as the private equity investors. The hedge fund activists lack this patience. They look for value but want it realized in the near or intermediate term. Their strategy is to tell managers how to realize the value and to challenge publicly those who resist their advice. The vulture funds follow a similar playbook tailored to the context of bankruptcy reorganization. Instead of buying companies outright, they purchase significant, non-controlling stakes and then seek to magnify returns by influencing the bankruptcy decision-making process; if control follows purchased at a bargain price, all the better.

Private equity also actively reshapes business plans, but does so behind closed doors over periods of years, after buying the company with mostly borrowed money and taking it private. Differences in governing investment contracts parallel these different behaviour patterns. Contracts governing investment in hedge funds typically lock up investor capital for six months, although some impose terms of two years or longer. Contracts governing private equity investment tend to lock up investments for ten years. These more liberal arrangements facilitate not only large, illiquid, and long-term equity positions, but patience. In contrast, the hedge funds' shorter durations, when coupled with the large, illiquid positions, invite aggression and impatience. But it should be noted that nothing in present practice dictates the terms of the activists' future arrangements with their investors. If they obtain longer lock-ups, modified strategies may follow.

Despite all the differences, activist hedge funds and private equity firms may be characterized as pursuing a common goal—in the words used in the OECD Steering Group on Corporate Governance (2007), both seek:

> to increase the market value of their pooled capital through active engagement with individual public companies. This engagement may include demands for changes in management, the composition of the board, dividend policies, company strategy, company capital structure and acquisition/disposal plans which are normally regarded as governance issues.

Thus committed, activist hedge funds and private equity have a track record of management intervention reputedly so successful as to give rise to an unprecedented, even radical question: have they together in some meaningful sense solved the problem of separation of ownership and control? To the extent that they have, a conventional wisdom about management dominance of the machinery of corporate governance needs to be reconsidered. At the same time, hedge funds and private equity continue to confront an objection that descends from the bust-up takeover era of the 1980s. They are accused of short-termism—they are said to focus on shareholder value maximization myopically, causing productive enterprises to forego investment opportunities necessary for long-term viability.

This book collects descriptive expositions and empirical analyses essential for an understanding of both varieties of interventionist shareholder. The chapters herein detail these investors' strategic approaches, the financial returns they produce, and the regulatory frameworks within which they operate. The chapters also provide historical context, both of activist investment and institutional shareholder passivity. Finally, the collection facilitates comparison between the US and the EU, juxtaposing not only regulatory patterns but investment styles. A more particular description of the book's chapters follows.

1.5 Part I—The Disempowered Shareholder

Part I sets the stage, describing the received context of separation of ownership and control and shareholder disempowerment.

In Chapter 2, Stuart Gillan and Laura Starks trace the evolution of shareholder activism in the US from the introduction of the SEC (Securities and Exchange Commission) shareholder proposal rule in 1942, through the takeover wars of the 1980s, and beyond, to the mutual and pension fund interventions of more recent years. Gillan and Starks go on to review the empirical literature on the effects of activism. News of shareholder proposals has consistently been shown, taken in aggregate, to lack a short-term impact on stock prices, although studies of proposals on particular issues (*e.g.*, poison pills) have shown some effects. Studies of subsequent long-term operating results of target companies also, on the whole, fail to show positive effects. Voting patterns respecting non-binding shareholder proposals have evolved along a more successful path, with governance-oriented proposals doing well in the present context. The authors close with an overview of recent hedge fund activity.

Many attribute the historical ineffectiveness of shareholder activism to the inherited legal institution of the shareholder franchise, which in the US historically has done nothing to facilitate shareholder challenges, at least apart from the SEC provision for non-binding shareholder proposals. In Chapter 3, Lucian Bebchuk subjects the legal regime to critical inspection, asserting that it fails to legitimate the considerable power that the law delegates to the board of directors. Legitimacy, in Bebchuk's view, means adherence to the goal of shareholder value maximization, a goal not forwarded by the prevailing process barriers to shareholder challenges. Bebchuk presents the results of an empirical study of proxy challenges to incumbent directors in the period 1996–2005: twelve challenges per year overall, including three challenges per year at companies with market capitalizations exceeding $200 million, of which only less than one annually results in a victory. Unfavourable process and cost allocation rules are held to be responsible.

Bebchuk would revamp the prevailing legal structure, according the shareholders access to the ballot every other year with expense reimbursement for challengers garnering one-third of the votes cast, along with shareholder access to the bylaws to propose legislation related to election processes. In addition, he would accord the shareholders a periodic right to replace all of the directors, institute a default rule of majority rather than plurality voting, allow 'no' votes, and provide for confidential voting.

Chapter 4 changes the venue to Europe. Peter Cziraki, Luc Renneboog, and Peter G. Szilagyi report on shareholder intervention through the proxy process at European companies, analysing a sample of 290 proposals submitted in nine countries between 1998 and 2008. The regulatory background is quite different from that in the US: immediate adoption of the proxy access provisions in place in a number of European countries would go some distance in satisfying the law reform agenda presented by Bebchuk. In Europe, shareholders who meet specified thresholds have the right to call meetings at which directors can be removed and elected, governance legislation amended, and business plans altered. The door is opened widest in the UK, which accords power to summon a meeting to a 5% shareholder block or, alternatively, to 100 shareholders with at least £100 invested. The UK goes on to extend a corporate subsidy to solicitation. Other countries ask for more, but as the value of a given shareholder's block increases the percentage requirement can drop as low as 1% of shares outstanding; solicitation subsidies are unavailable.

A US observer surveying these European provisions readily might predict a steady flow of challenges to the boards of underperforming companies and activist victories. Cziraki, Renneboog, and Szilagyi confirm that European activists target underperforming firms, particularly those operating under deficient governance regimes. But activity is sporadic and management incumbents tend to win—challenges in the UK average 38.6% of the votes, while challenges on the Continent average only 21.1%. Most challenges arise in the UK (195 to 95) and concern board personnel changes and corporate strategy. Challengers on the Continent tend to focus on governance issues. The stock market reacts negatively to the outcomes. The authors conclude that, in Europe, shareholder interventions serve as 'an emergency brake rather than a steering wheel'.

The US–Europe comparison raises a series of questions. If the shareholder access door were opened in the US would there follow a materially larger volume of challenges along with different outcomes? Perhaps relations between institutional shareholders and managers in UK work differently from those in the US, rendering statutory access relatively less important than would be the case were it available in the US. Perhaps family holdings and stock pyramids on the Continent relegate shareholder intervention to a secondary governance role. Alternatively, perhaps lack of access in the US has become less of a problem in the wake of the rise of hedge fund activism. Part II contains several chapters reporting that the hedge fund activists have had a precedent-smashing run of success at telling US boards what do to. Ironically, the activist success record suggests a defence of the inherited legal model of the shareholder franchise: when a properly incented shareholder does come along, the system allows its voice to register. For some it follows that no law reform is necessary. But for other observers, Bebchuk assuredly among them, the appearance of hedge fund activists only further enhances the case for reform: that it took decades for a properly incented variety of investment institution to appear only proves the case. Meanwhile, activist intervention is not a universal fact of life at listed companies, and questions arise regarding the business model's sustainability.

1.6 Part II—Hedge Fund Activism

Part II takes up hedge fund activism with a series of chapters that describe the funds in question, their strategies, and financial results.

1.7 Patterns and Policy Questions—Dark Sides and Light Sides

All of Part II's chapters, in one or another mode, address the question whether activist attacks hold out negative economic consequences. The lead questioner is the lawyer Martin Lipton, acting in his customary role as head of the management defence team. Says Lipton, 'We have gone from the imperial CEO to the imperial stockholder.' Critics like Lipton ask why, as between a team of managers who have been running a firm for years and an outside activist looking for above-market returns in the current period, the activist's judgement about the best way to run the business should command respect. The activists, they say, survey a target with a bias towards short-term gain, regardless of its future, the interests of its long-term investors, and the productivity of the wider economy. Hedge fund pressure on present and potential targets is thought to negatively constrain investment policy, skewing managers away from promising but difficult-to-value projects towards less promising but more easily valued projects. Where an activist extracts a payout financed by debt, the ongoing cash drain could leave the target vulnerable to distress in the economy's next downturn. Others warn of darker possibilities like lucrative side deals between unscrupulous funds and frightened managers or feigned interventions that create short-term trading opportunities.

Chapter 5 contains Marcel Kahan and Edward Rock's description of activist activity and their answer to the question just posed. They conclude that while hedge funds may not be the perfect embodiment of the long sought solution to the incentive problems of separated ownership and control, there is no basis for predicting an outbreak of short-term opportunism with long-term negative effects for individual firms and the wider economy.

Kahan and Rock begin with a description of hedge fund tactics, distinguishing both the tactics and the situations that trigger intervention from those characteristic of more conventional institutions. They go on to detail the incentive alignments that incline the respective institutions to activism. With conventional mutual funds, collective action problems, conflicts of interest, and investment duration all deter investment in interventionist strategies. The free-rider problem discourages investment managers from incurring the costs of challenges—gains must be shared with competitors who do not share costs. At the same time, many fund advisors sell services to managers, importing an independent business reason to stay cooperative. Finally, mutual fund investors can redeem at any time, inhibiting investment in large, illiquid positions. Public pension funds operate under a different set of constraints, largely political, that choke off financial incentives and constrain activist agendas. Hedge funds face none of these barriers. Their unregulated status frees them of diversification requirements imposed on mutual funds or restrictions on the setting of performance fees. The funds' managers have every reason to be aggressive in realizing value, given the carry of 20% of the profits. Small size and focused strategy minimize conflicts of interest. Finally, the governing investment contracts allow them to lock up capital for longer periods than do the mutual funds.

Kahan and Rock then detail a number of potential conflicts of interest and regulatory issues arising in the course of activist engagement—opportunities for voting manipulation, traversal of the federal securities laws' group disclosure rule, and greenmail. They go on to assay the short-termism charge, concluding that the allegations follow from speculative premises and predicting that operating companies will make appropriate adjustments that will deflect any threat to productivity. New regulation, in short, is not justified.

Chapter 6 follows, with a contrasting overview from John Armour and Brian Cheffins. They describe hedge fund activism as a 'market for corporate influence' and situate it historically, distinguishing today's hedge funds from the bust-up raiders of the 1980s, and detailing structural and secular changes that coalesced to produce a sudden burst of activist engagement in the mid-2000s. Amour and Cheffins look: (1) to the supply side, that is, the presence of profitable opportunities to exercise influence; and (2) to the demand side, that is, the presence of investors willing pursue the opportunities. Supply calls for underperforming or underpriced companies and a conducive legal environment. Demand calls for ready and cheap financing, and low costs, including regulatory costs. The authors show that much necessary stage-setting occurred long before the recent hedge fund surge, with information technology lowering search costs, bid-ask spreads dropping, access to private investment vehicles easing, and the SEC reforming the proxy rules to permit inter-investor communications. Their list of more particular supply side causes includes the post-tech bubble decline in stock prices and a concomitant climate of dissatisfaction within the institutional investor community, along with growing corporate cash accounts. On the demand side, cheap and ready credit both lowered the hedge funds' financing costs and facilitated defensive accommodations by targets.

Amour and Cheffins close with the distressed economic environment of 2008, asking some questions about the future. While depressed stock markets may keep up supply, the demand side suffered a temporary lapse. The disappearance of credit, along with a period of disappointing hedge fund returns plus consequent redemptions at many funds, impaired the sector, contributing to a drop off in activity beginning in mid-2009. But the activist sector, viewed broadly, coped 'tolerably well' with the market turmoil and was rousing itself again by 2010. Amour and Cheffins predict that the activists will retain a prominent place in US corporate governance for the foreseeable future.

1.8 Ownership Stakes, Operating Results, and Financial Returns

Chapter 7 presents an intensive case study of a single, activist fund from Marco Becht, Julian Franks, Colin Mayer, and Stefano Rossi. This work opened up a new era in the history of financial studies of institutional investors, reporting the first substantive evidence showing that activism can result in financial gain. The study focuses on the Hermes UK Focus Fund (HUKFF), a UK pension fund founded as an experiment in shareholder activism. HUKFF was to take positions in underperforming companies in which its parent, Hermes, already had invested through its index fund, taking stakes significantly large to make investment in intervention cost beneficial. Becht *et al.*, taking advantage of access to the funds' records, study HUKFF's positions, tactics, and returns for the period 1998–2004.

The authors focus on the subset of HUKFF investments that involved active engagement with investee companies (30 of 41). The positions' sizes varied depending on the relational posture of the case. Sometimes confrontation resulted, and in those cases the average stake amounted to 6.9% of stock outstanding. Other target managers responded cooperatively; there the average stake amounted to only 3.2%. Whether in confrontational or cooperative mode, HUKFF conducted its engagements in private, concentrating on direct contact with company executives and board members and the company's other institutional holders, and for the most part avoiding proxy solicitations and public announcements.

In twenty-eight of the active cases HUKFF invested with a view to substantial restructuring through the sale of non-core assets and limits on further diversification. The targeted results were achieved most of the time—targeted asset sales occurred in six of ten cases; diversifying acquisitions were blocked in nine out of ten cases; and capital expenditures were contained in six out of seven cases. CEO or chairman replacement showed up on the list of objectives in half of the cases, a result achieved in around three-quarters of that subset. Stepped up payouts were an objective in seventeen cases, a goal achieved at eleven companies. Favourable effects on operating results are reported, with increases in median return on assets and market-to-book. Total assets, and numbers of employees, decline drastically.

Becht *et al.*, show that HUKFF beat the market with raw annual returns of 4.9% (after adjustment for the Financial Times Stock Exchange (FTSE)) and a positive monthly alpha. Sorting out the portion of returns attributable to activist intervention presents a statistical challenge, however. The authors claim 90% causality, noting the novelty of their methodology. The study is not only ground-breaking but prescient. Many of the elements that Becht, Mayer, Franks, and Rossi detail at a single UK fund formed in 1998 later became common to a set of hedge fund investors operating on both sides of the Atlantic. There also would be variations in strategy. Where HUKFF proceeded gently and privately, their hedge fund successors proved rough and used publicity. The two chapters that follow provide intensive analyses of the hedge funds, their approaches, and their results.

In Chapter 8, Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas gather data on activist hedge fund engagements with 882 target companies commenced between 2001 and 2006. The evidence adduced, they claim, justifies a distinctive profile for this new set of activists: they occupy an 'important middle ground' between internal blockholder monitoring and external monitoring by hostile offerors. The hedge funds, they assert, are more flexible, incentivized, and independent than internal blockholders, and, as opposed to corporate raiders, take smaller stakes, benefit from cooperation with management, and have support from other shareholders. Brav, *et al.* make three more particular claims to this end: (1) hedge fund activism is about value creation through agency cost reduction; (2) the activists have succeeded in creating value; and (3) taking the record of success together with the persistence of the agency cost problem, this mode of activist engagement will take a permanent place in the governance picture. There is a subsidiary, negative assertion: hedge fund activism is not about stock picking.

Nor is hedge fund activism necessarily hostile. Brav, *et al.*, characterize only 30% of the engagements in their sample as 'openly hostile', entailing an actual or threatened proxy contest, a takeover threat, litigation, or confrontational public statements. The mode of engagement, note the authors, follows from a tactical decision. Hostility greets perceived management resistance, and entails greater cost.

Brav, *et al.*, profile the set of target companies as value opportunities, combining profitability and sound operating cash flows and return on assets with low market-to-book ratios. The targets tend to be small companies, as such well-suited to the amassing of significant shareholding stakes. At the same time, they have significant trading liquidity and higher institutional ownership than do their comparables, with the latter factor implying the presence of potential supporters in the shareholder population.

The authors go on to detail the market's reaction to public announcements of activist initiation. Positive abnormal returns in the [-20,+20] announcement window lie in the 7% to 8% range, with no reversal over the subsequent year. The returns are sorted according to the activists' stated objectives, with the highest returns (8.54%) accompanying a stated intent to effect sale of the company and the next highest (5.95%) accompanying a stated intent to change business strategy. In contrast, campaigns looking towards debt restructuring, recapitalization, dividend increases, and share repurchases, or alternatively, governance reform, yield positive but insignificant stock price reactions. The authors assert that the price effect reflects expectations of successful activist engagement, and reject the inference that the gains result a stock picking effect—the public revelation of the stock's selection by a respected value investor. To this end, the authors show that public revelation of a passive investment by the same funds has only a marginally lower positive abnormal return. At the same time, hedge fund withdrawal from an engagement triggers a price decline. The targets make significant governance concessions to the hedge funds in about two-thirds of the cases.

The chapter's statistical abstracts offer a concrete picture of the tactical parameters. The median initial stake taken in the target is 6.3%; a stake that grows to a median maximum of 9.1%. Hostile engagements command larger stakes. The median holding period for the engagements in the sample is one year, a result shortened by the necessity of imposing an arbitrary cut-off date on continuing engagements. The implication is that the activists in fact hold for more than one year, rebutting the short-termism allegation made by their detractors. The authors go on to examine operating results at the targets. They focus on payout policy and leverage, consistent with the agency theory focus on the problem of management misuse of free cash flow. Payouts increase on a two-year time frame, beginning one year before the engagement. The increase is 0.3% to 0.5% relative to market capitalization and as against an across-the-board sample mean of 2.2%; leverage increases by 1.3% to 1.4% as against an across-the-board mean of 33.5%. Operating results improve two years after the engagement's commencement, with increases in earnings before interest, taxes, depreciation, and amortization (EBITDA)/assets and EBITDA/sales. The figures, while amounting to early returns, enhance the defensive case.

Although hedge funds make up the most prominent and newsworthy subset of activists in recent years, we see from the study of a special purpose pension fund by Becht, *et al.*, that not all of today's shareholder activists happen to be hedge funds. Individuals, private equity firms, and asset managers also enter the scene. Questions arise: which interventions involve hedge funds and which involve other institutional actors, and does anything distinguish one activist from another?

April Klein and Emanuel Zur address these questions in Chapter 9. They collect two samples for comparison, drawing on filings made between 1 January 2003 and 31 December 2005. The first is comprised of 151 activist campaigns conducted by hedge funds, and the second is comprised of 154 activist campaigns conducted during the same period by actors other than hedge funds. In the second group the entrepreneurs were individuals (including a set of the target firms' former CEOs), private equity and venture capital firms, and asset managers. Having broken the activists into two groups, Klein and Zur show both similarities and differences in their approaches and effects.

As with the sample of Brav, *et al.*, small firms with low market-to-book ratios predominate amongst the targets. Also as in Chapter 8, there are positive abnormal stock returns during the period [-30,+30] surrounding public disclosure of the stock holding—here 10.2% for the hedge fund group and 5.1% for the second group. In contrast to the Brav group's results, however, the gains continue into the engagement's second year—11.4% for the hedge fund group and 17.8% for the non-hedge fund group. Levels of success are comparable—the hedge funds achieve their stated goals within one year in 60% of their engagements (gaining board membership in 31 out of 40 cases), and the other activists in 65% of their engagements (gaining board representation in 35 out of 45 cases). Interestingly, the market anticipates the engagements' eventual outcomes, with higher abnormal returns on filing respecting the targets where the intervention later proves successful.

Differences between the two activist groups open up when Klein and Zur break out target characteristics. Levels of research and development and capital expenditures and dividends are comparable across the two sets of targets. But the hedge funds tend to engage profitable, financially healthy firms, many of which are cash rich. They then demand share buy-backs or dividend increases and tend to get them—the targets on average double their dividends, increase their debt ratios, and decrease their cash and cash equivalents. The non-hedge fund activist group, in contrast, focuses on investment policy and operating strategies, the targets responding by reducing research and development and capital expenditures.

Klein and Zur associate levels of success with the level of aggression displayed in the activist's initial public filing, terming as aggressive demands for changes in the board, CEO firing, CEO salary cuts, termination of a merger, initiation of sale of the firm, dividend payments, and shareholder repurchases.

Finally, Klein and Zur collect operating data on the target companies one year after the engagement's commencement. They find no evidence of increased profitability at the hedge fund or other activist targets, measured as EBITDA/assets and cash flows from operations. Indeed, relative to comparable firms, the targets' EBITDA/assets and cash flows from operations, and cash balances, show statistically significant declines.

Overall, Klein and Zur offer a somewhat darker picture of hedge fund activism than do Brav *et al.* Even so, there is no direct conflict in the results—the positive operating returns reported by Brav *et al.*, show up only on a two-year time frame, compared to Klein and Zur's one-year analysis.

The empirical results collected in these chapters support a number of generalizations. First, an activist posture in a hostile case presupposes a 6% to 10% stake in the target. Second, investment durations do not tend to be short, even as the need to liquidate investments precludes investment for an indefinite, patient term. Third, stock prices react favourably to activist intervention. Fourth, activist investors, thus situated and armed with the threat of an open proxy contest, extract significant concessions from managers. Fifth, and more tentatively, approaches to targets differ across the Atlantic. In the UK the relational environment favours quiet, private communication. In the US, in contrast, loud voices and publicity prevail. Sixth, economic results range from 'highly favourable' to the activists to 'mixed'.

An additional generalization can be supported if we make reference to some additional results from Alon Brav, Wei Jiang, and Hyunseob Kim: the case for the hedge funds improves as more data accumulate. Brav, Jiang, and Kim (2012) report on 1,927 fund-target pairs formed from 1994 to 2007 and follow the longer-term average returns of the targets. They show that not only do target stock prices bump up once the engagement is made public, but that the stock prices stay up, failing to revert to pre-engagement levels for up to three years. This is argued to refute the claim that the stock market overreacts to news of activist intervention and to imply that long-term shareholder value is created. Brav, Jiang, and Kim (2013) also have gathered data on the targets' return on assets. They find that target companies outperform their industries three years prior to activist engagement, that target performance declines to underperformance by the time of engagement, and that target performance returns to the positive side in the three years following intervention. Drawing on US census data, the authors make similar findings respecting the productivity of the target companies' plants, and of plants sold by target companies in the wake of activist intervention. They conclude that hedge fund activism is not a 'purely financial' phenomenon. That is, activist impact is not just a function of balance sheet leverage and cash in the till; positive productivity effects occur also.

Summing up, the empirical studies strongly suggest (even if they fall short of proving) that hedge fund activism will have a permanent place in the corporate landscape. We also note that there emerges little concrete support for the 'dark side' possibilities highlighted by Kahan and Rock. Even so, the 'dark side' questions continue to come up. The two chapters that follow pick up a prominent line of such questions, exploring the problem of strategic voting.

1.9 Strategic Holding versus Collective Interest: Empty Voting and Bankruptcy Reorganization

Hedge funds are highly strategic about their shareholding, sometimes seeking to effect specific outcomes in the short or intermediate term, and deploying (or avoiding deployment of) the shareholder franchise as a means to the end. It is not always apparent that the activist hedge fund's interest is well aligned with those of the shareholders as a group. Misalignment is particularly likely when a hedge fund takes advantage of technical opportunities to separate the power to vote the stock from the underlying economic interest in the stock. In Chapter 10, Henry Hu and Bernard Black take up salient incidences of this, the problem they term 'empty voting'.

Let us illustrate the problem with the story of activist shareholder Carl Icahn's intervention against Mylan Laboratories' announced acquisition of King Pharmaceuticals in 2004. The deal valued King at $16.66 per share, a generous 61.8% premium over its pre-announcement price. Too generous, thought traders in Mylan stock, leading to the stock promptly dropping from $18.51 to $15.51. But the stock had at least one buyer on the announcement day, Icahn, who purchased 1 million shares. He continued buying over the next six weeks, investing $307 million and finally revealing himself as the owner of 6.8% of the company in a public filing. He simultaneously denounced the deal as an overpriced acquisition of a weak company and announced his intention to mount a proxy fight against it at the shareholders' meeting to be convened for its approval. Mylan eventually mooted the matter by terminating the merger agreement, citing adverse facts discovered in the due diligence process. Meanwhile, Icahn's frontal attack on the merger put him at odds with other Wall Street players making the more conventional 'risk arbitrage' move of buying shares of the target (so as to benefit from any increase in the merger price) and simultaneously selling shares of the acquirer short (so as to benefit from any further decline in its price due to the merger). Richard C. Perry, a hedge fund manager and risk arbitrage player, did just that in Mylan's case, but with a twist. Wishing to protect the merger (and thus his investment) he purchased Mylan stock in an amount matching his short position, thereby gaining control of 10% of the votes at the upcoming meeting. Icahn called a foul on the ground that Perry's long/short position left him without an economic interest in Mylan. It followed, said Icahn, that Perry, despite his record ownership, should not have the privilege to vote the shares. Icahn sued, but the merger's cancellation mooted the matter.

Perry, with its long/short position, was positioned to vote 10% of Mylan's shares in favour of a merger when it had no economic stakes in Mylan and, as a long holder of King, had every interest in Mylan overpaying. The proliferation of equity derivatives makes it easier and cheaper to decouple the equity interest from the vote in this way. Alternatively, an actor can have an economic interest in a stock and lack the votes, but have the means to access the votes as needed. Hu and Black term this a 'hidden (morphable) voting interest'. We can illustrate with another Richard Perry incident. Perry used equity swaps to acquire a 16% economic interest in a New Zealand firm, Rubicon, Ltd, circumventing New Zealand's blockholder disclosure rule in so doing. As a swap counterparty, however, Perry had no votes. But when Perry needed voting rights at a Rubicon shareholders meeting, he unwound the swaps and caused the swap dealers to convey to him the Rubicon shares they had held to hedge their short swap positions.

Hu and Black note that the scale of this new vote buying is unknown due the lack of effective disclosure rules but compile a list of over ninety examples, most of them occurring in recent years and many involving hedge funds. They argue that disclosure rules need to be substantially revised so as to be adequate to the task of dealing with the problem described, picking up economic as well as voting interests in stock, treating short positions symmetrically with long positions, and exposing all cases of vote buying. They also would completely deny voting rights to shareholders with negative overall economic interest and would allow companies to amend their charters to address the voting rights of those whose economic interest in the company is compromised.

Hu and Black extend their discussion of voting distortions to the debtor–creditor context. Creditors also vote, particularly creditors of distressed borrowers called on to approve out-of-court restructurings or bankruptcy reorganization plans. Credit default swaps and other credit derivatives permit formal ownership of debt claims to be decoupled from economic exposure to the risk of default or credit deterioration. Yet formal ownership usually still conveys control rights under the debt contract. Incentives can become misaligned as a result. Where, for example, a given creditor buys protection under a credit default swap in a notional amount equal to or greater than the principal amount of debt held directly, it has an incentive to vote against a pre-bankruptcy composition that benefits the issuer and the creditors as a whole. The reason is that blocking the composition can force the borrower into bankruptcy so as to trigger full payment under the swap. Hu and Black contend that securitization of debt claims also decouples economic risk from contractual control rights and bankruptcy rights, and that widespread uncoupling can increase systemic risk across the overall economy.

In Chapter 11 Douglas Baird and Robert Rasmussen deepen and extend this picture of creditor incentive misalignment, discussing problems stemming from the strategic activities of the subset of hedge funds that specialize in distressed debt. Hedge funds have long been major, aggressive investors in the debt markets, specializing in arbitrage activity respecting distressed issues. Indeed, it is in the debt markets that hedge funds made their first appearance as activist holders of interests in corporations two decades ago. There were immediate benefits. As the hedge funds became major market players, debt claims became more liquid. Syndicated loans now trade freely in a secondary market. Bankruptcy claims trade freely as well. Liquidity also has enabled hedge funds to become leading, sometimes outcome-determinative, players in negotiations respecting work outs and bankruptcy reorganizations.

Baird and Rasmussen describe the stresses and strains that result for the scheme of bankruptcy reorganization in the US, a system designed on the assumption that stable creditor groups coalesce around identifiable and common interests. Things work differently in a liquid world populated by strategic hedge funds acting free of the reputational constraints imposed on primary lenders. Major creditors now can come and go quickly, disrupting the committee representation system. Control acquisition schemes often drive these transactions—the hedge fund buys bankruptcy claims (and hence votes) with a view to manoeuvring itself into control of the post-reorganization entity. When such a strategically minded hedge fund shows up, the bargaining process can be disrupted and distorted. For example, a hedge fund seeking control does not necessarily bargain for an outcome that maximizes returns to all creditors. Control comes cheaper with a low valuation of the bankrupt firm, leading to an alliance between the hedge fund and the firm's managers against the interests of the classes of creditors. Alternatively, a hedge fund might be motivated by an interest in a competing company.

Voting strategies matter in the new liquid world. A hedge fund without votes sufficient to dictate its favoured result may still have enough votes to block a reorganization plan. Indeed, hedge funds key their purchases of distressed claims with an eye to consequences respecting voting outcomes. They also form informal groups for the purpose of coordinating their votes, moving by stealth. Similar gaming occurs in votes on out-of-bankruptcy compositions, where the proliferation of credit derivatives complicates things further.

Baird and Rasmussen term all of this the 'anti-commons problem'. In their view, more good than harm results from the new instruments and markets. But bankruptcy judges will inevitably be presented with cases where strategic behaviour by hedge funds invites discretionary sanction. Baird and Rasmussen counsel caution at this point. In contrast to Hu and Black, they recommend mandated transparency over outright invalidation of votes.

Chapter 12 provides empirical backup for the cautious approach taken by Baird and Rasmussen. Indeed, it provides a basis for concluding that the problems associated with the strategic actions of hedge fund creditors have been somewhat overstated. Here Wei Jiang, Kai Li, and Wei Wang report on their examination of hedge fund participation in 474 Chapter 11 cases from the period 1996 to 2007. The hedge funds prove ubiquitous, with observable involvement in 90% of the proceedings. More importantly, they take strategic positions with positive productive implications.

Jiang, Li, and Wang depict Chapter 11 reorganization as a field of conflict between two opposing groups. On one side stands the historical power holders—incumbent managers and by implication the pre-bankruptcy shareholders. On the other side stand the newly empowered creditors—banks holding secured claims, whether as pre-bankruptcy secured lenders or post-bankruptcy DIP lenders. In contrast to the banks, the hedge funds buy unsecured claims. Unsecured claims stand in the priority ladder between those of the more empowered interests, and, significantly, can import a more productive incentive posture than either as regards deployment of the debtor's assets. To the extent that the property under the secured creditors' liens amply covers the dollar amount of their claims, their incentives are compromised—as, between a suboptimal liquidation that certainly covers the amount of their claims and a value-maximizing reorganization as a going concern, they rationally choose the former. The performance of incumbent management, meanwhile, needs to be appraised by an appropriately incentivized claimant. Enter a hedge fund seeking a 'fulcrum' position in unsecured debt—a claim that will lead to a controlling interest in the common stock of the post-reorganization going concern. Arguably, it has high-powered incentive to maximize the firm's value, higher than any other claimant with a seat at the table.

Jiang, Li, and Wang provide a great deal of indirect support for the above picture of Chapter 11. They show that hedge funds target bankrupt companies in which unsecured creditors are likely to emerge in a control position. Given a hedge fund holding a large unsecured claim, the incumbents are more likely to lose their exclusive right to propose a plan of reorganization, the post of CEO is more likely to turn over, a key employee retention plan is more likely to be adopted, the entity is more likely to emerge from Chapter 11, and the proceeding more likely to result in payoffs to junior creditors. There is also evidence of efficiency gains: higher total recovery by all debt claimants and a more positive stock market performance at the time of filing.

We close noting that the chapters in Part II leave the hedge funds with a mixed scorecard. Interestingly, the strongest confirmations come from the empirical studies of financial economists. The most pointed questions come from legal academics citing anecdotal evidence.

1.10 Part III Private Equity and Corporate Governance

Part III looks at the structure and development of the private equity sector, including transactional motivations, performance drivers, fund returns, and exit opportunities.

1.11 Structure and Motivation

Private equity funds are usually structured as limited partnerships, with the private equity firm as general partner and the limited partners comprised of pension funds, insurance companies, hedge funds, other investment institutions, and wealthy individuals. The limited partnership form allows both the internal and external participants to use contracts to reduce opportunism and agency costs. The private equity firm, as general partner, uses the limited partnership agreement to achieve extensive control over operations subject to few intrusive legal obligations. Other features, such as tax benefits, flexibility respecting structure and terms, and fixed life, also contribute to the limited partnership's continuing dominance as the business form of choice for collective investment vehicles.

The relationship between the limited partners and the general partners tends to follow from explicit contract terms. The capital comes from the limited partners—the private equity firm typically invests only between 1% to 3% of the private equity fund's total committed capital. Table 1.1 shows the most common contractual measures developed for dealing with the investment activities of general partners, and the relationship between general and limited partners.

Table 1.1 Limited partnership agreement: negotiating the terms

General partners	Limited partners
Carry calculations	Carry calculations
Management fees	Clawback provisions
Clawback provisions	General partner conflict issues, including limitations of opportunities
General partner capital commitment	Key-man provisions
Limitations of liability	Management fees
Indemnification by general and limited partners	General partner capital commitment
Investment strategy, limitations, and guidelines	Side letters
Fundraising period, investment period, and term	Investment strategy, limitations, and guidelines
Permitted activities of general partners	Permitted activities of general partners
Limited partner approval rights	Portfolio company fee offsets

The compensation arrangement between the general partner/fund manager and the limited partner/investors is the critical provision in the contract. Compensation derives from two main sources. First, fund managers typically receive 20% of the profits generated by each of the funds. The second source is the management fee. Historically, a significant majority of funds assessed management fees as a constant percentage of committed capital. But management fees have decreased in recent years due to a number of economic factors. More particularly, some funds now receive a fixed fee of 2% of the fund's assets paid annually for the first five years with the fee thereafter decreasing by 25 basis points yearly for the next five years. Other contracts reduce the fixed fee based on a shift from a base in committed capital in years 1–5 to net invested capital in years 6–10. Given these changes, a substantial proportion of buyout firms' median off-the-top draw of committed capital has been reduced to 12% (Metrick and Yashida 2009). Some contracts also limit access to the carry, imposing hurdle rates that climb upwards to 15%–20%, which must be met before any profits are distributed. Finally, in order to protect the 80/20 deal, a clawback provision will be included in the agreement, that is, an over-distribution to a general partner will be clawed back to the fund and then distributed to the limited partners.

Agency cost reduction is held to be the primary motivation for buyouts. For the classic account, one looks to the agency story that accompanied the buyout's first rise during the 1980s. The story followed from Michael Jensen's (1988) description of suboptimal management performance and correction through capital market intervention. For Jensen, the 1980s outbreak of manager–shareholder conflict stemmed from the managers' habit of reinvesting more corporate cash flow than necessary to fund positive return investments, termed 'free cash flow'. Managers retained profits that should have been paid out to the shareholders and put them into unproductive plant and value-reducing acquisitions. Hostile takeovers and friendly leveraged buyouts were said to address the problem. Both paid shareholders a premium over market, in effect making up for past deprivations of cash flow. They then led to divestment of subpar acquisitions and redirection of investment policy in productive directions. Leverage also played a part in this disciplinary redirection of corporate focus. A higher level of corporate borrowing raised the rate of return on the equity even as it lowered the corporation's overall cost of capital due to tax savings. More debt also encouraged management discipline on a going-concern basis. Given the mandatory nature of the debt payments, they deterred ongoing waste of cash, returning the capital to the markets.

Jensen (1999) took the governance and capital structure of the buyout as an agency solution to separated ownership and control, suggesting that the 'LBO Association', with its combination of high leverage, control in the hands of market intermediaries, and high-powered incentives for managers, amounted to a robust one-size-fits-all mode of governance. But the buyouts' disappearance in the early 1990s put an end to the claim of early, levered disappearance for the Berle and Means corporation and the separation of ownership and control. At no time since has high leverage been seen as suited to a permanent place in corporate capital structures or as the sine qua non of shareholder value maximization.

The buyout retained its prestige in agency theory even as new going private deals disappeared. This stemmed partly from the attribution of the early 1990s shift away from leverage to regulatory constraints on institutional investors, a point that had some validity so far as risky lending by regulated institutions like savings banks and insurance companies was concerned. The continued vitality of the shareholder value norm and its dispersion into management suites also played a role. Empirical studies also offered support. These looked at the 1980s deals from various points of view and confirmed the story of governance improvement. The increased leverage and incentive realignment was shown to positively affect operating performance and productivity. There was evidence of increased sales and cash flows, decreased expenditures, improved margins, and reduced capital requirements.

In Chapter 13, Steven N. Kaplan and Per Strömberg offer an overview of the private equity sector as we know it today, describing its cycles over time and evaluating its performance. They begin with the structure of the buyout firms and then turn to the terms of the typical leveraged buyout transaction. They go on to present evidence respecting the evolution of private equity fundraising and transaction characteristics. In the first phase, during the 1980s, most targets were relatively large companies in mature industries like manufacturing and retail, with going private transactions accounting for almost half of transactional value. The junk bond bust brought not only substantial contraction in transaction value but a shift of target characteristics. 'Middle-market' buyouts of non-publicly traded firms came to account for the bulk of private equity transactions, with activity extending to industries such as information8 technology, telecommunications, financial services, and health care. The resurgence that began in the mid-1990s brought going private deals back into the mix to dominate at the recent peak. Activity also went global. Kaplan and Strömberg complete their picture with a survey of exit practices, showing a median holding period of six years, with 38% of exits achieved by sale to a strategic buyer, 24% by sale to another private equity fund ('secondary leveraged buyouts'), 14% by a public stock offering, and 6% in bankruptcy.

Kaplan and Strömberg also consider the effects of private equity, gathering evidence on its impact on capital structure, management incentives, and corporate governance. The evidence suggests that private equity activity creates economic value on average. But there is also evidence consistent with private equity investors taking advantage of market timing (and market mispricing) between debt and equity markets, particularly in the public-to-private transactions of the last fifteen years.

Finally, Kaplan and Strömberg review empirical evidence on performance and returns to private equity at the fund level. They show that private equity activity experiences recurring boom and bust cycles related both to past returns and the level of interest rates relative to earnings. They predict that while the recent market boom will eventually lead to some defaults and investor losses, the magnitude is likely to be less severe than after the 1980s boom because capital structures are less fragile and private equity firms are more sophisticated. They accordingly expect that a significant part of the growth in private equity activity and institutions is permanent.

Kaplan and Strömberg's prediction has turned out to be correct, at least as of 2013. Observers during the financial crisis looked at the capital structures of the bulge of buyouts that had closed through 2007 and noted a maturity wall. Bank borrowings were going to come due, and given the disappearance of liquidity and collapse of the market for going concern assets, private equity owners had no apparent means to pay them down. The maturity dates, however, came and went without a wave of bankruptcies. Where maturity occurred but takeout credit was unavailable, the portfolio companies and banks effected out of court compositions

1.12 How Has Private Equity Performed?

We now turn to attempts to benchmark the performance of private equity funds.

There is an issue about measurement. Even though private equity funds disclose soft information to investors about current returns, it is often difficult to obtain accurate hard information due to long durations, the absence of public trading, and, until recently, the lack of a legal obligation to disclose to a central data repository. Most financial economists accordingly rely on databases collected from voluntary reports of private equity investors rather than reports of private equity firms.

There are two leading measures of fund manager performance, internal rate of return (IRR) and public market equivalent (PME). The latter is a ratio of the present value of all cash distributions (including undistributed assets taken on book value) over the present values of all drawdowns using the year by year realized return of S&P 500 as the discount rate. A PME less than 1 means that the fund investor would have been better off putting capital in the market index.

In a path-breaking study, Stephen Kaplan and Annette Schoar (2006) analysed the returns of 169 buyout funds that were close to fully liquidated during the period 1980 to 2001.[1] They benchmarked performance using the IRR of the funds calculated by Venture Economics and their own calculation of the funds' PMEs. Kaplan and Schoar broke the results down into two time periods to show that both PMEs and IRRs were better for funds raised in the early 1980s and poorer for funds raised in the early 1990s. They showed average PMEs for buyout funds of 0.93. Further, they find that the average returns net of fees (for buyout funds taken together with venture capital funds in the sample) of 0.96 (equal-weighted) and 1.05 (value-weighted). Kaplan and Schoar also found that the performance net of fees depended on a range of factors including fund size, fund sequence, past performance, and public market returns during the investment phase of the fund's life.

The Kaplan and Schoar study's overall message was negative: it seemed that private equity was not the bonanza that institutional portfolio managers assumed it to be and that the private equity industry's own reports of extraordinary IRRs were unreliable. But other studies showed different results (see Robinson and Sensoy 2011; Higson and Stücke 2012). In a recent study, Harris, Jenkinson, and Kaplan (2013) make reference to different and larger databases, reversing the results of Kaplan and Schoar and attributing the earlier results to shortcomings in the earlier database. The new data, from Burgiss, pick up cash flows from nearly 1,400 private equity funds as reported by 200 institutional investors. The study finds that, since 1984, most US buyout fund have beaten the market. The net-of-fees PME outperformance versus the S&P 500 averages 20% to 27% over the life of the fund and more than 3% per year. Furthermore, the study finds that within a given vintage year, a fund's PMEs are reliably predicted by its multiple of invested capital and IRR. The substitution of other benchmarks, such as the (small-cap) Russell 2000, leads to lower but still positive results,

Dispute over private equity returns persists, however. In Chapter 14, Ludovic Phalippou questions the recent results. The results follow, he notes, from analysis of proprietary data. But he replicates the results of Harris, Jenkinson, and Kaplan by reference to a publicly available data source, yielding mean (median) PMEs of 1.20 (1.13) using the S&P 500 as a benchmark. The critical response commences at this point: Phalippou9 stresses that the outcome depends on the choice of benchmark. He argues that private equity targets being largely small-cap companies, a small-cap benchmark should follow. He employs the DFA micro-cap, an unlevered small-cap mutual fund. As a result, the PMEs drop to 1.04 (0.99), with similar results following

[1] A caveat respecting these studies needs to be entered: here, as with many empirical studies of private equity, the data set sweeps in venture capital funds as well as buyout funds, breaking out the numbers separately.

benchmarking directly to the Fama–French small cap index. The implication is that the market beating results found in other studies follow not from actual performance but from the Fama–French equity size premium.

Significantly, Phalippou makes no claim to employment of the ‘correct’ benchmark. His point instead is that correctness is hard to determine and that the only thing that is very clear is that results are highly sensitive to the choice. It follows that the bottom line question as to the competiveness of private equity returns remains open and debatable.

1.13 Part IV—The Regulatory Framework

Part IV takes up regulation, where issues emerge in sharp relief as new initiatives change the landscape in the wake of the financial crisis of 2008. There are two tranches of materials. Part IV’s first three chapters look at the treatment of hedge funds and private equity funds under legal regimes worldwide that promote investor protection and the safety and soundness of financial institutions. There follow two chapters on recent developments and controversies under US securities law that impact directly on the costs and benefits of shareholder activism. The final chapter offers a retrospective overview, suggesting that corporate governance world’s law reform agendas need adjusting in the wake of the activist sector’s appearance on the scene.

1.14 Structural Treatment of Hedge Funds and Private Equity: Investor Protection and Systemic Risk

We begin with global survey of regulation conducted during the years preceding 2008. In Chapter 15, Douglas Cumming, Na Dai, and Sofia Johan describe a series of studies of hedge fund regulation in twenty-four countries. The studies inquire into regulation’s impact on the structure and performance of 2,137 investment entities. The presentation is eye-opening, for it negates the widespread notion that hedge funds were an ‘unregulated’ sector prior to the financial crisis. The notion does turn out to have been correct as regards the US. But, viewed comparatively, the US stands out as an unregulated environment, having (briefly) required registration in 2006, but otherwise prior to the financial crisis having imposed only insider trading constraints. Meanwhile, in other countries investor protection concerns brought hedge funds inside the regulated fold. Some countries subject hedge funds to minimum capital requirements. Some countries also bar hedge fund access to foreign-based service providers, an economically important restriction in a sector of small shops that rely on outsourcing. In addition, some countries impose marketing restrictions, in contrast to the US where hedge funds go to market as unregulated private placements. Under the restrictions, a hedge fund must be marketed in a package (a 'wrapper') with the offering materials for its sponsor's fund, opening up a conflict of interest between the sponsor and the hedge fund managers.

The authors find little support for the common notion that hedge funds thrive only in unregulated environments and can be expected to gravitate geographically to unregulated comfort zones. Hedge fund managers pursuing riskier strategies or strategies otherwise holding out more pronounced agency problems do not systematically select jurisdictions with less stringent regulations. If anything, the data indicate the contrary, with potentially problematic funds more likely to operate under stringent regulation. Investor-protective regulations like minimum capital requirements are associated with higher levels of hedge fund capital inflows and better-quality informational reports. At the same time, not all regulation encourages hedge fund activity: constraints on choice of service provider dampen investment, presumably because they potentially constrain the quality of human resources. From all of this it follows that regulation plays an important role in influencing the size and stability of the hedge fund market, and the inquiry is not a simple one of plus (regulation) and minus (deregulation) or minus (regulation) and plus (deregulation) but of avoiding both under- and overregulation.

Our pre-2008 comparative inquiry thus highlights notable differences in regulatory outcome between the US and the EU. Differences persist in the wake of substantial regulatory reforms enacted since 2008. The US, under the Dodd-Frank Act of 2010,[2] now imposes substantial informational reporting requirements on hedge funds and private equity funds towards the end of collecting information regarding systemic risk. But it remains unclear whether Dodd-Frank's accompanying regime of substantive systemic risk regulation will ever extend to the sector. Even if an extension eventually occurs, it seems highly unlikely that more than a few large funds would be impacted. The EU, in contrast, has instituted an exhaustive new regime, the Alternative Investment Funds Managers (AIFM) Directive, covering all significant hedge and private equity funds. The Directive not only mandates a full range of investor protection measures but extends also to regulation of risky investments and capital structures.

Dodd–Frank's new registration and reporting requirements cover all hedge funds and private equity funds whose assets under management exceed a modest threshold. The stated purpose is the facilitation of data collection that would permit the new Financial Stability Oversight Council (FSOC)[3] to assess the funds' potential for generating systemic risk. The new reporting

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, H.R. 4173.

[3] Dodd-Frank Act, §§ 112–15.

requirements are intended to generate data to enable to the FSOC to make the relevant determinations, potentially bringing hedge funds and private equity funds into the regulated tent as systemically significant financial institutions (SIFIs). The determination process remains at an early stage, so for now the reporting requirements are the one clear thing that Dodd-Frank holds out for hedge funds and private equity.

Dodd Frank's Title IV[4] requires investment advisers to private funds (including private equity funds and hedge funds) to register as such with the SEC.[5] A long list of new regulations follows.

- Registered investment advisers are required to adopt and implement written policies and compliance procedures and designate a chief compliance officer to administer its compliance policies and procedures.
- Extensive record-keeping requirements covering both advisers and funds are to be monitored by the SEC through both routine and 'for cause' inspections. The reporting requirements are designed to allow the SEC to collect proprietary information concerning leverage, counterparty credit risk exposure, trading and investment positions, valuation policies and practices, and side letters.
- The SEC will be permitted to require the disclosure of the identities of an adviser's clients and related client information for the purpose of systemic risk assessment. The information will be shared with the FSOC for the purpose of assessing systemic risk and with other federal regulators and self-regulatory organizations upon request, subject to certain conditions to protect confidentiality.
- There will be regulation of sales materials, relationships with solicitors, and custody of client assets. In addition, adviser must adopt each of (1) an ethics code; (2) a proxy voting policy; and (3) a business continuity plan.

It does not appear that any of these regulations threaten the business models of hedge funds or private equity funds. The required disclosure of propriety information is the most invasive of the new provisions. If the Act's confidentiality assurance turns out to be effective, then the

4 Dodd–Frank Act §§ 401–16.

5 Under Dodd–Frank § 402(a), 'private fund' is defined as an investment vehicle relying on one of the so-called private fund exemptions under the Investment Company Act of 1940: Section 3(c)(1) (privately offered funds with fewer than 100 investors) or Section 3(c)(7) (privately offered funds for which all of the investors are qualified purchasers).

private investment sector could emerge with an added cost burden but otherwise unimpaired. Early returns from empirical studies are mixed, however. Where one study finds a short-term positive impact on hedge fund performance from Dodd-Frank implementation (Kaal 2014), another takes a longer time period and associates Dodd-Frank implementation with lower alphas, lower information ratios, and higher risks, also detecting capital outflow (Cumming, Dai and Johan 2015).

That said, the FSOC is indeed inquiring into systemic risk creation in the non-bank financial sector towards the end of imposing new regulation on non-bank financials that make significant systemic risk contributions. Regulations under Dodd-Frank allow the FSOC to differentiate among companies that are potentially subject to heightened prudential standards on an individual basis or by category. The FSOC has authority to name any predominantly financial company that could 'pose a significant threat to U.S. financial stability', but the FSOC has narrowed by regulation the category of subject companies to those with more than $50 billion in assets and either $30 billion in credit default swaps, $3.5 billion in derivatives liability, $20 billion in total debt outstanding, 15-to-1 leverage ratio or a 10% ratio of short-term debt to assets. The FSOC has estimated that fifty companies might fall into this scheme of classification, and presently is in the process of identifying and examining them. At this stage, the FSOC's process has led to the identification and designation of three companies: two large insurers, Prudential and AIG, and General Electric's massive financial subsidiary, GE Capital. As of this writing, Prudential has appealed its designation.

A positive determination brings the SIFI appellation and subjection to bank regulatory capital and leverage requirements, a formal liquidity standard, a single counterparty exposure standard set at 25% of capital and surplus, process requirements respecting risk management, periodic stress testing, and remediation actions in the event of distress.

Treatment of large hedge fund advisors and private equity firms remains an open question. As asset management firms, their structures and risk profiles differ materially from those of companies like Prudential and GE Capital, which own their risky assets (and finance them with risky capital structures) rather than manage them on behalf of others. Asset management companies themselves own few assets and do not rely heavily on leverage to finance them. The FSOC has acknowledged this difference. But, in an October 2013 report, the FSOC also assets that the activities of asset management firms implicate vulnerabilities that could 'pose, amplify, or transmit threats to financial stability'. It has commenced a review of the status of two of the largest asset managers: BlackRock Inc. and Fidelity Investments.

Dodd-Frank, then, puts hedge funds and private equity funds into a new class of reporting companies but withholds substantive regulation pending a finding respecting each fund's contribution to systemic risk. If it emerges that a fund (or collection of funds) as a practical matter operates like a big bank, then the fund ultimately can be regulated as such.

The EU, with its AIFM Directive, is taking the converse approach. The Directive also puts hedge funds and private equity funds into a new class of reporting companies, but lays down prudential regulation in tandem. In other words, in the EU hedge funds and private equity funds are treated like banks whether or not they perform a bank-like function in the wider economy.

The AIFM Directive harmonizes requirements for intermediaries that manage and administer alternative investment funds (AIFs) in the EU. AIFs are defined negatively to include collective investment schemes not requiring authorization under the EU's Collective Investments in Transferable Securities Directive. The definition picks up hedge funds and private equity funds, among others, but does exempt venture capital funds pursuant to a *de minimis* exception. The Directive contemplates that each subject fund will register in a home member state; home state authorization will then serve the fund manager as a regulatory passport authorizing it to advise and market funds throughout the EU. Registration and compliance is also required of AIFMs from outside of the EU that seek to market funds within.

Once registered and authorized, the AIFM is subject to requirements respecting its conduct of business and governance, in particular its risk management, with requirements covering liquidity risk and including periodic stress testing. There is also a modest minimum capital requirement. Disclosure mandates are included, with an emphasis on liquidity management. Investors and regulators are not the only disclosure recipients: if an AIFM acquires a controlling interest in an EU company exceeding a stated size threshold, it must make prescribed disclosures to the company and its shareholders and employees.

The Directive's investor protection provisions do not stop with mandated disclosure. Third party protectors also are contemplated: the AIFM must appoint an independent appraiser for an annual valuation of assets under management and securities issued. A third party depository is also required. This must be a credit institution with a registered office within the EU. It acts as recipient for capital raised from investors and, on a going-concern basis, as the safekeeper of the AIFM's portfolio assets.

Dan Awrey takes a critical look at the AIFM Directive in Chapter 16. Awrey explains the Directive in political terms as a European challenge to the heretofore dominant Anglo-Saxon mode of market regulation. But, for Awrey, what might make sense politically to some observers does not make sense as public policy. The Directive ring-fences and defines a capacious class of financial institutions, applying a set of rules on a one-size-fits-all basis despite manifest differences within the class. The fit is particularly bad in the case of private equity. Meanwhile, the Directive's proponents have not made a persuasive case for its superiority to existing national-level regimes of investor protection. Nor, as a unilateral initiative, does the Directive amount to an effective measure of systemic risk regulation.

In Chapter 17, Joseph McCahery and Erik Vermeulen take a look at the AIFM Directive in connection with private equity fundraising in the EU, which is now recovering after a steep decline that began in 2008. The chapter asks two prospective questions. First, what can be done to increase investors' interest in private equity while at the same time increasing the responsibility of private equity managers? Second, does the AIFM make a positive contribution to increasing investor interest and management responsibility? The regulation's proponents argue that the AIFM label will not only help reduce uncertainty and information asymmetry in the industry, but also provide an international stamp of quality. If they are correct, institutional and other investors will be more inclined to invest again in private equity. McCahery and Vermeulen question this position, predicting that the AIFM label will amount to little more than a 'boilerplate' formality to be observed in future fundraising. Most private equity funds have already taken measures to deal with the new requirements, either by enhancing their back office capacity or outsourcing their compliance units to specialized consultants.

McCahery and Vermeulen point out that the more important changes regarding private equity fundraising are occurring in contracting rather than in regulation. They show that investors are demanding changes in private equity limited partnership agreements, getting more investor-favourable compensation terms and conditions. The old 'two and twenty' compensation arrangements are giving way to scale down provisions and preferred returns. Private equity limited partners also are getting more control over the funds' investment decisions. Finally, private equity general partners now contribute more equity capital than did during the pre-crisis boom, better aligning the fund managers' interests with those of their investors. The appearance of these new limited partnership terms can largely be attributed to post-crisis problems in private equity fundraising and returns. Private equity managers have been forced to make concessions.

McCahery and Vermeulen conclude that these changes will better protect investors and have a more positive impact on the private equity industry than the need to comply with the cumbersome AIFMD rules.

1.15 Regulation and the Costs and Benefits of Shareholder Activism

In recent years, three topics have emerged as regulatory focal points for proponents and opponents of shareholder activism in the US—proxy access under section 14 of the Securities

Exchange Act of 1934 (34 Act), reporting requirements under section 13(d) of the same statute, and poison pills incorporating novel constraints on stock purchases by activists conducting proxy contests. The first topic, proxy access, poses the question whether the SEC can make a positive contribution to corporate governance by substantially amending its proxy rules to facilitate activist challenges to incumbent boards of directors. In Chapter 18, Jill Fisch addresses this question, suggesting that the goal of governance enhancement would be better served by SEC withdrawal from the field in favour of contractual solutions determined pursuant to state corporate law. The latter two topics pose the converse question of whether existing regulatory structures should be altered in order to discourage activist intervention. In Chapter 19, Lucian Bebchuk and Robert Jackson examine proposed changes to reporting requirements under section 13(d), making a case for the regulatory status quo towards the end of protecting the financial incentives of hedge fund activists. In contrast, in Chapter 20, John Coffee defends new modes of drafting poison pills that raise the bar against activist intervention.

1.15.1 Proxy Access

Proxy access would permit qualifying shareholders to include their own nominees for the board of directors in management's proxy statement at corporate expense. In the US it amounts to a sort of Holy Grail of shareholder rights, and the SEC has proposed proxy access rules on repeated occasions. One such proposal was mooted by the SEC in 2009. But business interests undertook to challenge the proposal in court on the ground, among others, that proxy access was not included in the SEC's grant of regulatory authority in section 14 of the 34 Act. The agency delayed promulgation until it received a supplemental grant of rulemaking authority in the Dodd-Frank Act.[6] The SEC thereupon went ahead with a rule requiring proxy access for candidates taking up to 25% of the seats on a given board of directors. The rule threw up a strict qualification requirement—the shareholder or group of shareholders proposing a candidate must have held 3% of the company's shares outstanding for a three-year period.[7] As a practical matter, only coalitions of investment institutions would have been able to meet the test. Thus constructed, proxy access held out no cost advantages for activist hedge funds. But the point was moot in any event. A federal appeals court voided the rule on the procedural ground that the SEC had supported it with an inadequate cost-benefit analysis.[8] The SEC is free to try again in another rulemaking proceeding but has not done so.

[6] Dodd-Frank Act §971.

[7] Rule 14a-11(b), 17 C.F.R. 240.14a11(b)(2010).

[8] *Business Roundtable and Chamber of Commerce of the United States of America v. SEC*, 613 F.3d 166 (D.C. Cir. 2011).

In Chapter 18, Jill Fisch questions the value of the entire enterprise. If, on the one hand, the SEC intended to facilitate shareholder nomination of directors, why make a rule that insulates companies from shareholder inputs? If, on the other hand, the SEC had no desire to shift the balance of power in publicly traded companies, why bother with rulemaking at all? For Fisch, the SEC's enterprise suffered from debilitating ambiguity because it lacked a normative vision respecting governance benefits to be obtained.

She suggests a radically different approach grounded in state law, in particular Delaware's recent amendment of its code to permit proxy access to be promulgated by means of a shareholder-initiated bylaw. In Fisch's view, the thoroughgoing set of rules through which the SEC regulates the proxy process holds out barriers to shareholder access, thereby inadvertently influencing the balance of power between managers and shareholders. She recommends that the agency step back from the regulation of corporate governance, contenting itself with creating a level playing field on which states, companies, and shareholders can experiment with governance structures. More particularly, all matters concerning director nominations, including shareholder access, should be left to state corporate codes and corporate charters and bylaws. The SEC proxy rules should limit themselves to requiring disclosure of all properly nominated director candidates (whatever the origin of the nomination) and the provision of a ballot containing all nominees. Meanwhile, groups of shareholders coalescing to support candidates should be left free of ancillary SEC controls.

1.15.2 Blockholder Reporting Under Section 13(d)

Section 13(d) requires parties acquiring more than 5% of a public company's stock to make a public filing disclosing their position and intentions respecting the issuer. Once the activist block becomes public information, the door opens for market free-riding, as stock watchers pile into the stock to take advantage of the positive price bump that tends to result from a disclosure of activist blockholding. Publicity accordingly constrains the activist's ability to make a profit from its investment in the target. But there are loopholes. Under a long-standing regulatory treatment, long positions held through equity swaps have been deemed outside of the section's scope. An activist accordingly can take an equity swap position during the pre-disclosure and filing stage of the engagement, acquiring what amounts in substance to an equity stake exceeding 5%, before the stock price bumps upward, ameliorating the free-rider problem.

A ruling from a US federal court *in CSX Corp. v. The Children's Investment Fund Management (UK) LLP.*,[9] for a time appeared to close the loophole, with negative implications for the activist sector. But the matter remains in doubt. An appeals court affirmed the ruling without opinion. Then, upon publishing its opinion three years later, the appeals court rejected the rationale of the lower court opinion even as it left the result in place.[10] Pressure accordingly mounts on the SEC to promulgate a rule that brings derivative instruments within the concept of 'beneficial ownership' under section 13(d). The SEC has undoubted power to do this under the Dodd-Frank Act,[11] but has not yet undertaken to exercise it.

The *CSX* ruling inhibits activist activity in another respect. When a 'group' of shareholders forms, the members' stockholdings are aggregated for purposes of applying section 13(d)'s 5% test. Prior to *CSX*, cases under section 13(d) read the group concept narrowly, and practitioners in turn read the cases to condition group status on entry into a formal contract by the putative group members. Thus, activists, like the funds involved in the case *The Children's Investment Fund Management (TCI)* and *3G Capital Partners*, communicate with one another and informally coordinate activities without aggregating their holdings for filing purposes. The *CSX* court read the group concept more broadly, sweeping in the activities of *Children's* and *3G*. Legal uncertainty has resulted.

The uncertainty bears particularly on activist 'wolf pack' activity. In many hedge fund activist engagements, after one fund makes a public appearance and a 13(d) filing, another, or sometimes two others, quickly appear in tow. A 5% block thereby can double or triple in size. The rules under 13(d), as presently drafted, grant a 5% holder ten days to file from the date of acquisition of shares triggering the filing. To the extent that informal coordination is permitted, one hedge fund can signal to potential allies with all accumulating stock positions before the disclosure date, ten or so days hence. To the extent that informal coordination is not permitted, and any advance communication to another fund means a compliance problem, wolf pack formation is deterred. Risk-averse legal advisors now counsel activists to avoid having any contact with potential follower hedge funds.

The ten-day filing window, which dates from the statute's enactment in 1968, has also become controversial. The Dodd-Frank Act extends the SEC authority to shorten the filing window by

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9 562 F.Supp.2d 211 (S.D.N.Y 2008).

10 *CSX Corp. v. The Children's Investment Fund Management (UK) LLP*, 654 F.3d 276 (2nd Cir. 2011).

11 Dodd-Frank Act § 766(e).

rule.[12] Management advocates, most prominently the law firm of Wachtell, Lipton, Rosen & Katz, now are pressuring the SEC to exercise that authority. In a famous petition delivered to the SEC in 2011, the Wachtell firm laid out the case for a shorter window,[13] suggesting that two days would suffice. Transparency, fairness, and equality of information are the stated grounds. Technical developments since 1968 also figure in: back in those days, a two-day reporting timetable was not practically feasible, whereas now it imposes no special reporting burden. Moreover, countries such as the UK, Germany, Australia, and Hong Kong have shortened their windows, in some cases also lowering acquisition thresholds.

In Chapter 19, Lucian Bebchuk and Robert Jackson make the rebuttal case. Bebchuk and Jackson caution that a window reduction could harm investors and undermine efficiency. This is not a simple case where it safely can be assumed that investors are better off because information becomes public on an earlier date. There is a trade-off between enhancing disclosure and encouraging activist intervention, and activist intervention holds out the benefits because it makes mangers more accountable and reduces agency costs. For the SEC, it follows that any change in the rule should be preceded by exhaustive empirical analysis. For Bebchuk and Jackson, the better the empirical preparation the weaker the case for amending the rule.

1.15.3 Poison Pills and Proxy Contests

The chapters in this collection have so far focused mainly on the positive effects of hedge fund activism. Based on a comprehensive analysis of the empirical literature, John Coffee seeks to offer, in Chapter 19, a balanced account of the impact of activism. He indicates that, on the one hand, hedge fund activism can generate positive short-term returns for shareholders. Indeed, earlier scholars have identified the strategies of activist investors that increase value of target firms and enhance the returns to investors. Based on more recent empirical research, Coffee shows, on the other hand, that there is little evidence of long-term positive returns following the announcement of a filing of a 13D or that positive returns tend to be concentrated in those firms that ultimately get acquired.

Moreover, the available evidence shows that as hedge fund activism has grown, there has been a significant growth in fundraising and an increased focus on the biggest companies as targets. Coffee argues that the emergence of new tactics of hedge funds, such as aggressive proxy

[12] Dodd-Frank Act § 929R.

[13] Letter of Wachtell, Lipton, Rosen & Katz to Secretary, Securities and Exchange Commission, 7 March 2011.

fights and takeovers, have become important mechanisms for influencing target firm's management to accommodate the agenda of activist fund managers. In fact, there is growing use of the discriminatory poison pill to erect barriers to those who challenge incumbent management's control by proxy context as well as to those who launch hostile tender offers. More particularly, the pill's 'flip in' trigger goes off once a proxy contestant acquires a 20% stake in the target's shares, diluting the contestant's blockholding. The use of the 20% figure amounts to a long-standing drafting practice. Still, nothing in US corporate law says that the trigger cannot be set lower than 20%, even as legal barriers against impairment of the integrity of the shareholder franchise and against arrangements that unassailably entrench incumbent management strongly imply that at some point a threshold trigger becomes so low as to become illegal.

In a recent case, *ThirdPoint LLC v. Ruprecht*,[14] the Delaware Chancery Court addressed the legality question in connection with a poison pill triggered at 10% and deployed against the hedge fund Third Point in its proxy solicitation to elect a dissident short slate of directors to the board of Sotheby's. The Chancery Court sustained the low trigger, even though the pill effectively blocked the hedge fund from adding shares to its 10% ownership block and thereby constrained its ability to increase its vote total.

Drawing on the business context surrounding Third Point's campaign against the incumbent board of Sotheby's, Coffee shows that activist hedge fund interventions can harm corporate business plans and thus the interests of the target corporations' long-term shareholders. The possibility of harm significantly bolsters the corporate law case for a lower trigger. A key component of Coffee's analysis is his 'creeping control' account of activist tactics. Under this view, a hedge fund 'wolf pack' that accumulates more than 20% of a target's stock can thereby acquire the power to effect or block a control transfer, potentially trading off a best price payable to all shareholders as a group for private benefits. Thus Coffee concludes that, given the uncertainty about the impact of hedge fund activism, firms may have good evidence in support of seeking protection against creeping control acquisitions.

1.15.4 Law Reform: The Burden of Persuasion

Fisch's suggestions regarding proxy access would once have been dismissed as misplaced contractarianism. Shareholders, according to a still widely held assumption, are structurally incapable of bootstrapping themselves into positions of empowerment by exercising their franchise; that lack of capability makes the separation of ownership and control corporate

[14] 2014 WL 1922029.

law's great unsolved problem, and justifies aggressive and preclusive regulation by the SEC. Yet in today's context it is not at all unreasonable to suggest that private ordering is the best means to the end of proxy access. What has changed?

Bratton and Wachter take up that question in this collection's final chapter, suggesting that enough has changed in respect of the balance of power between shareholders and managers to undermine the US case for shareholder empowerment through law reform. They, in effect, explore the implications of this collection's cumulated point: hedge fund activists, vulture funds, and private equity taken together have revolutionized shareholding and lending, solving layers of agency problems without any assistance in the form of regulatory reform.

In Bratton and Wachter's characterization, the case for law reform for the purpose of empowering shareholders comes down to the proposition that managers should manage to the market price of the stock. The case for shareholder empowerment through law reform begins with the principal-agent point: all other things equal, agency cost reduction enhances value, and enhanced principal control can conceivably lower agency costs. The shareholders, as principals, are well suited to provide value-enhancing inputs, for their investment in the residual interest lends them a pure financial incentive to maximize the company's value. The question is whether these pure shareholder incentives can be harnessed by the governance system despite the fact that dispersed, diversified shareholders labour under information asymmetries and lack business expertise. Here the market price of the stock comes in as the means to the end: if the stock price holds out an objective and accurate measure of the purely motivated shareholder maximand, then it provides the best source of instructions for governance and business policy. From this it follows that a manager-agent with correct incentives should manage to the market price. With the market price as the management yardstick, value-enhancing opportunities to merge, sell, or dissolve will no longer be frustrated by the managers' desire to hold on to control. Administrative coherence also would follow because the yardstick provides a means with which to evaluate management performance.

For Bratton and Wachter, shareholder empowerment proponents thus purport to offer a win-win, holding out benefits without asking about unintended costs. They counter on the cost side: what policy content, they ask, does the market price of the stock have to teach? Very little, in their view, once one puts aside a case like a hostile takeover, which poses a simple governance question in an information-enriched environment. As one moves away from an offer on the table for the whole to continuous business decision-making, the meaning of a market price signal becomes less and less clear and information asymmetries present more of a problem. Stock prices are less objective reports on particular value outcomes, than inputs for informed interpretation. Meanwhile, information asymmetries are real and unavoidable and market prices can be subject to speculative distortion.

More importantly, for present purposes, Bratton and Wachter ask whether agency costs remain wildly out of control. The shareholder empowerment advocates, they charge, pose as a static constant an agency cost picture that dates from the 1980s takeover era. In so doing, they have lost their way in history, failing to appreciate their own paradigmatic roots. Indeed, the shareholder proponents cost picture is the exact opposite of what Jensen and Meckling described in their fundamental exposition. Jensen and Meckling predicted, first, that actors will address agency costs as they arise over time, with managers bonding their fidelity to their investors and investors monitoring their investments, and, second, that when agency costs remain unaddressed, it is because their removal is too costly. In other words, markets and institutions work at agency cost reduction on a going-concern basis; at the same time, agency costs do not reduce to zero and a heroic attempt at agency cost reduction could be counterproductive.

Bratton and Wachter argue that post-1980s history acts out Jensen and Meckling's predictions. It has been a dynamic process of cost-reductive adjustment both inside corporations and outside in the market. Managers emerged from the 1980s sensitized to the benefits of shareholder value maximization. The board of directors simultaneously emerged as a more robust monitoring institution. Together, managers and boards used equity compensation plans to redirect management incentives in the shareholders' direction. Merger volume reached new records, with friendly rather than hostile deals as the means of moving assets to higher-valuing users. In addition, the corporate cash payout pattern underwent a notable shift to yield an unprecedented volume of share repurchases, a central shareholder agenda item.

Institutional investor activism comes to bear at this crucial point in the argument. Discipline, a factor supposedly lacking in the wake of antitakeover regulation, made a remarkable return to the governance front line when the private equity buyout re-emerged in the mid-1990s. With this business model, managers looking for enhanced upsides voluntarily put themselves under the control of market intermediaries who monitor costs intensively. And, on the market side of the line, activist hedge funds emerged to show that the shareholder collective action problem is not as preclusive as everybody assumed. The activists brought back hostility, but on a new platform independent of control transfer. They come forth as value investors, and pursue the very financial items that sit at the top of the shareholder proponents' agency cost agenda—increased leverage, payouts of excess cash, premium asset sales, and cost-cutting. In contrast to the accelerated share turnover that accompanied the shift to institutional holding, they, on average, invest for a period of two years. They have entered boardrooms in large numbers, all without any change in the legal model. The difference lies in the economics of their shareholding, and has to do with institutional incentive alignment.

In sum, where the shareholder proponents depict a governance system that chronically leaves big money on the table, Bratton and Wachter claim to depict dynamic adaptation towards the end of removing the money. Patterns of shareholding play a critical role in the process of adaptation. Much of the change can be attributed to the move away from individual to institutional holding and its role in ameliorating collective action problems. Critical changes in management policy follow when shares accumulate in three pockets—those of private equity funds, of hedge funds, and of corporate managers themselves. These critical shareholders have two things in common that distinguish them from the market price setters idealized by shareholder proponents. To wit, they are underdiversified (and thus highly incented to improve performance at individual firms) and well informed about the business (and thus positioned to offer productive planning and performance inputs). It follows that particular shareholders can be highly relevant so far as concerns value enhancement, even as their socio-economic status remains irrelevant.

1.16 Closing Questions

Our closing chapters bear close comparison with our opening chapters, bringing the collection full circle. The comparison triggers questions. Some focus on the persuasiveness of Bratton and Wachter's claim that activism, taken together with other shareholder favourable developments since the close of the takeover era, sufficiently ameliorates agency costs as to obviate the need for fundamental corporate law reform in the US. Does the evidence presented in this collection sustain the claim, or just open the door for a tentative suggestion? Other questions focus on the connection Bratton and Wachter make between shareholder empowerment, law reform, and the perverse effects of managing the market price. Given the open door to shareholder access in the UK, should not managing the market already have manifested itself there as a distinct problem? Alternatively, if shareholder activism has fundamentally changed the US governance context, should not managing to the market price already be an acute problem in the US, as an observer like Martin Lipton would claim? Either way, how important is law reform? If the balance of power between shareholders and managers in the UK lies differently than that in the US, is the difference due to company law or to institutional relationships of long standing? If US law were reformed in line with Bebchuk's agenda, would fundamental relational changes follow or would endogenous market adjustments lead us back to the present equilibrium? Finally, should lawmakers in the US, following Fisch, make sure pathways are open for management–shareholder contracting, but otherwise let shareholder empowerment take care of itself?

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