IS HEDGE FUND ACTIVISM NEW HOPE FOR THE MARKET?

Kuang-Wei Chueh*

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* J.D. Candidate 2009, Columbia University School of Law; Ph.D. Candidate 2009, National Chengchi University College of Commerce (Taiwan); M.B.A., National Central University (Taiwan) (2002); B.A. & L.L.B., National Taiwan University (2000). The author wishes to thank Professor Meyer Eisenberg for his comments, Allison M. Snyder for her thoughtful advice and editing assistance, and other survey team members.

I. INTRODUCTION

The American corporate system is characterized by separation of ownership and control.[1] In theory, shareholders monitor the elected directors, who manage the company as the shareholders' fiduciaries.[2] However, many experts regard shareholder passivity as inevitable.[3] This is troubling because without robust monitoring, managers can use their discretion to make business decisions that benefit themselves at the cost of shareholders.[4] The emergence of hedge fund activism may offer new solutions to the shareholder passivity dilemma as hedge fund activists engage in vigorous oversight. If hedge fund activists' interests are in line with the interests of their target companies, such activism may enhance the values of their target companies. If not, practitioners and academic commentators worry that hedge fund activism could generate negative results. This Note explores the impact of hedge fund activism on the market and concludes that the market as a whole will likely benefit.

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[1] Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 236 (2007).

[2] Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 521 (1990).

[3] *Id.* at 522 ("Most modern corporate scholars, especially those with a law-and-economics bent, accept shareholder passivity as inevitable.").

[4] Illig, *supra* note 1 (arguing that the scandals of Enron and WorldCom are manifestations of the phenomenon that weak monitoring encourages managers to pursue their own self interests).

Part II of this Note briefly introduces the definition of a hedge fund and of hedge fund activism, as well as its potential promise. It also outlines the regulatory and structural differences between hedge funds, mutual funds, and public pension funds. Part III introduces commentators' concerns about hedge fund activism, including "short-termism" and empty and negative voting problems that result from the decoupling of economic interest from voting power. This Note only focuses on short-termism because decoupling is neither a unique nor intertwined issue for hedge funds and its solution will not likely impact hedge fund activism. Part IV argues that the risk of short-termisim is overstated because (1) the assumption that hedge fund activists are extreme short-term investors has not been supported; (2) long-term investments in hedge fund targets have not shown a drastic decline; (3) hedge fund activism is, on the whole, value-increasing; (4) the counterbalance of other investors and reputational sanctions deter value decreasing activists. Part V concludes that the market is likely to benefit from hedge fund activism.

II. AN INTRODUCTION TO HEDGE FUND ACTIVISM

A. What Is a Hedge Fund?

Though the term "hedge fund" is commonly used in newspapers and daily conversation,[5] it is not easy to define. There are no statutory or universally accepted definitions of

[5] *See, e.g.*, Andy Kessler, *What's Next for the Banks?*, WALL. ST. J., Jan. 24, 2008, at A17 (mentioning that hedge funds and international investors look more forward to higher yields than government bonds); Andrew Ross Sorkin, *A Loophole Lets a Foot in the Door,* N.Y. TIMES, Jan. 15, 2008, at C1 (reporting that two hedge funds secretly acquired twenty-one percent equity stakes in CNet and planned to launch a proxy fight against the board).

a hedge fund.[6] Most definitions focus only on certain characteristics of hedge funds. Some definitions stress the sophisticated investment strategies of hedge funds and the traits of their investors.[7] Other definitions emphasize the comparatively less regulated status of hedge funds.[8] For example, in *Goldstein v. SEC*, the D.C. Circuit suggested that "hedge funds may be defined . . . by reference to what they are *not*,"[9] pointing out that hedge funds are exempt from the Investment Company Act[10] and the Investment Advisers Act of 1940 ("Advisers Act").[11] In practice, the structure of hedge funds is not only designed to be exempt

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[6] Jonathan Bevilacqua, Comment, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 BUFF. L. REV. 251, 258 (2006).

[7] Stephen Labaton, *Judges Weigh Hedge Funds vs. the S.E.C.*, N.Y. TIMES, Dec. 10, 2005, at C1 (defining hedge funds as "sophisticated pools of assets that are not marketed and are typically open only to wealthy investors").

[8] Troy A. Paredes, *On the Decision to Regulate Hedge Funds: the SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 976 (2006) ("In large part, hedge funds are defined by the extent to which the Securities and Exchange Commission (SEC) does not regulate them.").

[9] Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006).

[10] *Id.* ("[H]edge funds . . . are exempt from the Investment Company Act's coverage because they have one hundred or fewer beneficial owners and do not offer their securities to the public, 15 U.S.C. § 80a-3(c)(1), or because their investors are all qualified high net-worth individuals or institutions, 15 U.S.C. § 80a-3(c)(7)."). Hedge funds can be exempt from Investment Company Act either under § 3(c)(1) or § 3(c)(7). 15 U.S.C. § 80a-3(c)(1) (2006); 15 U.S.C. § 80a-3(c)(7) (2006). A hedge fund is exempt under § 3(c)(1) if it has fewer than 100 investors and there is no public offering. Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 694 (2000). A hedge fund is exempt from § 3(c)(7) if it only sells its securities to "qualified purchasers" and does not make any public offerings. *Id.* at 695.

[11] 15 U.S.C. § 80b-3 (2006) (setting forth criteria to be exempt from registration); Goldstein, 451 F.3d at 876 (stating that "[h]edge fund advisers also had been exempt from regulation under the Investment Advisers Act of 1940 . . ."); Gibson, *supra* note 10, at 697 ("To avoid registration, which triggers these ongoing compliance obligations, hedge fund managers typically structure their operations to qualify for the 'small adviser' exemption found within the Investment Advisers Act.").

from the Investment Company Act, but is also exempt from the key mandates of the Securities Act of 1933 ("1933 Act")[12] and the Securities Exchange Act of 1934 ("1934 Act").[13] Hedge funds are structured purposefully to take advantage of the exclusions in securities law.[14]

Hedge funds, however, are not completely unregulated because antifraud provisions in the securities and commodities laws are fully applicable to protect hedge fund investors.[15] Further, hedge fund advisers are subject to the anti-fraud provision of the Advisers Act, whether or not they are registered.[16] Nonetheless, hedge funds are clearly subject to fewer regulations than other types of investment vehicles, to which the Advisers Act, the Investment Company Act, the 1933 Act, and the 1934 Act fully apply.[17]

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[12] 15 U.S.C. § 77d (2006) (listing transactions exempting from registration); Gibson, *supra* note 10, at 689 ("Hedge funds typically satisfy the non-public offering requirement by limiting offers to both sophisticated investors with high net worth and to institutional investors.").

[13] 15 U.S.C. § 78o (2006) (requiring registration of brokers and dealers); Gibson, *supra* note 10, at 692. ("Because hedge funds and their managers are generally not considered broker-dealers, they are not required to register with the SEC. They are not considered brokers because a broker is 'engaged in the business of effecting transactions in securities for the accounts of others.' A hedge fund and its manager do not effect securities transactions for the accounts of others, but rather they engage in securities transactions for their own accounts.").

[14] Paredes, *supra* note 8, at 976 ("Hedge funds have simply been structured in an open and aboveboard fashion to take advantage of the exclusions that Congress has seen fit to build into the securities law regime.").

[15] Gibson, *supra* note 10, at 714 (explaining that "[h]edge fund investors are also protected by the antifraud provisions found within the securities and commodities laws").

[16] *Id.* at 697 ("While the exemption relieves hedge fund managers from registration and compliance obligations, hedge fund managers remain subject to antifraud provisions found within the Investment Advisers Act.").

[17] For example, mutual funds usually are not exempt from any of these statutes. For a relevant discussion, see *infra*, Part I.C.

B. The Meaning of Hedge Fund Activism and Its Potential Promise

Generally, an activist is an investor who aggressively engages in shaping or influencing their target company's business decisions.[18] A passive investor, in contrast, follows the Wall Street rule by selling his stock when unsatisfied with management.[19] Hedge fund activism arises when hedge funds exercise their influence within their target company. In the market, being a short-term value-increasing activist can generate profit.[20] If a company's board of directors makes a bad decision, such as maintaining unnecessary and excessive cash balances or driving the company in a direction not recognized by the market, the stock price will drop accordingly to reflect the market's negative reaction to this decision.[21] If anyone can purchase the stock after such a

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[18] Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV. 140 (Jan.-Feb. 1994) (suggesting that activists are those who have an influence on the way their invested companies are run).

[19] Gregory R. Andre, *Tender Offers For Corporate Control: A Critical Analysis and Proposals For Reform*, 12 DEL. J. CORP. L. 865, 866 (1987).

[20] The activist event launched by Pirate Capital against James River Coal provides an example. On November 17, 2005, Pirate Capital filed a 13D with the SEC indicating a 7.9% stake in James River Coal Co. at an average price of $33.45. On February 10, 2006, Pirate Capital sent a letter to James River Coal, expressing its concern that James River Coal's valuation was discounted relative to its peers and demanding the Board immediately redeem the shareholder rights plan and recruit an investment banking firm to pursue strategic alternatives. On March 10, 2006, management announced that they had hired Morgan Stanley to look at alternatives. James River Coal's stock price rose more than ten percent to $39.77, creating a nineteen percent profit margin for Pirate Capital in less than four months. Alon Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, 11, *available at* http://knowledge.wharton.upenn.edu/papers/1338.pdf.

[21] RONALD GILSON & BERNARD BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, 135 (2d ed. 1995) (suggesting that in the United States, there has been considerable empirical support for the proposition that at least for the common stock of large public companies, a semi-strong form of efficient capital market holds, meaning that at any point in time market prices are an unbiased forecast of future cash flows that fully reflect all publicly available information). Assuming this hypothesis holds,

drop and expeditiously push the directors to change their minds, the stock price will then bounce back and the intervening activist can earn a profit by selling the stock.[22]

Nevertheless, free riding problems dissuade most potential investors from playing an activist role because the costs may exceed the benefits.[23] For example, a potential activist, paying all accompanying costs, may only be able to purchase ten percent of a company's stock due to either financial or legal constraints, and will enjoy ten percent of the total benefit at most, while other shareholders can free ride on the activist's efforts.[24] In this scenario, unless the ten percent benefit exceeds the cost of activism, free riding discourages the shareholder from intervening as an activist.[25]

For reasons discussed in the next section, hedge funds are specially suited to be activists. Free riding is a less serious problem for hedge funds. They are not subject to the diversification or investment strategies restraints in the Investment Company Act.[26] Therefore, a hedge fund can pour all of its resources into an activist event and increase its stake within the target company.[27] In addition, hedge funds can establish stronger long positions without the need

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if the market has known that the management of a certain company made a bad decision, the stock price of that company will drop to reflect the bad impact brought about by the bad decisions.

[22] *See* example *supra* note 20.

[23] The free riding problem happens when someone takes the benefit from the efforts of someone else at almost no cost. This deters one from taking action in the first place because part of the benefit he creates goes to others. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW, 112 (6th ed. 2002) (introducing the free-rider problem in a trade association context where members of the industry do not have strong incentives to support trade association's campaign, because someone who contributes nothing to the association's campaign can derive the same benefits).

[24] *Id.*

[25] *Id.*

[26] *See* discussion *supra* note 10.

[27] *See* discussion *infra* Part II.C.1.

to buy as much stock through derivative markets.[28] Hedge funds also face fewer political and business concerns when fighting against the management of a company.[29]

Hedge fund activism comes in various forms. Marcel Kahan and Edward Rock provide useful insight to understanding hedge fund activism by outlining two categories of activism: corporate governance activism and corporate control activism.[30] Kahan and Rock call a hedge fund a corporate governance activist when it tries to influence the business decisions of its invested targets.[31] For example, in 2005, Pershing Square, a hedge fund, pressed McDonald's to sell company-owned restaurants.[32] In the same year, Carl Icahn, a famous hedge fund manager, in association with other investors, pressed Time Warner to spin off Time Warner Cable and other divisions.[33]

A corporate control activist engages in transactions involving change of corporate control.[34] In 2005, Novartis, the Swiss pharmaceutical giant, proposed to acquire fifty-eight percent of Chiron, a biotech company. Initially, the price offered by Novartis to Chiron's shareholders was forty

[28] Hedge funds can build up a strong long position within the target company with options which generally cost them less to acquire than an equal position through buying stocks. Therefore, with a given amount of money, hedge funds can establish a stronger position within the target company through options or similar derivative products. A stronger stake in the target reduces the free-riding problem. *See also infra* note 108 and the accompanying text.

[29] *See* discussion *infra* Part II.C.3.

[30] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1029, 1034 (2007).

[31] *Id.* at 1029. But the term "corporate governance" generally refers to the manner in which a corporation is directed, administered, or controlled. When an activist asks the target company to change its business decision, it may be more accurate to call it a "corporate management activist" than a "corporate governance activist."

[32] Jesse Eisinger, *Hedge-Fund Man at McDonald's*, WALL ST. J., Sept. 28, 2005, at C1.

[33] Andrew Ross Sorkin & Richard Siklos, *Icahn Tries to Form a Team to Take on Time Warner*, N.Y. TIMES, Aug. 10, 2005, at C1.

[34] Kahan & Rock, *supra* note 30, at 1034.

dollars per share, and was later raised to forty-five dollars per share by the efforts of Chiron's independent committee.[35] Then, ValueAct Capital, a hedge fund and the largest shareholder of Chiron, opposed the deal, forcing Novartis to raise its offer to forty-eight dollars per share to complete the deal.[36] In this case, ValueAct Capital intervened only to raise the price of the sale of control. Hedge funds may also be more aggressive and push the target company's board to sell the company. For example, in 2007, in light of the poor performance of Applebee's International, its shareholder, Breeden Partners, a hedge fund managed by former Securities and Exchange Commission Chairman Richard Breeden, publicly announced it would consider selling the company.[37] Breeden Partners and ValueAct Capital are corporate control activists according to Kahan and Rock's definition.

C. Comparing Hedge Funds, Mutual Funds, and Public Pension Funds

Even though hedge funds have become a large industry, they are still smaller than their close family members—mutual funds and public pension funds.[38] Hedge funds are

[35] David P. Hamilton, *Novartis Agrees to Acquire the Rest of Chiron for $5.1 Billion,* WALL ST. J., Nov. 1, 2005, at A6.

[36] *Health Care Brief -- Chiron Corp.: Novartis's $5.4 Billion Bid Is Approved by Shareholders*, WALL ST. J., Apr. 20, 2006, at B7; Karen Talley, *Lucent Rises on Alcatel's Offer*, WALL ST. J., Apr. 4, 2006, at C4.

[37] Karen Talley, *Alcoa, GM Lead Blue-Chip Surge--Industrials Near Record; Nasdaq, Ford Pull Back While 3M Receives a Lift*, WALL ST. J., Feb. 14, 2007, at C5.

[38] This Note does not focus on private pension funds because "[p]rivate pension funds are under management control; they are not constructed for a palace revolution in which they would assert control over their managerial bosses." Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 17 (1991). Although private pension funds have become a more important source of equity in recent years, they are generally not active shareholders under the current management structure. Rado Bohing & Stephen M. Bainbridge, *Corporate Governance in Post-Privatized Slovenia*, 49 AM. J. COMP. L. 49, 66 (2001).

now a $1.4 trillion industry,[39] whereas at the end of 2007, the overall assets managed by mutual funds exceeded $12 trillion, of which around $6.5 trillion was invested in equity.[40] In 2004, public pension funds already had real assets of over $2 trillion.[41]

Despite their smaller size, hedge funds are in a better position to play an activist role than other institutional investors. Mutual funds and public pension funds generally do not invest in portfolio companies expecting to earn profits from being activists.[42] They become active in the companies in which they have already invested only after perceiving mismanagement or under-performance.[43] In contrast, hedge funds make a calculated decision to invest in a company, expecting that being activists will bring them financial rewards.[44] Several characteristics unique to hedge funds, discussed *infra*, explain why hedge funds engage in aggressive activism, implementing tactics rarely used by mutual funds or pension funds.

1. The Differences Between Hedge Funds and Mutual Funds

Unlike hedge funds, mutual funds are subject to a comprehensive regulatory regime involving a number of significant restraints, such as diversification and compulsory disclosure requirements,[45] and restrictions on the

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[39] Deborah Solomon, *Regulators' Hedge-Fund Approach: Hands Off*, WALL ST. J., Feb. 23, 2007, at C1.

[40] Investment Company Institute, *Trends In Mutual Fund Investing*, http://www.ici.org/stats/mf/trends_12_07.html (last visited on Mar. 4, 2008).

[41] KEITH BRAINARD, NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS, PUBLIC FUND SURVEY SUMMARY OF FINDINGS FOR FY 2004 (Sept. 2005), http://www.publicfundsurvey.org/publicfundsurvey/pdfs/Summary%20of%20Findings%20FY04.pdf (last visited on Mar. 4, 2008).

[42] Kahan & Rock, *supra* note 30, at 1069.

[43] *Id.* (explaining that "[m]utual fund or public pension fund activism, if it occurs, tends to be incidental and ex post").

[44] *Id.* (explaining that "hedge fund activism is strategic and ex ante").

[45] *See supra* notes 9-14 and accompanying text.

compensation of fund management.[46] Neither of these regulations applies to hedge funds.[47] Further, in practice, mutual funds are limited in the amount of illiquid assets they can hold.[48] Ultimately, the regulatory and practical barriers on mutual funds make them less likely candidates for strategic activism.

i. Regulatory Differences

Section 30(e)(2) of the Investment Company Act requires mutual funds to file a semi-annual list of the amounts and values of the securities they own.[49] This compulsory disclosure prevents mutual funds from keeping their portfolios secret, and this makes some investment strategies, such as accumulating the stock of a target company without drawing the market's attention, more difficult, and more costly.[50]

Mutual funds are also subject to the regulations of the Investment Company Act, which provides that a mutual fund cannot advertise itself as diversified if, among the seventy-five percent regulated fund assets, it owns more than ten percent of the stock of any company or places more

[46] *See* discussion *infra* Part II.C.1.i.

[47] *Id.*

[48] *See* discussion *infra* Part II.C.1.ii.

[49] 15 U.S.C. § 80a-29(e)(2) (2006).

[50] Once other investors observe that a mutual fund is increasing its position in a company and will keep doing so with the expectation that the target's stock price will increase further, they may join in purchasing the target's stocks. This further inflates the target's stock price. The mutual fund eventually may have to spend more to reach its target goal, or the fund may acquire less, which reduces the profits from activism. On the other hand, if a mutual fund wants to avoid informing the market of its accumulation of stocks in a target company before it is finished, it must reach its desired goal within the period between disclosures. This is not always a viable option, and a fund's purchase of a large collection of stocks within a short period of time may alert the market as well. Without the compulsory disclosure requirement set forth in 15 U.S.C. § 80a-29(e)(2), a mutual fund only needs to file a 13D report with the SEC after acquiring a five percent stake within a company. 15 U.S.C. § 78m(d) (2006).

than five percent of its assets in the securities of any issuer.[51] In addition, the Internal Revenue Code allows only diversified mutual funds to pass income through to shareholders.[52] Thus, mutual funds must have at least half of their investments in companies constituting no more than five percent of the portfolio and constituting no more than ten percent of the portfolio company's outstanding stock.[53] For the other half, mutual funds can have no more than twenty-five percent of the funds' total assets in a single investment holding.[54] Such a ceiling on the use of fund assets limits the maximum stake a mutual fund can acquire in a certain company. Investors are better protected because diversification reduces the risk of a sudden price fluctuation of any single investment target, making their investment less volatile.[55] On the other hand, such a limitation restricts some aggressive investment strategies that involve taking a large position in a certain company, strategies that would otherwise be adopted by mutual funds.[56]

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[51] 15 U.S.C. § 80a-5(b)(1) (2006) ("'Diversified Company means a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.").

[52] 26 U.S.C. § 851 (2006) (setting forth the definition of a regulated investment company that can pass the income through to shareholders); Roe, *supra* note 38, at 20 ("The mutual fund that would control industry would be taxed unfavorably on its entire portfolio, since the tax code allows only diversified mutual funds to pass income through to shareholders, untaxed to the conduit mutual fund. And the tax code's notion of "diversification" parallels that found in the 1940 Act.").

[53] *See supra* note 51.

[54] *Id.*

[55] Gilson & Black, *supra* note 21, at 92 ("[D]iversification also greatly reduces the extreme outliers—a diversified investor is far less likely to become rich or to go broke.").

[56] *See supra* notes 51-52 and accompanying text.

Mutual funds also differ from hedge funds in their compensation structure. Given the same set of investment opportunities, those who are given stronger pay for performance-based compensation are theoretically more motivated to pursue those opportunities than those who are not.[57] "Hedge funds typically charge an asset management fee of one to two percent of assets, plus a 'performance fee' of twenty percent or more of a hedge fund's profits."[58] A few hedge fund managers take as much as fifty percent of the fund's profit.[59] Thus, the manager receives a remarkable profit from an increase in the fund's value. In fact, those fees are so high that they have aroused wide concern.[60]

These rewards are not available to mutual fund managers, who generally are paid a management fee of 0.3-1.5% or two percent of net asset value ("NAV"), scaled down at higher asset levels.[61] Section 205 of the Advisers Act prohibits compensation to a registered investment adviser on the basis of a share of capital gains or capital appreciation of any portion of the client's funds, unless the fee decreases on bad performance and increases on good performance.[62] Generally, in accordance with the statutory exemption,

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[57] Randall S. Thomas, *Explaining The International CEO Pay Gap: Board Capture Or Market Driven?*, 57 VAND. L. REV. 1171, 1213 (2004) (mentioning that if managers' pay is based on the return that shareholders receive, executives will have a financial incentive to act in a manner that serves the interests of those who own equity. Otherwise, there may be an agency problem). This logic can be applied to the relationship between fund investors and fund managers.

[58] *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, http://www.sec.gov/answers/hedge.htm (last visited Mar. 6, 2008).

[59] Alan Murray, *Hedge Funds Need to Open Up*, WALL. ST. J., Apr. 5, 2006, at A2.

[60] *See, e.g.*, Karen Richardson, *Buffett Says to Avoid Scandals, Managers Must Not Follow Herd*, WALL ST. J., Oct. 10, 2006, at A9 (reporting that hedge fund fees are one of the corporate governance issues that most concern Warren Buffett).

[61] Ian Salisbury, *Investing in Funds: A Quarterly Analysis—A Tale of Two ETF Trends: Prices Rise, as Prices Fall*, WALL. ST. J., Oct. 2, 2007, at R1.

[62] 15 U.S.C. § 80b-5 (a)(1) (2006).

mutual funds base compensation on a percentage of the value of assets under fund management.[63]

However, symmetrical pay-for-performance fees are not a feasible compensation structure because of the additional requirement that fees be calculated using at least a one-year performance period.[64] If a mutual fund performs exceptionally well during the first month of the one-year period, investors can redeem their shares to take profit from the increased NAV but only pay 1/12 of the annual performance fee.[65] Meanwhile, other investors will be discouraged from investing in that fund because they have to pay part of an annual performance fee reflecting that first month's outstanding performance without enjoying that month's increased NAV.[66] As the existing investors exit and new investors are discouraged from entry, the management's compensation actually decreases as the value of assets under management shrinks.[67] This illustrates an awkward dilemma—mutual funds' outstanding performance may result in a reduced management fee. Hedge funds, on the other hand, are not subject to the Adviser Act's limitation on performance fees.[68]

[63] *Id.* § 80b-5 (b)(2)(B) (setting forth that the restriction on calculation of management fees based on capital gains does not apply if a percentage of "the asset value of the company or fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify").

[64] Securities Industry Association, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2945, at *4 (Nov. 18, 1986) ("[A]ny performance fee [must] be based on a period of not less than one year, irrespective of how long the client and adviser have had a contractual arrangement.").

[65] Kahan & Rock, *supra* note 30, at 1050.

[66] *Id.*

[67] The calculation of the compensation for mutual fund managers is generally based on the values of assets under management. *See supra* note 63 and accompanying text.

[68] *See supra* notes 9-14 and accompanying text.

ii. Practical Differences

Some of the characteristics of mutual funds also impose a *de facto* limitation on the holding of illiquid assets. For example, an open-end mutual fund, which must redeem shares at NAV at the request of investors on short notice, cannot afford to possess too many assets that are illiquid or without a readily ascertainable market value.[69] Otherwise, it may not stand ready to redeem investors' holdings at NAV.[70] A mutual fund may choose to be a closed-end investment company to avoid such restraints, but a closed-end mutual fund may not be attractive to investors, especially since the share price of a closed-end fund may fail to reflect its NAV[71] and it may trade at a significant discount from its NAV.[72]

Such a *de facto* limitation discourages open-end mutual funds from being strategic activists if a large control position would be illiquid. [73] In contrast, hedge funds can be

[69] 15 U.S.C. § 80a-5(a)(1) (2006) ("'Open-end company' means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer."); Kahan & Rock, *supra* note 30, at 1049-50 ("Open-end mutual funds, by definition and by statute, must also stand ready to redeem their shares at the request of any shareholder on short notice. The redemption price of these shares is based on the fund's net asset value.").

[70] Kahan & Rock, *supra* note 30, at 1050 ("These requirements make it difficult for mutual funds to have illiquid investments, such as restricted securities, as illiquid investments cannot be readily transformed into cash when fund shareholders want to redeem their shares and cannot be easily valued.").

[71] Closed-end funds are traded in the open market like NYSE or NASDAQ. In contrast, the investors of open-end funds must tender their shares directly to the funds for redemption at the then NAV. David Shakow & Reed Shuldiner, *Symposium on Wealth Taxes Part II: A Comprehensive Wealth Tax*, 53 TAX L. REV. 499, 528-29 (2000).

[72] Gilson & Black, *supra* note 21, at 599 (introducing evidence showing that many closed-end investment companies trade at a twenty percent discount or more despite their well-known higher NAV).

[73] Liquidity becomes a serious issue when a hedge fund's equity stake in a target company far exceeds the company's average trading volume in the market, thereby making it difficult to sell all the equity interest without suffering from price decline. John C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L.

structured to set a long lock-up period within which the investors cannot redeem their investment.[74] The lock-in period of many hedge funds is usually one year or more, and investors are only able to redeem the interest a few times a year.[75] Therefore, the *de facto* restrictions placed on open-end mutual funds are not applicable to hedge funds.

Potential conflicts of interest further shape the investment strategies of mutual fund managers. Some mutual funds are controlled by investment banks or insurance companies.[76] The fear of enraging clients of the affiliated companies could impose practical limitations on the investment strategies of mutual funds.[77] For example, a mutual fund manager may not be willing to launch a proxy fight against the board of their affiliated companies' clients even though this action would be beneficial to that fund's performance. Until very recently, the primary investors in hedge funds were funds of funds,[78] wealthy individuals,

REV. 1277, 1318 (1991) (suggesting that mutual funds need liquidity more than others and that "taking a large control position is unacceptable if such a stake would be illiquid").

[74] Kahan & Rock, *supra* note 30, at 1063 (explaining that the lock-up period can be contractually introduced to limited the withdrawal right of hedge fund investors and that limitations can be designed to limit the time and amount of investors' withdrawals).

[75] Allison Bisbey Colter, *Monthly Mutual Funds Review—Fundamentals: Choose Your Fund: Hedge or Mutual—Each Vehicle Has Appeal, But Potential Risk, Reward Make Them Very Different*, WALL ST. J., Mar. 3, 2003, at R1.

[76] Kahan & Rock, *supra* note 30, at 1054 (mentioning that nine of the twenty largest mutual fund complexes had such affiliations in 2003).

[77] *Id.* at 1055 ("The mutual fund managers will, ex ante, often not know which portfolio companies have hired, or are about to hire, the investment bank as an underwriter or financial advisor. And, ex post, the investment banker, for public relations and legal reasons, would not want to interfere directly with the governance activism of the mutual fund when an investment banking client becomes the target of such activism. Thus, the easiest and safest way to avoid any problems is for affiliated mutual funds not to engage in governance activism at all."); Coffee, *supra* note 73, at 1321 ("[C]ommentators report that banks and insurance companies are the institutions least willing to oppose corporate managements.").

[78] A fund of funds is a fund that holds a portfolio of other investment funds.

pension funds, and some institutions such as university endowments.[79] The potential conflict of interest problem is comparatively less severe because these investors are unlikely to be the targets of activism.

2. The Differences between Public Pension Funds and Hedge Funds

State law, rather than federal legislation, regulates public pension funds.[80] Though public pension fund regulations are not identical across states, most states subject public pension fund managers to a "prudent person" fiduciary standard.[81] Many states also enumerate the types of investments that public pension funds are permitted to acquire.[82] Some states also limit the percentage of a fund's assets that can be used to acquire equity in any company.[83] Notwithstanding those restraints, since many public pension funds are larger than even some of the biggest hedge funds,[84] pension funds may still be able to acquire controlling positions. Furthermore, unlike mutual funds, pension funds are not subject to the control of the affiliated investment banks or insurance companies, and have no regulatory constraints on

[79] Dave Kansas, *Making Sense of Wall Street—As Investment Choices Pile Up, Grasping Fundamentals Is Key; Hedge-Fund Boom Explained*, WALL ST. J., Jan. 14, 2006, at B1 (reporting that the investors of hedge funds have moved from the wealthy to include pension funds, university endowments, other large institutions and funds of funds).

[80] Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 800 (1993).

[81] *Id.*

[82] *Id.*; *see also* N.Y. RETIRE. & SOC. SEC. LAW § 13 (2007).

[83] Romano, *supra* note 80.

[84] It is estimated that the average hedge fund has assets of about $100 million, while the largest hedge funds have assets of over $10 billion. Kahan & Rock, *supra* note 30, at 1062. But large public pension funds are as large as hundreds of billion dollars. For example, in 2007 CalPERS's, assets under management exceeded $247 billion. CalPERS Facts at a Glace, *available at* http://www.calpers.ca.gov/eip-docs/about/facts/investme.pdf.

performance fees.[85] From the effects of the legal restraints alone, public pension funds, like hedge funds, seem to be better suited to be strategic activists than mutual funds.

However, public pension fund managers are subject to political pressure.[86] The managing board of a public pension fund is chosen through the political process specified by each state.[87] They are usually gubernatorial appointees, representatives elected by fund beneficiaries, or individuals named because of the office they hold.[88] Such political affiliation not only impedes public pension funds from being involved in highly controversial or risky investments,[89] it also limits the compensation that pension funds managers can receive.[90] As a result, lack of pay for performance-based compensation and restrictions based on the political agenda

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[85] Kahan & Rock, *supra* note 30, at 1057 ("But, unlike mutual funds, public pension funds are not subject to specific diversification requirements or regulatory constraints on performance fees, face predictable liquidity requirements, and have no business ties with portfolio companies that would be jeopardized by activism.").

[86] *See, e.g.*, Roberto Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE. J. REG. 174, 181 (2001) (introducing evidence showing that the New York pension fund managers operated the fund assets with an aim to seek a higher political office).

[87] Kahan & Rock, *supra* note 30, at 1057 ("The makeup of their boards of trustees is governed by state law and differs from fund to fund.").

[88] Romano, *supra* note 80, at 800-01.

[89] *Id.* at 807 ("The workers of an Illinois printing company in financial difficulty sought to purchase the firm from its owner, a leveraged buyout fund operated by Kohlberg, Kravis, Roberts and Co. ('KKR'). The Illinois state treasurer threatened to withhold future investments by the state pension fund in KKR's leveraged buyout fund and to 'alert state pension boards across the country about the situation' if KKR did not ensure that the plant continued to operate without any reduction in employment."). This is evidence that political pressure on public funds creates significant constraints on their pursuit of a value-maximizing investment strategy.

[90] Kahan & Rock, *supra* note 30, at 1058-59 ("Consistent with the tendency illustrated by the Harvard endowment example, empirical evidence has shown that the compensation of public pension fund administrators is less frequently based on performance – and is less performance sensitive when it is – than that of private-plan administrators.").

of states[91] reduces the incentive of public pension funds managers to engage in activist events.[92] Unless there is a dramatic change in the political climate, it is likely that the behavior of hedge funds and pension funds will not converge in the near future.[93]

III. CONCERNS ABOUT HEDGE FUND ACTIVISM

The impact of hedge fund activism on the market has drawn significant attention.[94] Academics and practitioners point to "short-termism" and "empty" or "negative" voting to illustrate how a hedge fund activist's interest, as a shareholder, is not aligned with the company's best interest. This Note only focuses on short-termism because empty or negative voting is neither a unique risk nor an intertwined problem for hedge fund activism. Therefore, the solution to such problems likely will affect neither the incentive nor the less regulated status of hedge funds that encourage their activism.

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[91] Romano, *supra* note 80, at 809 (listing states with instructions to foster local economic development).

[92] Kahan & Rock, *supra* note 30, at 1061.

[93] However, this Note does not argue that it is always a good thing for a public pension fund to be aggressive. Public pension fund managers may simply choose not to take serious risks. After all, pension funds' investors are not wealthy individuals or institutional investors who are willing to pursue higher financial return at a higher risk. The author only emphasizes the reality that the political process offers an additional disincentive to aggressive activism.

[94] *See, e.g.*, William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L. J. 1375 (2007) (introducing the idea of hedge fund activism, its uniqueness and explores it potential problems); Brav et al., *supra* note 20 (conducting empirical survey of hedge funds' behavior and the market's reaction); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 IOWA J. CORP. L. 681 (2007) (conducting an empirical survey of hedge funds' behavior); Kahan & Rock, *supra* note 30 (exploring the problems of hedge fund activism extensively).

A. Short-Termism of Hedge Funds

Short-termism describes a phenomenon that occurs when an investor owns equity in a company for a short period of time and therefore is not fit to participate in the long-term business decisions of that company.[95] Some commentators believe that hedge funds act as extremely short-term investors, focusing on short-term profit at the cost of the long-term development of the company.[96] Pursuits of short-term interest are not necessarily in conflict with long-term wealth creation; these commentators' concern arises only when short-term interest conflicts with the company's long term interest and the latter outweighs the former. [97] But the real difficulty comes from the almost impossible mission of quantifying the short-term and long-term interest in order to make a comparison.[98]

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[95] *See, e.g.*, Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37, 40-41 (1990) (mentioning that corporate managers and contractarian scholars believe when shareholders are "transfixed with short-termism, they are inappropriate participants in long-term governance decisions").

[96] *See, e.g.*, Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 746 (2007) ("[C]ertain vocal shareholders, notably hedge funds and arbitrageurs, invest over much shorter time horizons – 'they are primarily financial engineers interested in the largest possible profit in the shortest period of time,' who usually maintain 'laser-beam focus on quarter-to-quarter earnings . . . .'"); Alistair MacDonald, *Activist Hedge Funds Take Fight to Europe—Dutch Case Tests Ability to Demand Changes by Firms*, WALL ST. J., Jan. 17, 2007, at C5 ("Some politicians and regulators say they worry that funds are short-term investors out to turn a quick profit by dismantling a company.").

[97] Kahan & Rock, *supra* note 30, at 1088 (doubting whether the "short-term payoff preferred by hedge funds [is] sometimes the more valuable one"). From a cost-benefit point of view, if the increase in the short-term profit exactly offsets the decrease of the long-term interests, we should be indifferent. Therefore, this Note only cares about hedge fund's pursuit for short-term interests that decrease the overall value of the target company.

[98] For example, it is hard to evaluate whether a certain R&D investment is going to succeed in the future and how much profit it will generate.

Commentators and practitioners sharply disagree with respect to whether hedge fund short-termism generates a serious problem.[99] While some argue that this behavior will have negative consequences in the market,[100] others characterize the attack as a "debater's weapon" used to defend underperforming corporate managers.[101]

Strong opponents of hedge fund activism, such as Martin Lipton of Wachtell, Lipton, Rosen and Katz, a well known defender of incumbent management, argue that as hedge funds invest over much shorter time horizons, they value a short-term stock price increase over long-term value accumulation.[102] Furthermore, hedge fund activists frustrate the board's obligation to manage the corporation in a direction of sustainable long-term growth because these investors are not long-term equity holders and thus have no interest in the long-term success of that company.[103] Academic commentators echo this concern by pointing out that shareholders with short-term investment horizons, such as hedge funds, will support corporate policies that tend to inflate current share prices at the expense of long-term value, such as foregoing research and development

[99] For example, Martin Lipton believes that short-termism will frustrate the long-term development of corporate America but Mark Roe believes that this is only a debater's weapon. *Compare* Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. L. 101, 104 (1979) *with* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 242-43 (1994).

[100] Lipton, *supra* note 99, at 104 (questioning "whether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of those shares").

[101] *See, e.g.*, ROE, *supra* note 99, at 242-43 (characterizing short-termism as merely a debater's weapon used by defenders of corporate incumbents); Barry Rosenstein, *Activism Is Good for All Shareholder*, FIN. TIMES, Mar. 10, 2006, at 17 (suggesting that "the 'short-term' versus 'long-term' distinction is often a non-sensical cover-up for poor performance from managers who have failed to deliver results over either horizon").

[102] Lipton & Savitt, *supra* note 96, at 746.

[103] *Id.*

investment or accepting an immediate, though less than fully priced, premium bid.[104]

B. The Empty and Negative Voting Problems

Opponents of hedge fund activism are also concerned with "empty voting," which happens when a shareholder's vote lacks an accompanying economic stake.[105] This is achieved when an investor takes a short position equal to his equity interests in a company, enabling him to vote without concern of any downside risks.[106] There is more than one way to acquire votes without economic interest. The growth in equity swaps, other privately negotiated equity derivatives, and the share lending markets make it easier and cheaper to decouple economic interests from voting power.[107] A hedge fund may use these market breakthroughs to increase its long position in a company.[108] This reduces the free riding problem[109] and makes it financially viable for hedge funds to spend their resources ousting under-performing incumbents or blocking harmful deals. These financial vehicles may also be used to the detriment of a public company and its

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[104] Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579-80 (2006) (introducing evidence showing that the average turn-over rate of stocks of hedge fund is three times that of mutual funds and suggesting that hedge funds only care about profits within the shortest period of time).

[105] Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006) (suggesting that hedge funds are taking advantage of derivatives that make empty voting possible).

[106] What Richard C. Perry did in Mylan Laboratories in 2004 provides an example. *See* discussion *infra*.

[107] Hu & Black, *supra* note 105.

[108] *See, e.g.*, *In Brief*, WALL ST. J., Dec. 26, 2007, at B4 (reporting that Pershing Square, the hedge-fund group run by William Ackman, increased its stake in an unnamed target from 9.97% to 12.6% via options and derivatives called total return swaps); Brav et al., *supra* note 20, at 16 (showing, among their sample of hedge fund activism events, that hedge funds have reported derivative positions in the target company).

[109] *See* POSNER, *supra* note 23 and accompanying text.

shareholders.[110] What's worse, if the amount of the short position exceeds the stocks owned by an investor, that investor has an incentive to cast his vote in ways that are contrary to the best interests of the target company (referred to as "negative voting").[111] These practices are in tension with the traditional theory that assigns voting rights to shareholders in proportion to their ownership in the company.[112]

The 2004 merger deal between Mylan Laboratories ("Mylan") and King Pharmaceuticals ("King") illustrates the problem with decoupling.[113] On July 26, 2004, Mylan announced its agreement with King for a stock merger valuing King with a 61.8% premium over the trading price.[114] After this announcement, Mylan's stock price instantly plummeted from $18.51 to $15.51 per share.[115] Carl Icahn immediately started to purchase Mylan's shares until he became the owner of 6.8% of the outstanding stock.[116] After filing a Schedule 13D with the SEC, Carl Icahn announced his intention to launch a proxy contest against what he alleged to be an over-priced merger deal.[117] Carl Icahn's strategy clashed with that of an arbitrage player, Richard C. Perry, a hedge fund manager who bought King's shares and sold short Mylan's shares in expectation of the success of the merger.[118] To protect his investment, Perry acquired ten percent of Mylan shares to vote in favor of the merger but meanwhile obtained a short position equal to the stock he

[110] Hu & Black, *supra* note 105.

[111] *Id.*

[112] *Id.* at 814. *See also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, 63-67 (1991) (suggesting that placing the power to oversee company managers in the hands of residual owners, who get paid after everyone else is paid, creates an incentive for them to supervise the board to increase firm value).

[113] Bratton, *supra* note 94, at 1377.

[114] *Id.*

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] *Id.*

had purchased.[119] This rendered him a ten percent stockholder without any economic interest tied to the future of Mylan.[120]

It is important to note, however, that empty voting and negative voting are not hedge fund specific. Decoupling is not a newly emerging investment tactic like hedge fund activism.[121] This strategy can be and has been used by other types of investors.[122] Further, unlike the alleged problem of short-termism, which arises because it is almost impossible to sort out those hedge funds who extract short-term profits but cause more serious damage to the target's long term development, clear criteria exist to sort out those who vote with zero or net negative economic interests. This is not a problem that intertwines with hedge fund activism. Next, the current proposed solution to empty or negative voting refers to a systematic compulsory disclosure requirement that large shareholders disclose their short positions.[123] A stricter disclosure rule would affect neither a hedge fund's incentive to be an activist, nor its less regulated status. Therefore, this Note does not pursue further discussion over this issue.

IV. THE ALLEGED RISK OF SHORT-TERMISM IS LIKELY OVERSTATED

The alleged risk of short-termism is overstated; this suggests that hedge fund activism could play a positive role in the market. First, assumptions about hedge fund behavior and the market's reaction to hedge fund investment have not been supported by empirical evidence. Second, investors and reputational sanctions deter value-decreasing

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[119] *Id.*

[120] Hu & Black, *supra* note 105.

[121] *Id.* (suggesting that "the theoretical possibility of decoupling votes from economic ownership is not new").

[122] *Id.* at 819 (listing examples of decoupling economic interests from voting rights (voting buying) where many cases do not involve hedge funds).

[123] *Id.* at 864-86.

hedge fund activities. Finally, hedge fund activism can have a positive impact on the market.

A. Mistaken Assumptions about Hedge Fund Activists

Crucial assumptions about hedge fund behavior underlie opposition to hedge fund activism. However, empirical evidence and other considerations suggest that these assumptions are misguided. Hedge fund activists are not extreme short-term equity holders. Long-term investment, such as research and development ("R&D"), does not drastically decline in hedge fund activists' targets, and hedge fund activism is overall value-increasing.

1. Hedge Fund Activists Are Not Extreme Short-Term Equity Holders and Are Not Necessarily More Myopic Than Corporate Managers

Those who criticize hedge fund activists as value-decreasing short-termists assume that hedge funds hold equity only for an extremely short period of time[124] and that hedge funds are more short-sighted than corporate managers.[125] These two assumptions are misguided.

A recent study investigates the amount of time hedge fund activists hold equity of their target companies and concludes that hedge fund activists typically commit to their targets for at least two years.[126] The vast majority (eighty-one percent) of hedge fund activists studied either retained their investment during the three-year measured period or exited when the target company was sold.[127] Among the few

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[124] Lipton & Savitt, *supra* note 96.

[125] Barnard, *supra* note 95 (discussing that many managers and scholars believe managers are entitled to more deference when long-term business decisions are made because most institutional shareholders are merely short-term traders).

[126] Bratton, *supra* note 94, at 1380 ("The activists more typically invest for an intermediate term of two years or longer.").

[127] *Id.* at 1412 (finding that during the measured period 2002 to 2004, an impressive eighty-one percent of the cases "either retained a

cases in which hedge fund activists sold their holdings, only eight of them held stocks less than a year.[128] This evidence rebuts the assumption that hedge funds are generally extremely short-term traders.

Further, short-termism is not exclusively a hedge fund problem because corporate managers who receive stock options as part of their compensation packages may also be short-sighted.[129] For example, managers pursuing their short-term interests may adopt strategies that will exaggerate earnings or hide losses, thereby distorting the company's financial statements to ensure that the company's performance lives up to the short-term market expectation. This will lift the stock price above its actual value, making their options more valuable.[130] If the manager is about to retire, the danger of such short-sightedness may be even greater because reputational sanctions will no longer deter him.[131] Thus, a hedge fund activist may be a better

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substantial investment in the target or took payout on a pro rata basis with the target's other shareholders upon the sale of the company").

[128] *Id.* ("We also need to take a look at the cases where the activist sold its shares. Four of these targets were held for two years or more, another five for one to two years, and eight for less than one year.").

[129] Bengt Holmstrom, *Symposium on Bebchuck & Fried's Pay without Performance: Pay without Performance and the Managerial Power Hypothesis: A Comment*, 30 IOWA J. CORP. L. 703, 707-08 (2005) ("[T]here is increasing evidence that stock options led to short-termism and in many cases outright fraud.").

[130] George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 IOWA J. CORP. L. 39, 58 (2005) ("Executives of a poorly performing firm may doctor their reports in order to deflect just criticism from directors and shareholders. In so doing they may also temporarily fool the securities markets, thereby enabling themselves to unload stock and options at inflated prices. Such behavior seems to have been common among executives of companies hit by the recent scandals.").

[131] Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 694-95 (1999) (suggesting that when a manager is about to retire or perceives himself to be in a final-period situation, he may not be disciplined by the fear of reputational sanctions on the managerial labor market).

gatekeeper for the company's long term interests than its managers.

2. Long-Term Investment Does Not Decline Drastically in Hedge Fund Activists' Targets

Opponents argue that hedge fund activists will inflate short-term stock prices at the cost of the long-term wealth creation of the target company to ensure a better short-term financial performance. [132] Two recent studies suggest otherwise. They investigate the impact that hedge fund activism has on R&D expenses, which is a proxy for the long-term interest.[133] The first study shows that, on average, none of the R&D costs, executive bonuses, sales, or general and administrative costs were "strongly impacted."[134] The second study also found no significant difference between the long-term R&D investment in the firms targeted by hedge funds and those in the control sample.[135] Therefore, the empirical evidence supports that overall, hedge funds do not extract the target company's short-term value at the expense of its long-term development.

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[132] *See* Anabtawi, *supra* note 104 and the accompanying text.

[133] *See, e.g.*, Mary M. Bange & Werner F.M. De Bondt, *R&D Budgets and Corporate Earnings Targets*, 4 J. CORP. FIN. 153 (1998) (using the R & D budget of a company as a proxy for its long-term interest).

[134] Although it was too soon to know how many of these commitments would endure in the long-term, Bratton proposed that the evidence, taken as a whole, did not sustain the claims of the activists' detractors. He also examined whether the long-term investments were undercut by hedge fund activists. The study showed that, on average, neither the R&D costs, executive bonuses, nor sales, general, and administrative costs were strongly impacted. Bratton thus concluded that hedge fund activists had not had a remarkable impact on cost cutting. Bratton, *supra* note 94, at 1415.

[135] April Klein and Emanuel Zur also found no significant difference between the long-term investment in research and development between the firms targeted by hedge funds and the control sample. April Klein & Emanuel Zur, *Hedge Fund Activism* 32 (Eur. Corp. Governance Inst., Finance Working Paper, No. 140, 2006), *available at* http://w4.stern.nyu.edu/accounting/docs/hedge_fund_activism_october2006.pdf.

3. Hedge Fund Activism Is Value-Increasing

Even if it is assumed that the problem of short-termism exists, that does not mean hedge fund activism makes the macro economy worse off. For example, if hedge funds discover that the management is doing something that is not in the best interest of a company, they may intervene to correct the deviation and take profit when the stock price bounces back to reflect the value of the correction.[136] Therefore, a short-term investor is not necessarily a value-decreasing raider.

Moreover, empirical evidence shows that hedge fund activism is actually value-increasing. From a cost-benefit perspective, if the values created by hedge fund activists exactly cancel out the aggregate harm done by short-termists, the whole market's value remains unaffected.[137] If instead hedge fund activists generate more value than harmful short-termists, then the market benefits from hedge fund activism.

In a semi-strong efficient capital market, a hedge fund activist's announcement of a value-increasing proposal will increase the value of the target company's stock.[138] Empirical evidence suggests that on average, the market views proposals by hedge fund activists as value-increasing. Two recent studies investigate the market's response when a hedge fund files a Schedule 13D with the SEC (which signals to the market that they intend to be activists) and conclude that the market reacts positively to such information over either a one-month or sixty-one-day period.[139] Although

[136] *See* Brav et al., *supra* note 20 and accompanying text.

[137] This statement reflects the application of cost-benefit analysis which requires people to decide whether the advantage gained from a particular action is likely to outweigh its drawbacks. This is a valuable and constantly used tool in decision making. *See* DAVID R. HENDERSON, THE FORTUNE ENCYCLOPEDIA OF ECONOMICS 3 (1993). But this statement does not take into consideration other external losses that are not reflected in the market prices.

[138] Gilson & Black, *supra* note 21, at 135.

[139] Klein and Zur define hedge fund activism as a strategy in which a hedge fund purchases at least a five percent stake in a publicly-traded

studies provide different explanations for such a reaction, these studies show that the hedge fund activism is generally value-increasing when viewed as a whole.[140]

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firm with the stated intent of influencing the firm's policy. They collected data from 13D statements during January 1, 2003 and December 31, 2005 that (1) correspond to a U.S. publicly-traded firm, (2) are purchased by a hedge fund or hedge fund manager (these two terms are not defined), and (3) present an activist agenda in its purpose statement. Their study identifies 155 hedge fund activist samples and found that the market reacted favorably to the filing of a 13D. Over a sixty-one day period, firms targeted by hedge funds activists had an abnormal return of 10.3% in contrast to 2.9% abnormal return for the matched-firm control sample. Klein & Zur, *supra* note 135, at 32, 35-36. A study by Brav et al., acknowledging the difficulty in defining a hedge fund ducked this problem with a two-step procedure to compile their sampling. Brav et al., *supra* note 20. First, they searched Factiva and Lexis-Nexis news databases for stories during 2004 and 2005 mentioning both the terms "activism" and "hedge fund." From those stories, they gathered the names of approximately 100 hedge funds. Then they performed searches in the SEC Edgar database for securities filings by institutions with those names (or under other affiliated names). Also, with respect to each fund-target pair, they further identified additional hedge funds that had participated in the event but were not found during their first search of media sources. To supplement the sample's inclusiveness further, they sought suggestions from industry members for additions or deletions to their list of hedge funds at various stages during the process. Their study, covering a list of 110 activist hedge funds and 374 fund-target pairs, shows significant, abnormal returns within a month after hedge funds activist filed a 13D. *Id.* at 10, 24.

[140] Klein and Zur's study found that hedge fund activists did not improve the accounting performances of firms in the year after the initial purchase. Earnings per share ("EPS"), return on assets ("ROA"), and return on equity ("ROE") declined in the fiscal year after the activism, while those indicators for the control sample increased and the difference is significant. Instead, hedge funds extracted cash from the firm through increasing the debt capacity of the target firm and paying themselves higher dividends. The latter result, coupled with the positive stock price reaction surrounding the 13D filing date, persuaded Klein and Zur that shareholders perceive benefits to reducing agency costs associated with excess cash and short-term investment. Klein & Zur, *supra* note 135, at 36. The study of Brav et al. sets up six different constructs to explain what kinds of considerations generated the abnormal returns. These six categories are: (1) general: all events where the hedge funds do not specify any specific goal or motive; (2) capital structure: activism targeting excess cash, leverage, dividends payout or recapitalization; (3) business strategy:

However, the empirical studies results do not end the inquiry. What hedge fund activists did in the past does not necessarily reflect what they will do in the future. Furthermore, the currently available empirical studies are still limited in number, and some empirical studies have their own methodological problems.[141] Finally, the two surveys relied on data collected from 2003 to 2005,[142] when the stock market was rising.[143] The role of hedge fund activists in a sharp market decline, such as the recent collapse in the subprime market,[144] is yet to be assessed.

activism related to diversification, spin-off of assets and pending merger and acquisition deals; (4) sale: hedge funds request the sale of the target company; (5) governance: events related to rescinding takeover defenses such as staggered board and poison pills; and (6) financial: events where the main motive is to provide financing to the firm, either for business growth or for reorganization of financial assets. The model shows that the abnormal returns are not generated by the changes in capital structure or governance. Instead, the highest abnormal returns occur in the third and fourth category—when activism targets the sale of the company or changes in business strategies. Brav et al., *supra* note 20, at 22-24. This result contradicts Klein and Zur's conclusion that the disgorgement of excessive cash best explains the existence of abnormal return.

[141] The current empirical studies may be flawed for various reasons. The empirical study done by Brav et al. used press reports as a basis to form their data pool. Brav et al., *supra* note 20. This reflects the difficulties in doing empirical research regarding hedge fund activism when there is no regulatory or statutory definition on either the term "hedge fund" or "activism." However, there is a danger in relying on the media's classification, as every reporter may have different views about what constitutes hedge fund activism. Bratton notes that a big question is whether the sample results is a skewed presentation of adversary investment, in particular by leading to an under- or overstatement of the number of successful outcomes. Bratton, *supra* note 94, at 1385. Larger targets are probably overrepresented as they tend to be more newsworthy. This fact could lead to understatement of success to the extent that larger firms imply a higher level of difficulty. *Id.*

[142] The measured periods of Klein and Zu and Brav et al. are respectively 2003 to 2005 and 2004 to 2005. *See* discussion *supra* note 139.

[143] From the start of 2003 to the end of 2005, the Dow Jones Industrial Average Index rose from 8607 on January 2, 2003 to 10,717 on December 30, 2005.

[144] From December 10, 2007 to the January 22, 2008, the Dow Jones Industrial Average Index dropped from the climax of 13,727 to 11,971.

B. Counterbalance from Other Investors and Reputational Sanctions Deter Value-Decreasing Activists

Despite the obvious limits of the available empirical data, there are additional reasons why hedge fund activists will not ultimately harm a target company. Market mechanisms, such as other investors' counterbalancing actions and the threat of reputational sanctions deter hedge fund activists from undertaking value-decreasing initiatives.[145] When a hedge fund plans to launch an attack that pursues short-term interests at the cost of the long-term interests of the target company, other shareholders who value longer-term interests may counterbalance such an attack simply by supporting the management in the proxy contest.[146] In addition, hedge fund managers may also be deterred from implementing such tactics because of the potential impact on their reputation.[147]

When a hedge fund activist announces its dissatisfaction with the management and board by proposing a change, the board has several options. It may agree to the hedge fund's request, negotiate a settlement acceptable to both parties, or reject the proposal.[148] If no friendly solution can be reached and the management refuses to surrender to the hedge fund,

That represents a drastic twenty percent decline in about one and a half months.

[145] This Note does not address the possibility of under-the-table negotiations between hedge funds and management. If a hedge fund that originally plans to be an activist later enters into under-the-table negotiations with the management to share the surplus arising from a harmful deal proposed by the management, the hedge fund is no longer a gatekeeper for the company but merely engages in rent seeking activities. But since there has not been sufficient evidence indicating this problem, this Note does not take it into further discussion.

[146] *See* discussion *infra*.

[147] *See* discussion *infra*.

[148] According to the survey by Brav et al., in half of the cases involving aggressive attacks by hedge funds, targets fought back. In about one-third of the hostile cases, hedge funds reached their main stated goals. In another third of the cases, hedge funds achieved partial success by gaining concessions from the target. Brav et al., *supra* note 20 at 3.

that hedge fund can only prevail over the management if it defeats the management in a proxy contest.[149] In such a scenario, unless a hedge fund has acquired sufficient shares to dominate the final outcome, which has rarely happened in the past, it cannot prevail without the support of other shareholders who share the fund's views.[150]

There are four primary types of institutional investors in the market: commercial banks, mutual funds, insurance companies, and pension funds.[151] Among these investors, commercial banks and insurance companies tend to support the management unless there is serious dissatisfaction with the management or the company is seriously underperforming.[152] Support from pension funds and mutual funds will turn on whether their investment strategies align with a hedge fund's pursuit of short-term interest. For example, the goal of a stock index fund is to replicate the performance of a certain stock index.[153] As long as the target

[149] Without a shareholders' resolution or restriction set forth in the article of incorporation or bylaws, the business of a corporation shall be managed by or under the direction of a board of directors. *See* DEL. CODE ANN., tit. 8, § 141(a) (2007).

[150] Kahan & Rock, *supra* note 30, at 1088 ("Though hedge funds have become highly active in the corporate governance area, they generally have not become powerful enough to exercise control over the targets of their activism. Rather, they purchase a sizeable, but far from controlling stake – rarely more than five to ten percent – and then seek to influence corporate strategies.").

[151] *See* Scheherazade S. Rehman, *Can Financial Institutional Investors Legally Safeguard American Stockholders?*, 2 N.Y.U. J. L. & BUS. 683, 718 (2006); Roe, *supra* note 38, at 16 (showing that in 1990, commercial banks, mutual funds, insurance companies, and pension funds had assets of $3.2 trillion, $548 billion, $1.8 trillion, and $1.9 trillion, respectively).

[152] Coffee, *supra* note 73, at 1318 (stating that commercial banks and insurance companies have been characterized as the institutions most unlikely to oppose corporate management).

[153] See generally Wikipedia, http://en.wikipedia.org/wiki/Index_fund (last visited Mar. 7, 2008) ("An index fund or index tracker is a collective investment scheme that aims to replicate the movements of an index of a specific financial market, or a set of rules of ownership that are held constant, regardless of market conditions.").

company remains a component of a certain index, that index funds' managers will keep holding that company. They are indifferent to whether a hedge fund's pursuit of short-term interests succeeds because the goal of an index fund is to track the index rather than beat the market.[154] In practice, index fund managers compete with one another on the basis of fund expenses rather than on short-term performance.[155] Therefore, even though index fund managers may not have incentive to be activists,[156] when called on to vote in a proxy fight, they have no incentive to support a value-decreasing move.

Though it is likely that some institutional investors may be interested in a quick profit and thus may choose to support a hedge fund's pursuit of short-term results, "the available evidence strongly suggests that institutional investors are not *systematically* myopic."[157] If the target company is not controlled by institutional shareholders, whether hedge funds can get support from these other shareholders, such as the family of the founding persons or employees of the target company, is also uncertain.[158]

With the counterbalancing power in place, other longer-term investors may simply stand by the management and defeat a proposal pressed by the hedge fund that is harmful to the long-term value of the company. The battle between Carl Icahn, a famous hedge fund manager, and Time Warner Cable in 2005 provides an example.[159] Icahn failed to win

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[154] Coffee, *supra* note 73, at 1365 ("[I]t is impossible to calculate how an index fund's performance exceeded that of the market when, by definition, it sought to match the market.").

[155] *Id.* at 1341.

[156] *Id.* ("Although indexed investors are typically long-term and substantial holders, it does not follow from this that they will be active monitors.").

[157] Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 862 (1992); *see also* Kahan & Rock, *supra* note 30, at 1085 ("[T]he empirical evidence on the extent and magnitude of myopia is sketchy at best.").

[158] Kahan & Rock, *supra* note 30, at 1089 (pointing out that the support from neither type of shareholders can be taken for granted).

[159] *See supra* notes 113-19 and accompanying text.

over even a fraction of his fellow shareholders and called off the control contest before it started.[160] This example illustrates that the market is not merely a passive "rubber stamp," unconditionally endorsing hedge fund proposals. Hedge funds have to proffer good reasons to persuade the market to act in concert with them. On the other hand, if hedge funds do provide proposals beneficial to the company, other shareholders, even other hedge funds, may simply free ride by supporting such proposals.[161]

The reputational sanction provides an additional deterrent pressure against value-decreasing moves by hedge funds. In the closely-knit investment industry, major institutional investors, such as hedge funds, mutual funds, and pension funds, interact with one another frequently on a variety of issues.[162] Fund managers with a good reputation of "playing it straight" will elicit cooperation from other managers while managers with bad reputations will invite non-cooperation or retaliation in the future.[163]

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[160] Matthew Karnitschnig, *Icahn Ends Effort to Take Control of Time Warner: Activity Cuts Director Slate After Faining Little Support; Settlement Talks Under Way*, WALL ST. J., Feb. 17, 2006, at A1.

[161] Julia Angwin, *Icahn Issues Time Warner Challenge: Financier Confirms Alliance With Other Investors to Seek Changes at Media Company*, WALL ST. J., Aug. 16, 2005, at A3 (reporting that Jana Partners, a hedge fund activist that manages $4 billion, joined hedge funds led by Carl Icahn in numerous activist campaigns, including a successful effort to persuade Kerr-McGee Corp. to shed some assets and to do a larger stock buyback than originally planned).

[162] Black, *supra* note 157, at 857 (arguing that institutional investors have to join forces to influence the corporate managers, and therefore they have to interact constantly over various issues). It is worth noting that Professor Black, in his more recent work, was less optimistic about institutional investor activism. BERNARD BLACK, *Shareholder Activism and Corporate Governance in the United States*, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459 (Peter Newman ed., 1998). But he did not consider hedge fund activism in his evaluation of the effect of institutional investor activism.

[163] Black, *supra* note 157, at 857 (suggesting that reputation is important because "[i]n the language of game theory, shareholder voting is a repeated game without a final period, in which players can retaliate").

Accordingly, if a hedge fund manager initiates a proposal which benefits itself at the cost of other shareholders and prevails over the incumbent management and other institutional investors, that hedge fund manager runs a risk of retaliation from other institutional investors in future battles. The fear of establishing a bad reputation may thus deter hedge fund managers ex ante from launching a value-decreasing attack. On the other hand, if a hedge fund builds a good reputation by being a value-maximizing activist, other investors will reward it by providing support in future battles.

V. CONCLUSION

This Note suggests that the market as a whole is likely to benefit from hedge fund activism. With less serious free riding problems and fewer legal restraints, hedge funds are in a unique position to pursue value-increasing proposals and confront self-interested or under-performing management. Hedge fund activists can be effective watchers in the market, deterring corporate management from undertaking a harmful course of action and instead encouraging value-enhancing behaviors. If the management does proceed with proposals that are deemed harmful to the company, hedge fund activists can obtain the support of other shareholders to defeat the managers and take their profit after the stock price bounces back to reflect a successful correction.

While some worry that hedge fund activists are short-term investors and thus pose risk to the market, these concerns are misguided and overstated. First, empirical evidence has shown that hedge fund activists typically commit themselves to the target company for an intermediate term of at least two years. Second, hedge funds may actually be less short-sighted than management. The evidence has also shown that indicators for long-term investment, such as R & D expenses, do not drastically decline in the target companies and that activism is value-increasing overall. Third, market mechanisms deter value-decreasing hedge fund activism. Shareholders can counteract such proposals by supporting the management in proxy fights. The threat of reputational sanction also prevents a hedge fund activist from making such proposals in the first place. This Note ultimately concludes that hedge fund activism will likely generate positive effects on the market.