THE IMPLICATIONS OF ALTERNATIVE INVESTMENT VEHICLES

FOR CORPORATE GOVERNANCE:

A SYNTHESIS OF RESEARCH

ABOUT PRIVATE EQUITY FIRMS AND "ACTIVIST HEDGE FUNDS"

Issued by the OECD Steering Group on Corporate Governance, July 2007

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Summary of the Discussion of the Steering Group on Corporate Governance and Main Conclusions

In November 2006, the OECD Steering Group on Corporate Governance initiated a study of the role of privately organised pools of capital (sometimes referred to as "alternative investment vehicles") in corporate governance. The Steering Group's inquiry is focused on those private equity firms and hedge funds that pursue investment strategies that explicitly aim at increasing the value of their pooled capital through active engagement with individual, publicly held companies. While the terminology may not be perfect, these investors are referred to as private equity firms and "activist" hedge funds. As a consequence, the inquiry is limited to a relatively small subset of privately organised pools of capital and does not cover other policy aspects, such as financial stability or the participation of retail investors in private pools of capital. The Steering Group recognises that financial stability and investor protection are also important since sound financial markets are important for promoting good corporate governance practices. Nevertheless, at this stage of the debate, the Steering Group considers it more appropriate to focus on its area of specific expertise and experience in the area of corporate governance, leaving the broader issues to be considered by other specialised fora.

While private equity firms and "activist" hedge funds have been operating for some time in both the UK and the US, they are comparatively new in many other jurisdictions where they have been subject to increased attention, partly due to differences in corporate governance frameworks and company structures. With a rapid increase in the size of transactions and investments, there has been a growing public interest also in the US and the UK. The Steering Group agreed that the distinct corporate governance aspects that emerge in these discussions required special attention based on the OECD Principles of Corporate Governance (OECD Principles).

This Section summarises the main conclusions from the Steering Group's meeting on 16-17 April. The following sections present the findings of a factual review undertaken by the OECD that were taken into consideration.

In developing their conclusions, the Steering Group drew on principle I.A of the OECD Principles: *The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets*. This meant that the Steering Group considered not only the direct actions of the investor categories being considered (in relation to the OECD Principles), but also the available empirical and analytical work reviewed by the OECD about the impact on economic efficiency and the adequacy of the corporate governance framework in which these investors operate.

On the basis of this evidence, the Steering Group concluded that "activist" hedge funds and private equity firms could help strengthen corporate governance practices by increasing the number of investors that have the incentive to make active and informed use of their shareholder rights. This may include demands for changes in management, the composition of the board, dividend policies, company strategy, company capital structure and acquisition plans. Such active and informed ownership is expected to stimulate the search for the best possible use of corporate assets and thereby contribute to better risk and resource allocation in the economy as a whole. Promoting efficient outcomes for actions taken by active and informed ownership is therefore likely to remain an important policy objective for the years to come. To this end, the Steering Group discussed the potential implications for some areas of the OECD Principles, notably: the efficiency of the market for corporate control (including takeover regulation),

transparency requirements, the reliability of voting systems and the monitoring/management of conflicts of interest through the exercise of fiduciary duties by management and boards.

It was agreed that, from a corporate governance perspective, there was no need to promote a special set of principles for private equity firms and "activist" hedge funds. The opportunities and challenges that follow from their ownership strategies should instead be analysed within the general framework of the OECD Principles. The analysis will also take into account existing voluntary standards established and promoted by the industry.

It is hard to define the differences between activist hedge funds and private equity and between these investors and other investors

The Steering Group's attention is focused on those self-described private equity firms and hedge funds that pursue investment strategies that explicitly aim at influencing corporate behaviour and organisation of publicly held companies. This Section refers to these investors (or investment strategies) as private equity firms and "activist hedge funds" respectively. The Group recognised that legal definitions of these two types of investors are not forthcoming and that other categories of investors pursue similar investment strategies and use similar financial techniques to support investment strategies such as hedging, leverage and share borrowing. Moreover, not all private equity firms and far from all hedge funds pursue such strategies. This difficulty of definition is an additional reason to focus on the effects of the increasing role of private equity and activist hedge funds on the robustness and effectiveness of the overall corporate governance framework rather than developing corporate governance regulations addressing specifically the behaviour of these investors.

The business model of private equity firms and "activist" hedge funds can be summarised as seeking 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 corporate governance issues. The investor may also take a public company private for a period of restructuring before either returning it to public ownership or by selling it to another company. This "public-to-private" strategy is typically associated with private equity firms (it has been adopted by a few activist hedge funds, too) and is the form of private equity transaction covered by this Report. In line with this focus, the Report does not cover, for example, private-to-private deals by private equity firms.

"Activist" hedge funds are only a small part of the capital market.

Although there is little to prevent a migration of hedge funds to the activist strategy, the number of activist hedge funds in the global economy is probably only about 100-120 with funds under management of around USD 50 billion (excluding leverage). If all funds pursuing "event-driven strategies" were to be included, the sum would rise to about USD 200 billion and perhaps to some USD 1-1.5 trillion if high leverage is taken into account. By way of comparison, the global mutual funds industry alone has USD 18 trillion under management.

Record levels for public-to-private transactions in 2006 involved larger companies and more employees, but conventional mergers and acquisitions remain more significant

The value of public-to-private buyouts surged to a record USD 120 billion in the USA in 2006 from around USD 85 billion in 2005, about 1.5% percent of GDP. Outside of the US, the figures are very

sensitive to a few large transactions. In the UK, public-to-private transactions amounted to GBP 7.2 billion in 2005 falling to GBP 5.8 billion in 2006 (around 1.75% percent of GDP) with just 24 transactions and none involving a FTSE 100 company. In Continental Europe, transactions amounted to EUR 25.7 billion in 2006 from 16 transactions but almost 85% came from two large transactions in Denmark and in the Netherlands. In most OECD countries, the level of public-to-private transactions remains well under 1% of GDP. The transactions also need to be viewed against the background of a mergers and acquisitions boom: in 2006, public-to-private buyouts accounted for only 20% of total mergers and acquisitions, albeit up from around 10% in 2001.

The average share of debt in financial structures varies markedly across deal sizes with larger deals having the higher shares of senior and mezzanine debt. Among the very largest deals, the average combined share of financing structures accounted for by debt has increased from 55% in 2000 to 67.3% in 2006.

Public-to-private transactions sometimes involve very large publicly held enterprises and the size is tending to increase. This also means that the work forces are correspondingly significant. In 2003, 450 000 employees were involved in new European deals. In 2005, the figure reached 850 000, although biased by one large transaction in Denmark. The larger deals often involve a number of funds. There are some indications pointing to coordination problems with "clubs" of private equity funds, suggesting that they are also starting to experience coordination problems similar to public company shareholders.

Any addition to the pool of informed and active investors is positive for corporate governance

The Steering Group concluded that in the presence of perfect capital markets there would be little scope for a special category of "active" investors, like private equity firms and "activist" hedge funds. However, when markets are not perfect but characterised by information asymmetries and costs of collective action, managements might pursue their own goals and interests rather than those in the best interest of the company and its shareholders. In these circumstances, there is an important role for "active" investors with incentives to invest in both acquiring and using information. Capital markets around the world are, however, increasingly dominated by institutional investors that often adopt passive investment strategies. These strategies include index-tracking rather than stock picking. There is also a collective action problem made worse by the side-effects of prudential regulation that limits the share of equity held in a company by some institutional investors. As the OECD Principles note, limiting the proportion of equity held in a company reduces the private returns from monitoring the corporate governance arrangements of a company and in exercising shareholder rights. In such a situation, activist hedge funds that are not constrained in their shareholding levels and that have strong incentives to exercise their shareholder rights could improve the overall efficiency of capital markets and underpin good corporate governance.

The OECD Principles call for an efficient and transparent market in corporate control which will counter-balance any tendency for management and boards to weaken their accountability to the company and to its shareholders. The Group recognised that active ownership functions as an incentive for improving corporate governance practices. In this context, private equity transactions and "aggressive" demands vis-a-vis the management, or indeed the threat of such actions (where they do not undermine market integrity), could make a contribution to improving corporate governance and also to improving economic performance.

The case of short termism

It is sometimes suggested that activist strategies weaken corporations by directing resources away from long-term, value-creating strategies, which are the ultimate objective of good corporate governance.

This point of view is associated with other propositions including a belief that the economic and corporate governance frameworks together foster short termism rather than patient, long-term investment by "real owners" that leads to improved economic performance. The period of engagement by activist investors of some 2-6 years is often taken as proof of the "short run" proposition.

The claim is closely related to a long running debate about the degree of market myopia and about whether and under what circumstances markets are likely to be strongly efficient ("perfect foresight"). Empirical work suggests that while markets are not necessarily perfect, longer term factors are valued even in markets characterised by short-run behaviour: equity valuations tend to reflect corporate investment activity and price/earnings ratios imply long term considerations of often around 15 years. Research and development (R&D) investments and related innovation strategies are also incorporated quite rapidly into market valuations. Even if investors as a whole might be myopic, the literature indicates that a small pool of active investors looking at long-run prospects are key to market performance even if the same investors will only invest in the company for a limited period. Hence, at least in cases where these market participants consider long-term prospects, reference to the investment horizon of an investor class does not say much about the efficiency of the market and long-run economic performance.

Available empirical research suggests that it is the lack of a credible long-term strategy that makes a company a target for active investors in the first place, especially when it has large cash reserves and is unable to communicate a credible investment strategy. It is not surprising that corporate strategies that have been developed to make companies less attractive to private equity firms and "activist hedge funds" typically highlight the need for the company to: *(a)* have an informed board; *(b)* communicate a viable long-term strategy to market participants; *(c)* review the capital structure; *(d)* establish a clear dividend policy, etc. That is to say, even in response to investors with a limited time horizon, companies are encouraged to make sure they meet standards that are commonly associated with good corporate governance.

How well does the corporate governance framework accommodate new ownership practices?

The OECD Steering Group agreed that there is scope to analyse the specific issues that relate to the behaviour of private equity firms and "activist hedge funds" within the framework of the OECD Principles. In line with the OECD Principles, this analysis should be made with a view to overall economic performance, market integrity, incentive structures for market participants and the promotion of transparent and efficient markets. Areas where deviations, shortcomings and/or stresses in the corporate governance system may appear include: (a) the integrity of voting systems; (b) the efficiency of the market for corporate control; (c) transparency; (d) market integrity; and (e) controlling potential conflicts of interest among managers, board members and shareholders. Going forward, it should be noted that some of these issues are addressed by voluntary standards developed and promoted by the industry. It will also be useful to obtain a better empirical understanding of practices beyond the US and the UK, which are the two dominant markets for private equity firms and "activist" hedge funds, in order to also analyse the role of these new forms of activism in systems characterised by different models of ownership structures and control mechanisms. It would be interesting, in particular, to investigate if there is room for a positive role for active investors to play in the corporate governance of companies with a high level of ownership concentration and in more bank-oriented financial systems.

"Activist hedge funds" seek to influence corporate behaviour without acquiring control …

"Activist hedge funds" use a range of strategies, usually founded upon ownership of relatively small but nevertheless significant voting stakes in companies and the threatened use of voting rights, often

combined with public campaigns for change. They sometimes use derivatives (or other financial techniques such as share lending) to boost their voting power at a relatively low cost and often solicit support successfully for their reform programmes from other private pools of capital and more traditional institutional investors. From this position, they make corporate governance demands on boards and management from a position of strength. Their demands often target the company's operational strategies and use of capital. They may also seek changes in corporate governance structures and policies where it appears that shareholders' ability to exercise key ownership functions (such as to elect and remove board members) has been restricted. Their success rate seems to be impressive with several studies indicating rates of 60-75% in preventing mergers or supporting takeovers, changing CEOs and board composition, and in altering the capital structure of a company through share buybacks, etc. There is no evidence that such firms have been damaged for short term gain by an activist investor.

…which puts the voting systems to a test ...

Hedge fund activism has led to more closely fought corporate votes, *e.g.* in board elections and contests for control in some jurisdictions. In a few jurisdictions, these battles have raised questions about the integrity and efficiency of the existing mechanisms to identify, process and execute voting rights. This problem seems to have been accentuated when "activist hedge funds" make use of share lending close to a proxy contest or shareholder meeting in order to increase their influence. While there is nothing inherently problematic about share lending, it has put the voting system to a test and appears to have resulted in cases of over-voting in a few jurisdictions. This will of course make the outcome of close contests difficult to judge and challenges the principle of equitable treatment of shareholders. Another issue concerns activism in cases where the shareholder turnout at annual or extraordinary general meetings is low. The first, best solution in this case is to remove the barriers to shareholder participation.

A practice that has received a great deal of attention by academics is so-called "empty voting" but in practice it does not appear to be widespread. This happens, for example, when the economic interest in a share (*i.e.* the risk held in a company) is hedged or in effect sold so that the voting right is all that remains. Empty voting is not the exclusive domain of hedge funds. Management might use this technique to transfer the economic risk of ownership while retaining voting power to facilitate entrenchment. A majority shareholder might use the technique to maintain control while minimising its exposure to the company. A few hedge funds using this strategy have attracted attention when it puts them in a potential conflict of interest relative to other shareholders. This could happen, for example, if a hedge fund that has an interest in both the acquiring company and the target company fully hedges its exposure in the acquiring company and publicly comes out in favour of the acquisition even though the purchase price overvalues the target company. Similar conflicts of interest between shareholders have arisen in the past, so the issue is not a new one in company law, but managing this situation can become more problematic with the increasing importance of new active investors and with continuing financial innovation.

While the problems connected with these practices can be very relevant, it seems necessary to carefully consider the effects of any possible policy actions on the development of capital markets and on the effectiveness of corporate governance discipline. An adequate balance among different needs could be reached mainly through increasing transparency rather than prohibiting or hampering these new practices. In any case, costs and benefits of any "selective" rule should be carefully evaluated, once market failures have been clearly identified.

…and may call for improvements in related regulatory provisions for disclosure.

In the course of building up their ownership stakes, "activist hedge funds" are subject to laws of general application requiring timely disclosure, consistent with the OECD Principles. These take the form of disclosure once certain ownership thresholds have been reached (*e.g.* 2%, 5% or 10%). In some jurisdictions, detailed disclosure must also be made regarding the blockholder's intentions and its arrangements with the company or other shareholders. While originally introduced to control takeovers by stealth, such requirements have served to improve transparency and discipline in the market for corporate influence. Questions have arisen in some jurisdictions, however, about whether existing requirements: (a) fully and consistently encompass the kinds of economic and voting interests that can be created through derivatives transactions; and (b) are set at the optimal threshold for these new market conditions where it is possible for investors to exert significant influence without having or seeking control.

In executing their value creation strategy, "activist hedge funds" typically rely on the support from other investors with whom they might consult and often use public declarations rather than private negotiations with management. Communication and coordination between investors is advocated by the OECD Principles subject to safeguards regarding market abuse. The opportunity for market abuse and especially insider trading and abusive self-dealing appears to be a significant concern at times and in some jurisdictions and would not be compatible with the OECD Principles that advocate equitable treatment of shareholders. An appropriate regulatory framework and effective oversight in this area are particularly important, given the powerful incentive structures for hedge fund managers.

Private equity is a major force in public-to-private transactions…

Private equity firms apply a wide range of different and complementary strategies including financing public and private companies and the provision of venture capital. As mentioned above, the Steering Group has focused on transactions where publicly held companies are taken private, so-called public-to-private transactions. The objective of such transactions is typically to restructure the company, improve the use of corporate assets, increase its value and sell it again at a higher price. The pooled capital that is used in this process is typically locked-in for a period of ten years and levered by taking on debt, often at a ratio of about 3:1 depending on the type of transaction.

... which requires an efficient and transparent market for corporate control.

The process of taking a public company private involves some key corporate governances issues covered by the OECD Principles. The review of current practices undertaken for the Steering Group points to several potential concerns that deserve special attention. These are primarily related to the requirement that the "markets for corporate control should be allowed to function in an efficient and transparent manner". A related issue concerns the fiduciary duties of board members and management, since they are often a party to the takeover and therefore conflicted. One study of fifty large public-to-private transactions in the US showed that 34% of the boards of target companies did not form an independent committee to evaluate, negotiate and approve the proposed transaction. Questions about whether boards have fulfilled their duties to the shareholders in general and to the company have also arisen with a number of transactions in other jurisdictions.

Compensation structures might also be an issue and might raise specific problems with regard to the integrity of management and board behaviour as defined by the OECD Principles. For example, it appears that in some cases options for managements and board members might vest in the case of a successful takeover, leaving the suspicion that they might be disposed to accept a takeover (*i.e.* "throw in the towel") even if the transaction does not maximise value for shareholders and the company. Pension funds and other institutional investors might also be disposed to lock in a cash gain. In combination with the recent

tendency to form private equity clubs to bid for large firms, there is often a perception that despite high acquisition premiums of 30-40 %, some companies are being sold too cheaply.

Other concerns can arise, from an opposite point of view, where the fluidity of the market for corporate control is hampered by regulations or practices which over-protect and lead to the entrenchment of management. While public-to-private transactions are often uncontested by the board and management, the OECD Principles recognise that an efficient market for corporate control requires that anti-take-over devices should not be used to shield management and the board from accountability. It cannot be excluded that the presence of such anti-take-over provisions may limit the number of companies that may otherwise be the target of "activist investment strategies".

Only some companies attract private equity investors…

Empirical work suggests that the typical target for a public-to-private transaction is likely to be undervalued, with high cash balances and a relatively low level of debt. Since the transactions are rarely "hostile", there will also be a potential for close relations with management and the board, many of whom have significant equity positions and will be favourable to the transaction. In the UK, companies that are subject to public-to-private transactions have a significantly higher default probability prior to being bought-out than other companies. This is not the case in the US where the probability of a public-to-private transaction is actually lower when there is potential financial fragility.

Tax arrangements can drive transactions but is far from the sole factor

The Steering Group was also interested in the role of taxation in public-to-private transactions. On average, pre-transaction shareholders in the target company of a public-to-private transaction receive a premium of approximately 40%. In trying to determine how tax influences the premium, studies for the US and for the UK come to different conclusions, although it should be noted that the research covers different time periods. Older research in the US suggests that the tax effect might account for between 20-70% of the premium depending on the structure of the transaction. In the UK, the fact that higher premiums are paid for firms with lower leverage provides weak support for the tax benefits hypothesis. The unused debt capacity is likely to create a large additional tax shield. However, the tax system is important in other ways than just through corporate taxation of the target company.

Taxation of private equity partners and of limited liability partnerships differs from one country to another and can encourage or discourage investment activity through private pools of capital. The treatment of capital gains is also important, especially for the general partners (*i.e.* carried interest). In some countries there appears to be a contradiction between taxation incentives to encourage venture capital on the one hand, and the desire to discourage private equity involving public-to-private transactions on the other hand.

Exits by private equity are a critical part of the process

A key step in the private equity model is the exit phase when the private equity fund sells the company either through a new listing, sale to another company (trade sales) or through sales to another private equity firm (secondary sales). An initial public offering (IPO) is usually the most profitable and desirable route for a fund but trade sales have been the most common form of exit except in recession periods, accounting for a third of all exits in some jurisdictions. It is important to note that in an IPO, the private equity fund often maintains a sizeable equity position for some time thereafter, and presumably remains an active monitor.

Partial sale of the portfolio company provides a means for realising part of the initial investment without losing control and might indicate an evolution of the private equity model. The number of partial sales following buyouts is generally between 70 and 100 per year in the UK and around half this level across Continental Europe. The total value of partial sales peaked at around Euro 9 billion in 2005, with Euro 2.2 billion worth of disposals in Continental Europe.

The performance of companies re-listed after a public-to-private transaction is good and in many cases superior to other companies

It is sometimes argued that firms exiting private equity are weakened by high debt. While there are some high profile examples of quick collapses (*e.g.* Refco), this image is not supported by the data. The review of empirical work conducted for the Group pointed to one important study of 496 private equity-led IPOs in the US during the period 1980-2002 that found that these companies, and especially the larger ones, significantly outperformed the market and other IPOs. The exception to this result concerns "quick flips", such as when a company is returned to the market within one year. Such "quick flips" receive a great deal of press attention but are not common.

…but some methods have raised concerns

Some concerns have been raised about the sharp rise in refinancing and leveraged recapitalisations in recent years. Leveraged recapitalisation usually involves returning to the debt market in order to release capital from the enterprise to investors (*e.g.* by a special dividend). At this stage it is difficult to see whether this is a temporary phenomenon or a sign of a change in the business model.

Company performance appears to improve under private equity…

The review of research about company performance commissioned by the Steering Group noted that empirical evidence is at present mainly confined to the UK where there is a reasonable sample of exited transactions. This allows for the measurement of the increase in the value of the enterprise as distinct from the return to equity which is biased upwards by leverage and dividend distributions. One study of exited buyouts in the UK found an average return of 22% net of market index returns on the enterprise value of the firm, indicating that real gains are achieved. The most common form of value creation by private equity investment is through add-on acquisitions (53%) and replacements within the top management team (43%). In around a fifth of the cases, value-creating activities involved expansion of the product line, growth in sales, a new marketing approach, strategic reorientation, organisational restructuring, geographical expansion, cost cutting and adjustments in work force/consolidation and outsourcing.

…. but the risk adjusted returns to investors do not suggest unlimited potential for private equity so that it might be seen as a complement to public markets

An important question is whether the private equity model is sustainable and represents an alternative to public markets. While it appears to be highly profitable for private equity partnerships (one has to also bear in mind the significant losses from failed investments), does it offer returns to investors net of fees that would encourage them to maintain their investment? The evidence considered by the Steering Group is mixed. A recent study of 199 US buyout fund investments finds a positive and statistically significant alpha (*i.e.* excess returns to the market return) in comparison with equally risky levered investments in the S&P 500. Other studies are more agnostic, indicating average returns net of fees to be roughly equal to holding the S&P 500 but there is a wide and persistent difference between private equity funds. This might indicate that the room for such funds is limited so that it is a far from universal model.

The empirical work reviewed for the Steering Group indicates that private equity is a risky business with a number of transactions involving companies already in difficulties yielding low returns, offset by some highly profitable investments. As an illustration, one study showed a mean rate of return to equity of 70.5% but a median of -17.8%.

The aggregate effect on employment is not inherently negative and should be further assessed…

The Steering Group noted that employment effects were often a public concern when discussing ownership by private equity firms and intervention by "activist" hedge funds. However, it is not possible at this time to draw any substantiated conclusions about their aggregate effect on the overall level of employment, which is the relevant aspect from a public policy perspective. The aggregate employment effect will depend on how long companies have been held by private equity funds and the age composition of the portfolio of public-to-private companies. It will also depend on the state of the business cycle, labour market flexibility and adjustment policies. It would not be economically meaningful to record the employment of a public-to-private company sold to another company (*i.e.* trade sale) as an employment loss associated with private equity. When viewed over the whole life of the public-to-private investment, it does not appear that active ownership strategies have an inherently negative impact for employment by a company. Considering this topic's importance, the Steering Group will nevertheless continue to follow empirical and analytical work related to the link between active ownership strategies and the aggregate impact on employment.

…together with stakeholder issues more generally.

In line with Chapter IV of the OECD Principles, the Steering Group recognised that various stakeholders often have a strong interest in the outcome of a public-to-private transaction. In some jurisdictions, these rights might be less defined and enforceable than in others. One aspect that has been observed in a number of cases concerns creditors in the target company suffering a market loss when their debt is downgraded due to a leveraged buyout. Such an event can also happen in a conventional merger or acquisition when the purchaser is highly leveraged. A solution adopted by some creditors is to insist on change of control covenants in their loan agreements, but these may not be enforceable in some jurisdictions.

The Steering Group also noted that in some jurisdictions, employee rights established by mutual agreements might also be an issue in a public-to-private transaction. The acquired rights include agreed health and pension provisions as well as performance-enhancing mechanisms. The issues are often complex, especially in those cases where a company is in financial difficulty and is being acquired by private equity to be restructured. The question facing employees might be either to renegotiate the pension or health agreement or force the company into bankruptcy in the hope that claims will be protected. Much evidently depends on the specifics of the jurisdiction including the insolvency regime. In some jurisdictions, performance-enhancing mechanisms are enshrined in labour or corporate law and therefore, like other rights established by law, do not change even in the event of a change in ownership.

I. Introduction

Capital markets continue to evolve with significant implications for corporate governance. In November 2006, the OECD Steering Group on Corporate Governance (Steering Group) asked the OECD Secretariat to prepare a report (Report) focusing on the potential implications for corporate governance of the increasing ownership by privately organised pools of capital in publicly held, and formerly publicly held, companies. More precisely, this Report focuses on those private equity firms and hedge funds that pursue investment strategies that explicitly aim at influencing corporate behaviour and organisation through active engagement with individual companies.

The Steering Group's interest in these investors derives from the close connection between their impact on the behaviour, governance arrangements and performance of the companies in which they invest and the objectives and outcomes advocated in the OECD Principles of Corporate Governance (Principles). Some people believe these investors' behaviour is detrimental to good corporate governance. They characterise private equity firms and hedge funds as "locusts", "pirates" or "wolf packs" and blame them for diverting the attention of existing management and boards from their supposedly long-term goals to short-run financial objectives ("short termism").

Others see these investors in a positive light, characterising them as active investors who help reduce agency costs caused by under-disciplined management and under-performing boards, thereby filling a gap in the capital markets through the exercise of market discipline. They are therefore viewed as contributing to the outcomes advocated by the Principles. Some people also say that alternative investors do not act in a way that is greatly different from other investors who are involved in monitoring the performance of their investments.

It is easy to find individual cases to support either viewpoint. Until recently, however, there have been very few systematic analyses of how these investors affect the corporate governance and performance of publicly held companies. This Report seeks to contribute to better understanding of the existing situation by drawing together recent studies and presenting the available data in a framework based on the Principles. In particular, the Report considers the following questions:

- How does the behaviour of these investors resemble, or differ from, that of other investors in capital markets?
- Do these investors fill any gaps in the corporate governance landscape and capital markets, *e.g.* by inducing better corporate governance practices in environments where other market participants have shown less initiative or had less success?
- Do the activities of these investors complement or facilitate efforts by other investors to exert market discipline?
- To what extent is the behaviour of these investors, on average, consistent with the OECD Principles?[1]

1. In particular, relevant Principles to be considered include:

- Is there any significant risk that these investors are achieving abnormal returns in certain markets through the exploitation of weaknesses in corporate governance systems?

- Do the activities of these investors, put stress on certain components in the corporate governance framework, such as voting systems?

- How does the corporate governance framework described in Chapter I of the Principles affect these investors' behaviour and the associated market outcomes? (For example, regulatory arrangements might create incentives for particular behaviour in some jurisdictions that is not observed in others.)

- Chapter II (*e.g.* Principles II.A covering voting rights and the sharing in the profits of the corporation, II.B concerning fundamental corporate changes, II.C covering effective participation in shareholder meetings , II.E regarding the market for corporate control, II.F recommending that the exercise of ownership rights by all shareholders should be facilitated, II.G recommending that shareholders should be allowed to consult with each other on issues concerning their basic shareholder rights, subject to exceptions to prevent abuse);

- Chapter III (*e.g*. Principles III.A recommending equal treatment of all shareholders of the same series of a class , III.B calling for the prohibition of insider trading and abusive self-dealing, III.C regarding disclosure by board members and key executives of any material interest they have in any transaction or matter directly affecting the corporation);

- Chapter IV (*e.g.* Principles IV.A concerning respect for the rights of stakeholders established by law or through mutual agreement, IV.C concerning performance-enhancing mechanisms for employee participation in corporate governance and IV.F regarding enforcement of creditor rights);

- Chapter V (*e.g.* Principle V.A.3 regarding disclosure about major share ownership and voting rights, V.A.4 regarding disclosure of information about remuneration policy and regarding board members, the selection process and their relationship to the company, V.A.5 regarding related party transactions, V.A.6 regarding disclosure of foreseeable risk factors, V.A.7 regarding disclosure about issues affecting employees and other stakeholders, V.A.8 regarding disclosure about governance structures and policies and V.E regarding equal, timely and cost-efficient access to relevant information for all users); and

- Last, but not least, most of Chapter VI (*e.g.* Principle VI.A defining the duties of the board).

II. Private Equity Firms and Activist Hegde Funds: Definitions, Structure, Size and Scope of Operations

1 Activist alternative investors: then and now

Activist alternative investors are not a new phenomenon, and this is not the first time they have raised corporate governance concerns.[2] For example, there was a remarkable level of takeover activity in the 1980s in the United States, including highly leveraged takeovers by so-called "raiders". This pejorative term was used because it often seemed that there were no obvious synergies between this group of bidders and their targets. In such deals, the bidder often planned to sell core assets to repay the debt incurred in the acquisition. Their behaviour led to debates about the respective rights of boards and shareholders in the market for corporate control as well as about the market efficiency of different takeover arrangements.[3] The takeover wave briefly quietened in the early 1990s due in part to an economic slowdown, the collapse of the junk bond market and the development of takeover defences and protections.

Buyout activity increased again in the second half of the 1990s and accelerated after 2002/2003 in both Europe and the US but with a different business model. Investor-led buyouts (IBOs) developed in the late 1990s as private equity firms sought attractive deals in an increasingly competitive market and corporate vendors preferred to sell large divisions through auctions instead of giving preference to incumbent managers in MBOs. These private equity managers generally operated with a longer time horizon than the earlier "raiders" and were supported by investors taking a similar time horizon. This acquisition model is very different from the junk bond-financed model frequently used earlier. With private equity acquirers employing staff with a longer-term managerial perspective, the difference between friendly and unsolicited takeovers lost a great deal of its significance in the course of the 1990s.

Hedge funds have also been active at least since the early 1990s. In the 1990s, many such funds used long-short equity strategies, investing especially around the time of takeovers with a view to locking in a riskless gain through arbitrage plays.[4] Many were also particularly active in foreign exchange transactions. However, activist hedge funds, the focus of this Report, were less obvious until the 2000s.

2. B. Cheffins and J. Armour (2007)

3. For instance, some argued that the market in corporate control at that time dealt with the free cash flow problem and resulted in the restructuring of US industry and a break-up of value-destroying conglomerates (*e.g* Jensen, 1993). Others argue, to the contrary, that shareholder rights plans (often called "poison pills"), decisions of the Delaware courts validating certain defensive strategies employed by company boards (such as the "just say no" defence) and the enactment in some states of legislation inhibiting certain acquisition strategies that lacked the target company board's support "saved" corporate US. Critics of these developments predicted an increase in agency costs from greater management entrenchment. In retrospect, the corporate governance framework was adapted by market participants, with greater recourse to independent boards and performance-based management remuneration that altered the incentives faced by insiders (see Kahan and Rock, 2002).

4. These strategies are described in Block (2006).

2 The difficulty in classifying investors

2.1 Hedge funds

Although the financial press and policy makers regularly use the term "hedge funds", it is difficult to define them in such a way that they are clearly different from other investment vehicles and/or financial market participants. Indeed, in many if not most OECD countries, and even in those that regulate hedge funds or their managers, there is no definition of a "hedge fund" for regulatory purposes.[5]

Despite the absence of formal definitions, a number of features generally are considered to define hedge funds (Box 1), but other investors and/or financial market participants often possess one or more of these features, too. Indeed, as discussed in Part 2.3 below there is some convergence between "hedge funds" and other forms of investment and/or asset management vehicles, so that even the classification of hedge funds as "alternative investment vehicles" has lost a lot of its analytical power.

Box 1. The difficulty in defining hedge funds

The features which distinguish hedge funds are generally accepted to be:

(i) They tend to be unregulated collective investment schemes, even if the managers are regulated and they must follow other financial market regulation such as disclosing significant shareholdings.

(ii) They make extensive use of derivatives – but so do banks, insurance and securities companies.

(iii) They use shorting techniques – but so do others.

(iv) They use extensive leverage but so do others including private equity funds.

(v) They have performance related fees of 20%, but in the UK one fund manager reports that about a fifth of its actively managed funds were managed against a fee structure which was broadly similar.

(vi) They tend to seek investment opportunities across the market widely, looking not only at established markets in equity and bonds (and their derivatives) but also at commodities, catastrophe insurance, film financing and investments in illiquid assets. Banks, insurance companies, and securities companies also pursue such investments.

(vii) They have a short term time horizon, but so do long term investors such as mutual funds that have to stay close to the market index and stay within a risk envelope.

Source: McCarthy (2006) and OECD

5. In its recent report, The Regulatory Environment for Hedge Funds: A Survey and Comparison, the Technical Committee of the International Organisation of Securities Commissions (IOSCO) found that none of the twenty surveyed jurisdictions had a comprehensive definition of "hedge fund". See IOSCO (2006).

2.2 "Activist" hedge funds

"Activist hedge funds" are defined in this Report as investment vehicles that seek, often through the exercise of voting power or the threat of it,[6] to influence publicly held companies to take actions that the hedge fund believes will increase the company's value. This Report, however, does not look at "hedge funds" that are simply arbitraging the market by taking long and short positions in equities[7] unless, as in the case with some proposed takeovers and mergers, they combine arbitrage activities with private or public efforts to influence the outcome of the proposed transaction through engagement with companies, investors, analysts or advisory services such as Institutional Investor Services Inc. (ISS).

Many other investors are also "activist" but it is often argued that they are long-term investors, whereas hedge funds are considered to be short-term investors. However, recent studies suggest that such a broad and arbitrary classification is inaccurate and unhelpful. As discussed in more detail in Section V below: *(1)* many activist hedge funds invest in companies for as long or even longer periods of time than many so-called traditional institutional investors; and *(2)* short-term investment strategies are not necessarily correlated with adverse impacts on corporate governance, nor are "long-term" investment strategies uniformly correlated with better corporate governance and increased value. For the efficient operation of markets and the promotion of good corporate governance, it is necessary that at least some investors take a long view of what determines value, and this calculation is independent from the issue of how long shares will be held.

2.3 Private equity investors

For this Report, private equity is defined as financial enterprises/funds that pursue a business model based on acquiring control of publicly held companies and, in the process, taking the acquired company private. The universe of private equity enterprises/funds is much broader, with a large number focusing on investments in unlisted companies, sometimes in the form of venture capital.[8] Because the Principles focus on publicly held companies, the Report excludes from its scope these private equity enterprises/funds.

One factor that distinguishes the private equity investors who are the focus of this Report from other potential acquirers of publicly held companies is that private equity investors generally do not intend to maintain control indefinitely of the company they seek to acquire (target company). Instead, they seek to acquire control of companies, implement value-adding changes and then realise the resulting capital gain by disposing of their investment within a relatively short time frame. This business strategy is discussed in detail later in this Section.

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6. In addition to the actual or threatened exercise of voting rights, other key shareholder powers that can be exercised (or threatened to be exercised) for the purpose of influencing company behaviour include: *(a)* the power to dispose (or refrain from disposing) of shares in the context of a change of control transaction (such as a takeover bid); and *(b)* voice, *i.e.* the power to express opinions about the company's activities in dialogue with other investors or stakeholders and/or through public media such as publicly available regulatory filings and press releases

7. Shares that have been borrowed (share lending) are actually owned by the borrower who can make use of the associated voting rights if the registration requirements are met. The definition used in this Report thus covers the case where the direct economic interest in the borrowed shares has been simultaneously hedged and even reduced to zero. See Black and Hu (2006).

8. For more detailed discussion about some aspects of venture capital see OECD (2006).

Other investors who seek to acquire control of publicly held companies include other companies (*e.g.* operating companies or holding companies), individuals and company managements. Acquiring companies are often regarded as investors pursuing strategic objectives related to their own line of business, but with profitability still a major motive. The contrast with private equity is, however, more one of degree. While a non-private equity acquirer might initially regard its acquisition as "permanent", the acquirer might change its mind and sell or liquidate its investment at a later date if the acquisition does not perform as expected or ceases to fit within the acquirer's strategic plan. With MBOs and individual buyouts, "permanent" ownership motives are at play. Private equity investors might participate in MBOs by providing finance or advice. When "private equity" remains in a purely financial role and has no direct managerial control, it is excluded from the scope of this Report.

Property and infrastructure funds are often included within the definition of private equity investors. They have been involved in some very large transactions, such as the takeover of Thames Water (valued at GBP 8 billion) but are excluded from this Report since their objective is to maintain ownership. Generally, these funds are set up with the backing of pension funds (and private equity funds) to buy infrastructure or property-based companies that will deliver long-term predictable cash flows (an annuity type investment). Since their underlying objective is to maintain ownership, rather than to realise a relatively short-term capital gain, these funds are excluded from the definition of private equity investor for the purposes of this Report.

2.4 Convergence and inter-relationships

Any attempt at a clear delineation of "activist hedge funds" from "private equity", and both investment vehicles from other classes of investors such as mutual funds, pension funds, investment banks and commercial banks, can be highly misleading. Some of the categories overlap and often merge. As well, traditional institutional investors are participating as investors in activist hedge funds and private equity vehicles. Finally, these different categories of investors sometimes participate in the same engagements with particular companies and seek the same outcomes. This Report also documents some of these inter-relationships.

Furthermore, one regulator noted that many banks, brokers and insurance companies carry out activities indistinguishable from those of hedge funds and went on to observe that there were around 60 UK-based "mainstream" fund managers who manage hedge funds alongside traditional funds. Financial firms have also bought or established their own hedge funds in the US, the UK and Continental Europe. Proposed changes by the SEC to certain rules will also further blur the distinction between hedge funds and traditional investment vehicles and financial market participants.[9]

There is also some convergence in the strategies employed by different categories of alternative investors (Table 1) and even as between "traditional" and "alternative" investors. For example, some hedge funds now invest in small companies by acquiring illiquid securities, a position also undertaken by private equity vehicles and other investors. The difference appears to be that the latter are generally more active in management. Both hedge funds and private equity are involved in "private investment in public equity" (PIPE) transactions. Private equity is now taking small positions in large listed companies (*e.g.* Deutsche Telekom), very much along the lines of activist and other hedge funds – and indeed other institutional investors. Some hedge funds are offering to acquire publicly held companies, as the private equity

9. These are the proposed end of the short sale price test and the approval of portfolio margining accounts for customers of US broker dealers. See *Financial Times*, "Fund Management", Page 10, February 12, 2007.

investors who are the focus of this Report do. There is also some institutional convergence with some private equity funds having hedge fund operations and vice versa, although this development might only apply to the larger players and is not expected to become widespread.[10]

Table 1. Table 1. Fund management strategies

Private equity funds	Hedge funds
Global buyout	Global macro
Middle market buyout	--
Country focused	Emerging market
Mezzanine	Fixed income
Distressed debt trading	Distressed securities/event driven
Distressed debt control and restructuring	Distressed securities/event driven
Secondaries	--
Industry sector	--
Venture capital	
Fund of Funds	Fund of funds
	Market neutral
	Market timing
	Futures
	Convertible arbitrage

Source: Grant Thornton (2006).

There can also be close relationships among alternative investors. For example, private equity funds' partners often contact hedge fund managers when arranging financing for a buyout and do not rely solely on banks. In highly competitive financial markets, however, private equity firms and hedge funds can end up on opposite sides of a transaction. For example, in the Netherlands, a private equity firm succeeded in taking VNU private against strong opposition from two hedge funds. The private equity firm then appointed a top-level CEO to run the company.

10. See Grant Thornton (2006).

3 Size and scope of hedge funds and private equity funds

3.1 Hedge funds

The difficulty in delineating "hedge funds" from other investors means that estimates of the number of hedge funds and the value of their assets under management vary widely. One knowledgeable official has stated that the number of funds globally is between 8500 and 9200.[11] Estimates of the value of hedge funds' assets under management (*i.e.* money deposited with hedge funds by investors) vary from USD 1.2 trillion to USD 1.6 trillion. In 2006, this represented around 1.0-1.4% of the global securities market capitalisation (Reserve Bank of Australia, 2006).[12] It is also small in comparison with the global mutual funds industry which has USD 18 trillion under management. The estimate does not include leverage of the hedge funds, which serves to increases their financial assets, although tighter control by counterparties as well as ample global liquidity appears to have resulted in less leverage than at the end of the 1990s.[13]

Globally, the hedge fund industry is dominated by US, UK and to a lesser extent, French-based managers/partners. The funds themselves are often based offshore, *e.g.* in Jersey or the Cayman Islands, for tax reasons. The US hedge fund industry represents approximately 60% of global hedge fund assets under management. The total European industry had around USD 400 billion under management at the end of June 2006 (FSA, 2006). Contrary to popular belief, most hedge funds are relatively small with only a few large managers/partnerships.[14] For example, in Europe the top 25 managers accounted for USD 180 billion or 44% of the overall European assets under management (FSA, 2006).

Although hedge funds currently are small in size relative to the world's securities markets, they are important for market liquidity and are growing rapidly. Generally, they are active traders and that often makes them important buyers and sellers of securities in many markets, including equity, commodities, derivatives and foreign exchange markets. On the New York and London Stock Exchanges, between one third and half of trading has been attributed to hedge funds (FSA, 2005). Growth of funds under management around the world has been particularly rapid since around 2004. The UK FSA has suggested that, in 2006, growth was around 40-50% in the European market (McCarthy, 2006).

Institutional investors are the predominant source of additional money in North America, Europe, Japan and Australia. According to the Reserve Bank of Australia, the share of institutional investment in hedge funds has increased since 2001 from around 18, 18 and 30% in North America, Europe and Japan respectively to 28, 35 and 58% respectively in 2005. Moreover, the average portfolio allocation to hedge funds by some classes of investors, such as pension funds, has also risen strongly from under 3% to approximately 6-8%.

11. McCarthy (2006).

12. Reserve Bank of Australia (2006). Market capitalisation includes equity, sovereign debt and corporate debt securities markets, in all of which hedge funds are active.

13. McCarthy, *op cit*, cites the average leverage of funds (calculated as long market positions divided by net equity) in 2005 as between 2¼ to 2½ times. Long Term Capital Management, whose conduct and failure has dominated the formation of many ideas regarding hedge funds, operated on a long run average leverage of 25 times, and as it approached crisis more than 50 times.

14. One study reports that in 2003 the assets under management of 38% of hedge funds were less than USD 25 million. Only 6% of all hedge funds had assets under management of USD 500 million or more (Netherlands Authority for the Financial Markets, 2005).

For the purposes of this Report, the question is how much of this rapid growth is associated with hedge funds that are likely to be activist investors in publicly held companies and, therefore, likely to affect corporate governance practices? Only general orders of magnitude can be given since hedge funds can shift resources rapidly so long as they keep within the mandates they have specified for their investors. If the activist strategy appears to be successful, other funds from around the world may adopt this strategy as followers, even if they do not have the expertise themselves to develop such a strategy. Moreover, widespread access to corporate governance recommendations by proxy advisory services such as ISS might make that change of strategy easier. Public campaigns by high-profile activist hedge funds as well as by other activist institutional investors can also attract hedge fund participation.

JP Morgan estimates that only 5% of hedge fund assets, or about USD 50 billion, are available for shareholder activism.[15] However, a "value investor" pursuing an activist strategy might also be involved in "event-driven strategy"[16] Event-driven strategy, while still only followed by a small number of funds, is nevertheless one of the fastest growing strategies in 2006 and one estimate is that it accounts globally for around 20% of hedge fund assets (USD 200 billion).

3.2 Private equity

Private equity raised a record USD 404 billion in 2006 with buyout funds constituting about half the money committed.[17] Moreover, the trend appears to be strongly upward. One source reports that, in the first half of 2006, 267 new buyout and mezzanine funds raised USD 82.8 billion in new commitments so that the second half of 2006 accelerated to around USD 120 billion. This trend was confirmed by another USD 50 billion in commitments in the opening weeks of 2007. In 2005, US buyout funds raised a record-breaking USD 173.5 billion, bringing total private equity capital under management by 1546 firms to USD 811.2 billion as of June 2006.[18] According to another source, there are approximately 3000 private equity funds worldwide managing USD 1.5 trillion (Grant Thornton, 2006).

Private equity fundraising is termed "commitments" since not all funding is made available immediately to the private equity vehicle. Rather, funds are called up as projects covered by the private equity vehicle's mandate become available. Thus, committed funding for private equity buyout funds represents "pressure in the pipeline" for the takeover market, even though that pressure is not immediately apparent. One tenth of the capital committed in 2002 was "called up" or handed over by investors and put to use within one year. For funds raised in 2005 the corresponding proportion was almost 30%. The overhang of committed but uncalled buyout capital rose to USD 280 billion in 2006. With the current level of takeover activity, the level of free commitments declined from 36 months (in 2005) to 28 months' worth of activity in 2006. Despite strong fundraising at the start of 2007, several very large transactions if consummated should have reduced the overhang (McKinsey & Company, 2006).

Although the sums are impressive, the overall scale of transactions is relatively modest, generally ranging from 1-1.5% of GDP (Figure 1). The stock of private equity investments as a percentage of GDP is also relatively low, since exits are also significant each year, amounting to just under 4% of GDP in the US

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15. As quoted in Kahan and Rock, 2006 *op cit*, page 18 from J.P. Morgan, *Global Mergers and Acquisitions Review*.

17. Estimates from *Private Equity Intelligence* as reported in the *Financial Times*, 22 January 2007.

18. Estimates by *Buyout Magazine* as quoted in Grant Thornton (2006).

and 1½% in Europe with the UK just under 2%.[19] However, it is not always clear from the figures whether leverage has been included, so that the ratio of private equity investments to GDP might in fact be somewhere closer to double those reported above.

With respect to PTP buyouts, the focus of this Report, there is a clear trend toward ever larger transactions. This is reflected in the sharp increase in both the number and value of transactions in the US since 2004 (Figure 2). In 2006, there was a record buyout worth USD 32 billion, exceeding the record RJR Nabisco deal of USD 30 billion set in 1989.[20] This record was broken again in early 2007 by a deal worth USD 39 billion (Office Properties) and this could be exceeded if a proposed takeover of a US power utility (TXU) is consummated. The volume and size of completed transactions has also surged in the UK, Continental Europe and Japan, although the latter is from a very small base (Figures 4, 5 and 6). The move to larger transactions has also meant that the deals also involve sizeable workforces. Several of the buyouts involved companies with between 20 000 and 40 000 employees (TDC in Denmark and VNU in the Netherlands) and the largest transaction in 2006 involved a company with a work force of 190 000.

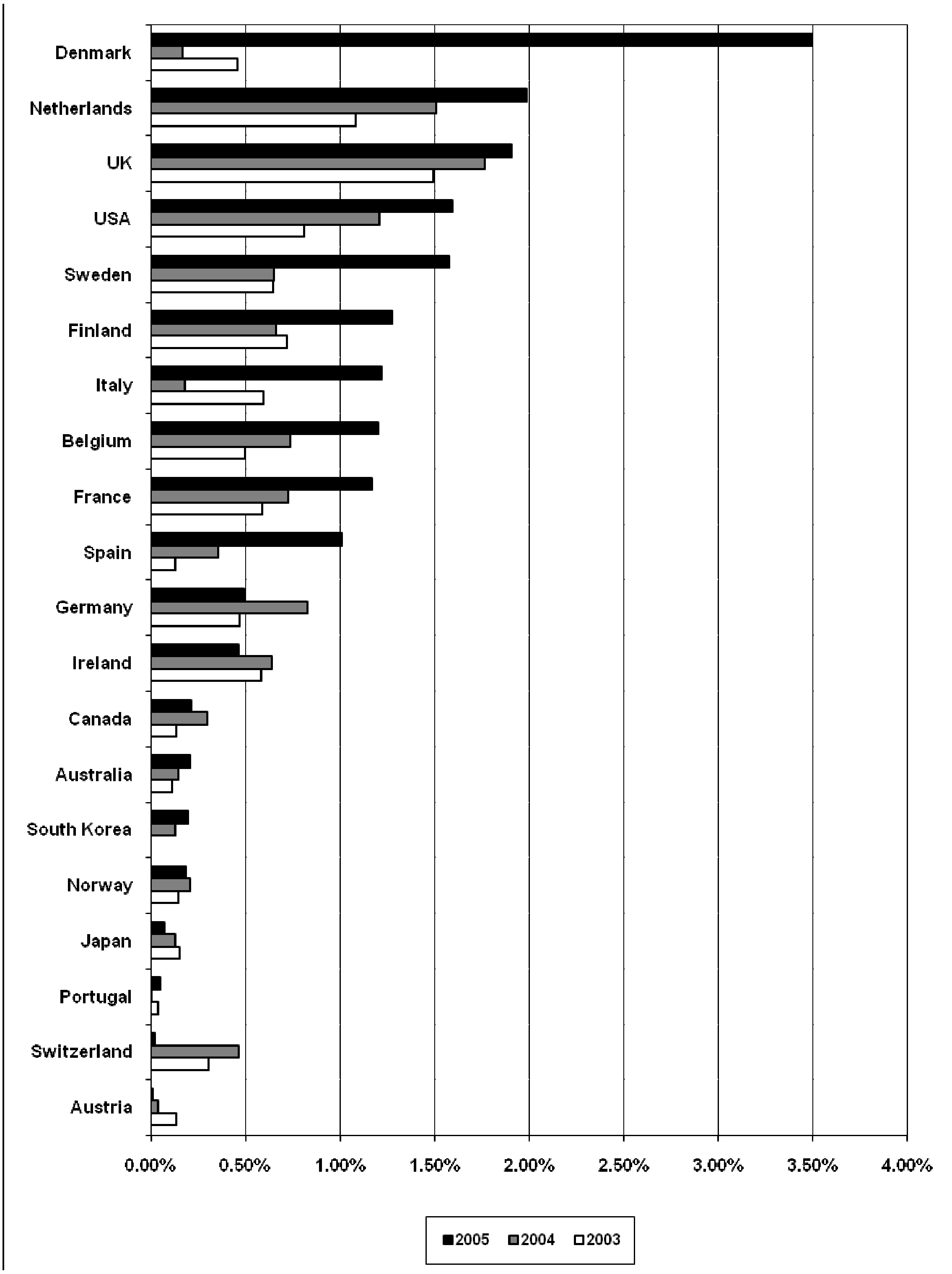
Although these PTP transactions are large, they still represent only a modest proportion of private equity's activity. In the UK, PTP transactions account for only 30% of the value of the total buyout activity, while in Europe they account for only 10%. Several very large transactions in the US during 2006 pushed the value of PTP to around 60% of the value of all LBO transactions, up from 16% in 2002. The number of employees working for firms that have undergone a buyout is large. One estimate is that the number of employees across the whole of Europe increased from 450 000 in deals completed in 2003 to 850 000 for deals done in 2005 (see Annex 1).

Nevertheless, while PTP transactions might appear to be a deluge, as a proportion of total mergers and acquisitions (M&A) activity, they still represent a modest (but increasing) proportion. M&A activity is still dominated by corporate buyers. M&A activity reached a new high in 2006 at around USD 4 trillion (and this might be exceeded in 2007) with private equity buyouts accounting for around 20% of the total. This proportion is much higher than at the time of the last peak in M&A activity in 2000, when the proportion was closer to 10% (Dobbs, 2007). Many of the public concerns regarding PTP are also shared by M&A transactions more broadly (*e.g.* asset sales, restructuring and work force reductions).

19. SAVC as quoted in *The Economist*, 20 January 2007.

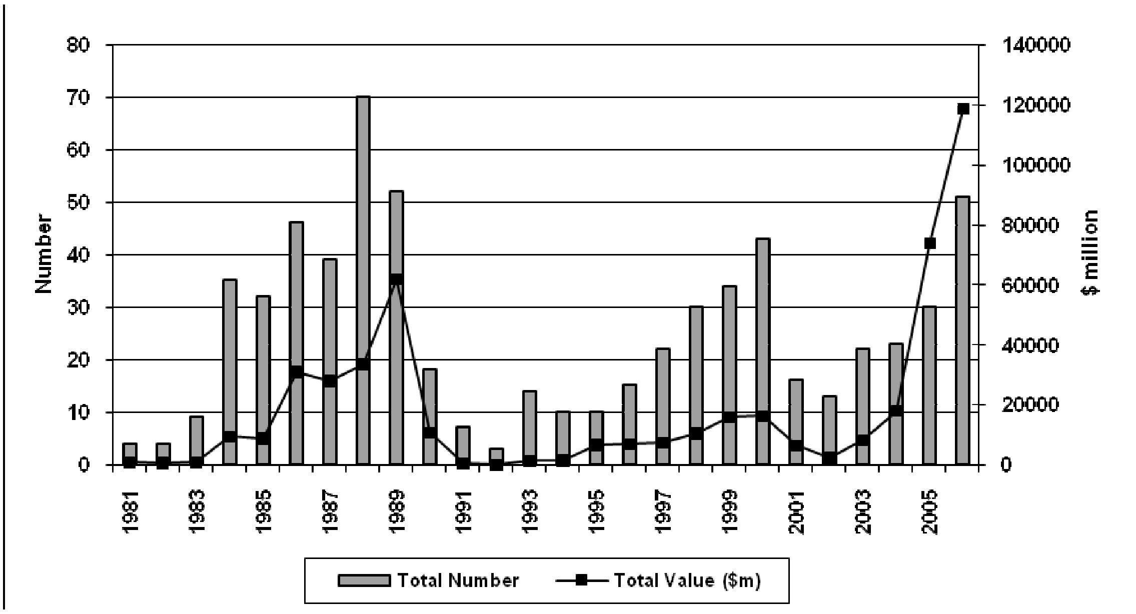
20. If measured in constant prices, the RJR deal would remain substantially greater than the recent PTP transactions. The HealthCare deal is often reported as a private equity transaction, but is a very borderline case resembling more a normal M&A. A South African listed health care company acquired 51% of the voting equity with a consortium of private equity partners acquiring 49%.

Figure 1. Buyouts as a percentage of GDP are modest



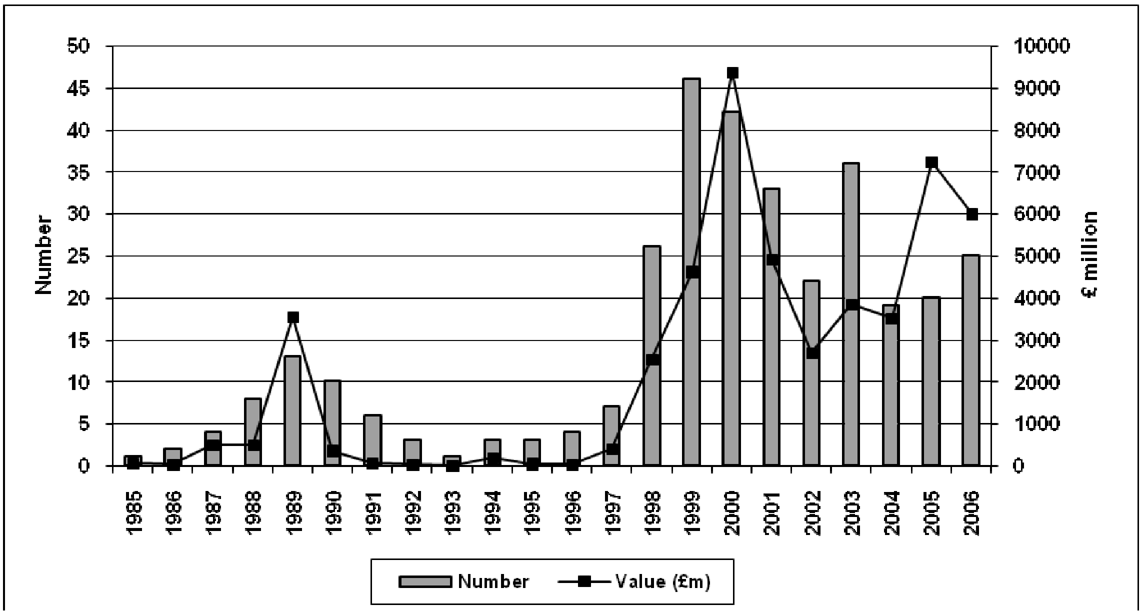
Source: CMBOR/Barclays Private Equity/Deloitte/OECD/Thomson Financial

Figure 2. PTP buyouts in the USA are increasing in size



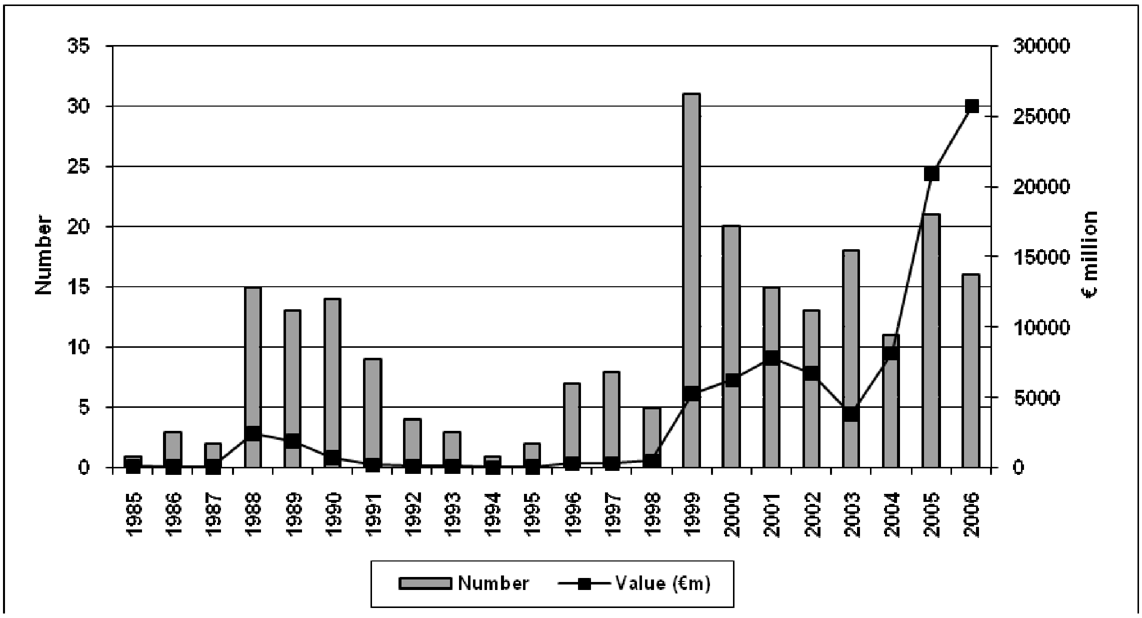
Source: Thomson Financial

Figure 3. PTP buyouts in the UK remain strong



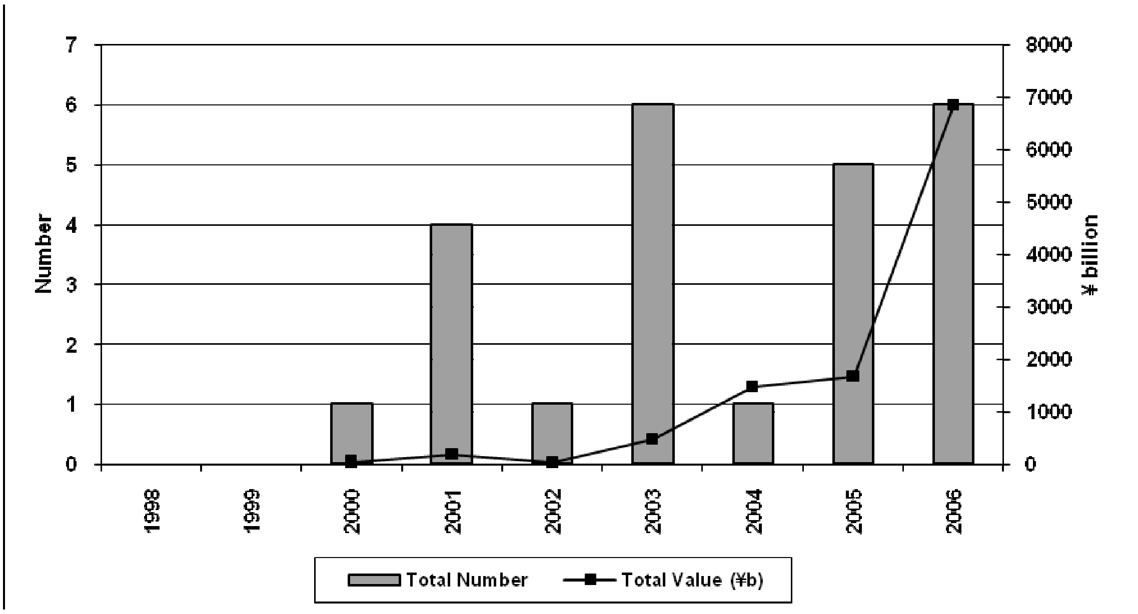
Source: CMBOR/Barclays Private Equity/Deloitte

Figure 4. PTP buyouts in Continental Europe are dominated by a few large transactions



Source: CMBOR/Barclays Private Equity/Deloitte

Figure 5. PTP buyouts in Japan remain limited



Source: Japan Buyout Research Institute

4 Macroeconomic determinants of the recent growth of private equity and hedge funds

Although this Report focuses on corporate governance, it is nevertheless important to keep the bigger financial picture in mind. The rapid growth in recent years of both private equity and hedge funds is a universal phenomenon and, as such, has a global background. The surge in global liquidity since the late 1990s is due both to highly accommodative monetary policy around the world as well as financial innovation and high *ex ante* savings[21]. At the same time, population ageing in many countries has left large groups of investors, especially pension and superannuation funds, searching for ways to adapt their investments to their liabilities, hedge their investment in bonds and equities and increase yields to be more in line with their actuarial assumptions.

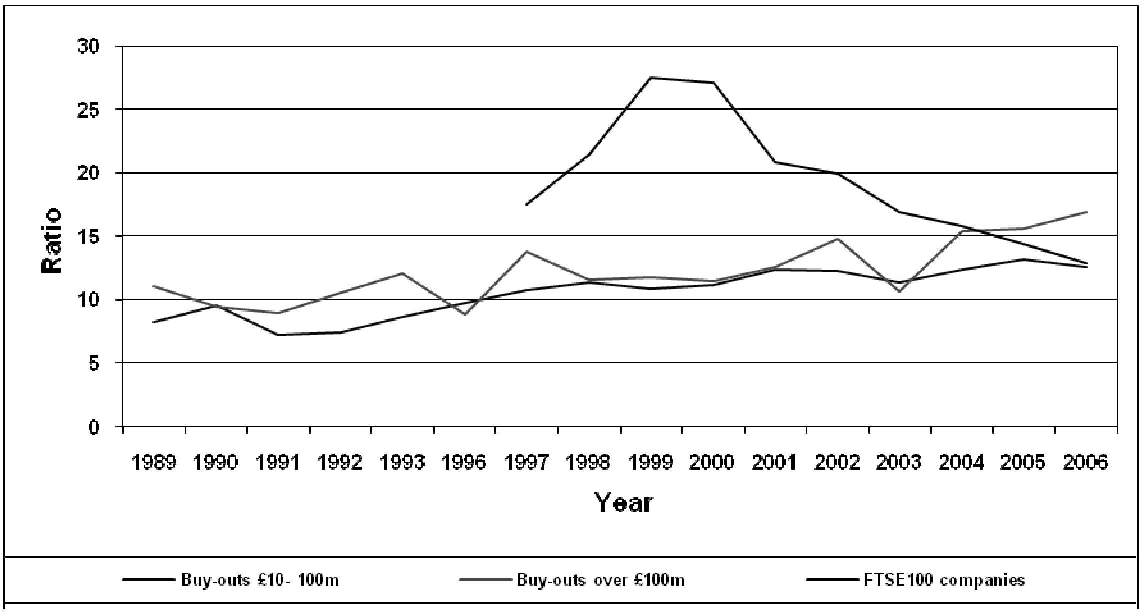
The search for diversification has been met by, among other things, alternative institutional investors and their strategies.[22] One can think of this development as a rise in the demand by investors pursuing a corporate governance-oriented strategy. This development has in turn forced more conventional institutional investors to adopt many of these strategies, leading towards some convergence in fund management techniques. As a result of this strong demand, the landscape for reasonably priced investments has become far more competitive, with more money pursuing the same target companies. Consequently, pricing multiples (*i.e.* purchase price for a transaction as a multiple of earnings before interest and taxes (PBIT)) have increased rapidly in the last two years (Figures 6 and 7), moving in the opposite direction to the price earnings multiple of the FTSE 100. Net debt to EBITDA has now reached 7.7 times for large private equity transactions in the UK, in comparison with 1.7 times for FTSE 250 companies (KPMG, 2007).

21. For further discussion about the global forces driving world financial markets and the private equity/hedge fund boom see Blundell-Wignall, 2007.

22. One study observed that the growth of investment in private equity in North America has come from public pension funds increasing their allocations from an average of 6.1% in 2001 to 7.8% in 2005, while corporate pension funds decreased theirs from 7.1 to 6.4% and endowments from 14.4 to 9.5% (McKinsey and Company, 2006).

Figure 6. UK buyout prices have risen strongly

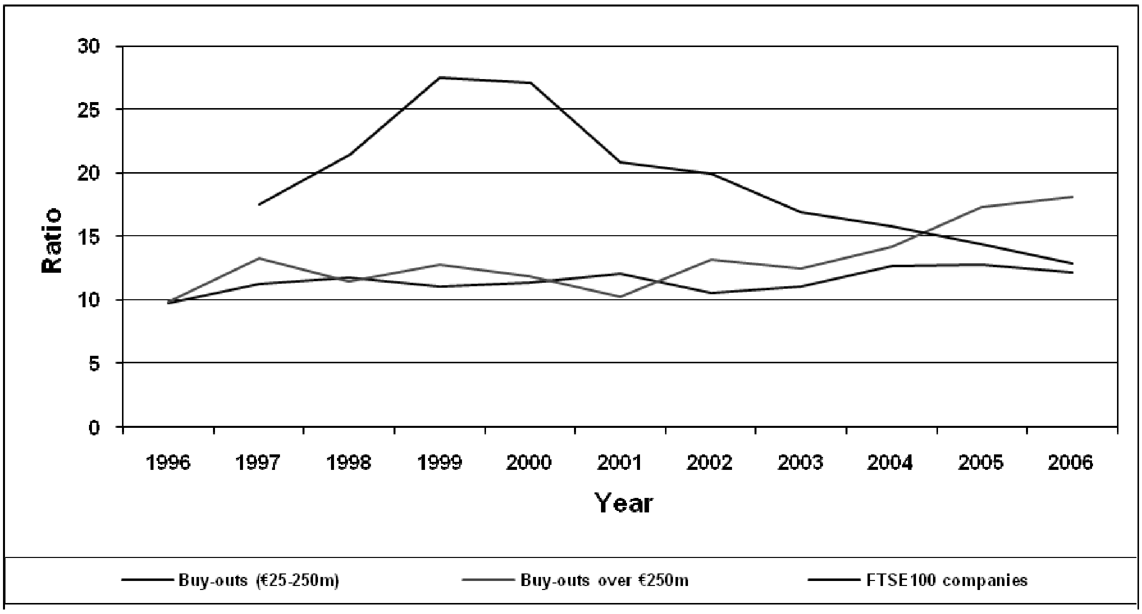
(PBIT Ratios)*



Source: CMBOR/Barclays Private Equity/Deloitte/Datastream
*The FTSE100 data is expressed as a P/E ratio = total market value of companies/sum of net earnings

Figure 7. Continental Europe buyout prices have also surged

(PBIT Multiples) *

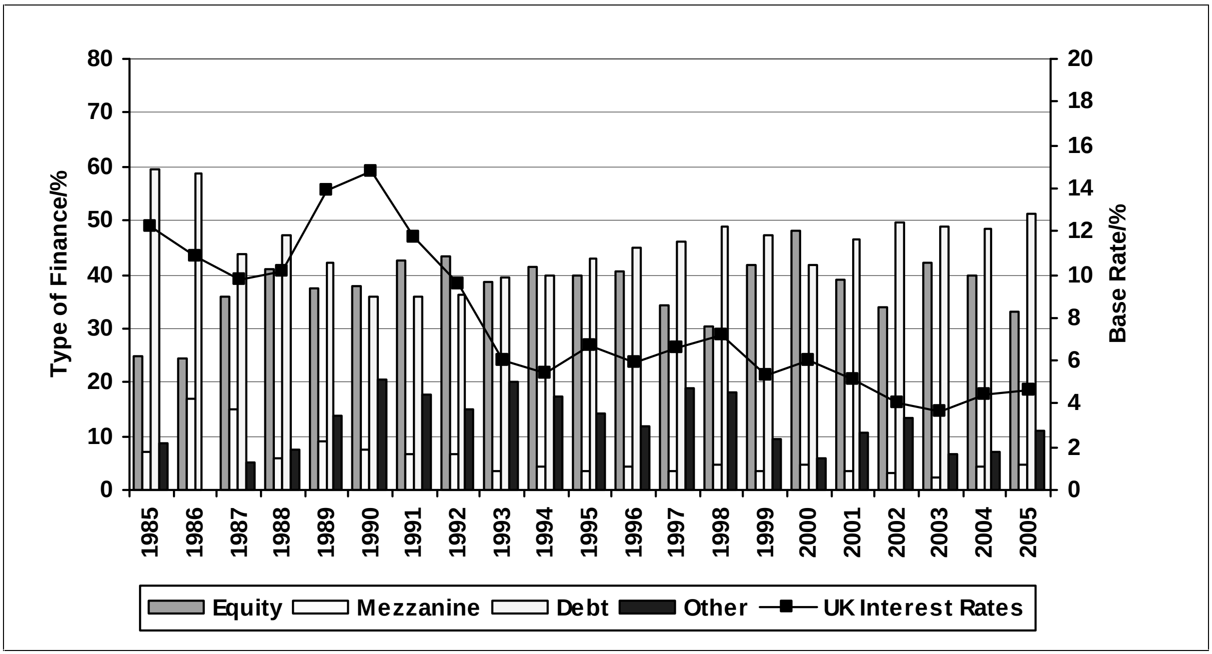


Source: CMBOR/Barclays Private Equity/Deloitte/Datastream
*The FTSE100 data is expressed as a P/E ratio = total market value of companies/sum of net earnings

At the same time, many publicly held companies in OECD countries have become cash-rich due in part to lower investment than is normal in this stage of the business cycle and have reduced their level of debt: the "supply" of companies susceptible to a corporate governance-oriented strategy has increased.[23] At the same time, bond yields have remained relatively low: Citigroup calculates that the corporate bond yield in the UK is lower than the free cash flow yield on equities and the same is generally true for the US (Blundell-Wignall, 2007, Figure 9). It thus makes sense for private equity firms and others to make cash bids for companies and for companies to issue bonds and buy back their own shares. Even risky companies have been able to issue debt easily, with risk premiums falling to unusually low levels. By contrast, despite strong initial public offerings from emerging markets in London, the volume of equity on issue at the LSE fell by 3% in 2006. Low interest rates have also led to an increase in leverage in PTP transactions although the equity component is still around 30% (Figure 8). However, the equity component needs to be interpreted with care since a great deal of this has been "borrowed" from investors by the buyout funds, even though on a ten year basis and with a fairly close relationship between the fund manager and the investors. As discussed throughout the remainder of the Report, there also appears to have been a shift in the type of companies being targeted by private equity and by hedge funds toward cash-rich, under-valued stocks.

Figure 8. Leverage has increased as interest rates have remained low

(Average Buyout Structures and U.K. Interest Rates)



Source: CMBOR/Barclays Private Equity/Deloitte

The search for higher yields, together with low interest rates, has meant that the time horizon for some investors has lengthened and not shortened, as is often thought. For private equity, the time frame for transactions (*i.e.* from purchase to disposal of a company) has increased from around two years in 2001 to what appears to be more like five years by 2006. Increasingly, hedge funds that historically offered their

23. The cash levels held by the S&P 500 industrials (as a percentage of market value) reached around 8% in 2006, having steadily increased from around 2% in 1999 (Standard & Poor's).

investors relatively easy access to liquidity are now requiring investors to commit to up to three years before they receive full redemption. Moreover, with this additional flexibility provided by hedge fund investors' longer-term commitments, hedge funds are increasingly taking longer positions and/or acquiring illiquid assets such as distressed debt and debt and equity in non-listed companies. Private equity firms' investment time horizons are also changing. For example, there is a greater interest in acquiring infrastructure (*e.g.* acquiring privatised companies or new privatisations) with a time horizon of 25-30 years

In sum, the large volume of liquidity in the world economy, combined with low investment demand and high *ex ante* savings, has lowered interest rates across the board and has driven investors to search for greater yields. This has enabled alternative investment vehicles offering a corporate governance-based value creation strategy to expand rapidly, spurred by a powerful incentive system (see below). However, such benign macroeconomic conditions might not be sustainable, so it is hazardous to extrapolate recent trends for alternative investments much into the future.

5 Structure, financing and operation of alternative investment vehicles

5.1 Hedge funds: structure for an activist strategy

Activist hedge funds derive their strategy from the extensive corporate governance literature that links (a) the quality of corporate governance to the valuation of a company with (b) the traditional hedge fund model with its emphasis on absolute returns (above a risk free rate) and the focused taking of risks. This has led the activists to adapt the hedge fund model more generally. First, they raise capital from a small number of investors and manage the liquidity commitments to their investors so that they have the flexibility to invest in companies through a period long enough to generate value from their engagement with the company. Where possible, the limited liability partnership offers a flexible basis for the relationship between the hedge fund managers and their investors (see below on private equity). The fund is often established in an offshore, tax-efficient location. Second, to make the activist strategy work, the hedge fund must take a significant voting stake in the target company (see Section III). Third, the fund takes on debt to increase its ability to make sufficiently large investmentsin the companies and increase the returns to equity. Fourth, hedge funds have developed an incentive structure to underpin the efforts of managers in executing the strategy. This latter aspect of the system is discussed in this Part.

Little is known about the incentive structure of activist funds, but a reasonable working hypothesis for this Report is that it approximates those of other types of hedge funds. Typically, a hedge fund manager (i.e. general partner) will receive compensation consisting of a fixed fee of approximately 2% of investors' funds under management, plus a performance-linked fee of approximately 20% of returns above a pre-specified benchmark, such as the yield on risk-free securities. Often a "high water mark" applies, so that performance fees are earned by the fund manager only when the value of a fund is above the previous high water mark, but there is no "claw back" of fees if the fund makes a subsequent loss.[24] There are many other complexities to fund compensation structures, including allowable expenses. Funds of funds also charge both types of fees with a typical arrangement internationally of 1% and 10% respectively. Most importantly, hedge funds typically tie compensation to quarterly performance, which requires periodic valuations. This can be quite difficult with complex products. For activist funds, valuation is not such an

24. In other words, if a fund makes losses, these losses have to be made up before any incentive fee is payable (high water mark). However, if a fund makes profits and earns an incentive fee, the fee does not have to be returned if the fund suffers subsequent losses (no claw back).

issue since they are dealing with securities with a market value, although the combination of “high water marks” and no “claw back” might still favour one–off effects.

Such incentives could favour extreme risk with the hedge fund managers participating in upside risk, but not on the downside. Therefore, investors are reported to be demanding an equity participation by the partners/managers in the hedge fund so that they also bear a downside risk (*i.e.* “there is skin in the game”). Also, studies report that reputation effects are important in conditioning behaviour and ensuring that investors subscribe to follow-on funds, an important factor given that the hedge fund will also have borrowings to roll over. Retaining investor confidence is important for the success of the activist strategy given the high stakes that activist funds take in individual firms, sometimes for an extended period. For example, one study reports a median stake in companies in which success is not assured as around USD 15 million going up in some cases to USD 100 million (Brav *et al*, 2006).

In sum, while activist funds may adopt an investment horizon of up to three years with similar lock-up periods for investors, the remuneration structure is essentially based on short term returns, although with some checks and balances to avoid any tendency to temporarily inflate returns. Whether the lessons learned from the options debate where the incentive structure was held responsible for a number of corporate measures to massage quarterly results are applicable remains an open question until the actual incentive structures are better understood. The high-powered performance incentives (20%) can also be contrasted with traditional mutual funds where the implicit performance fee might be more in the range of 2-3% and provide little in the way of direct incentive for activism (Box 2).

Box 2. Implicit performance fees of traditional investors

In the US market, regulatory barriers make it difficult for mutual funds to charge performance-based fees so that 97% of all funds accounting for 92% of all mutual fund assets charge fees based on a flat percentage of the fund’s assets under management. Asset-based fees provide only small direct incentives to engage in costly activism.

The median stock fund in 2004 charged investors total fees of 1.45% of assets, of which about a half were management fees. Thus, when a manager of a USD 1 billion mutual fund earns additional profits of USD 100 million (a 10% return), total annual fees increase by USD 1.45 million and management fees increase by USD 750 000.

To get a sense of how much a fund management company benefits from increased profits, Kahan and Rock (2006) assume that USD 1 million of the USD 1.45 million in total increased fees constitute profits for the fund managers and that investors leave any profits earned by the fund in the fund for three years before they withdraw them (*i.e.* equivalent to many activist hedge funds). Applying a 5% discount rate, the USD 100 million in fund profits would then generate USD 2.85 million in additional profits for the fund management company, equivalent to a modest implicit performance fee of 2.85%. Although there are further complexities in calculating actual performance fees, the difference with the 20% common for activist hedge funds is striking, especially since the latter is increased through leverage.

Source: Kahan and Rock (2006).

5.2 Private equity: an alternative governance model

As private equity transactions have increased in size they have attracted controversy. For example, some people claim that private equity funds merely engage in financial engineering, *e.g.* taking advantage of tax-benefited debt, and that publicly held companies could employ the same strategies to achieve the same results. However, there is also a considerable body of research illustrating that while tax incentives

are important, private equity funds have developed their own corporate governance model for the publicly held companies they acquire. This Part reviews studies about the model, while behaviour in implementing the strategy is covered in the following Part. Whether the governance strategy of private equity is economically viable and represents a serious challenge to the public firm, or whether it is only financial arbitrage, is examined in the Section V. A word of caution: most of the studies reviewed refer to the large private equity funds and often the top quartile performers. However, this is where the political sensitivities are greatest. Lower quartile private equity vehicles vary in structure and performance, but they also deal with different companies than the large funds.

5.2.1 Form and incentive structure

Although several private equity firms have now become listed companies, like hedge funds they are for the most part organised as partnerships. In the UK, investors become limited partners in an equity fund and have a formally passive role in the partnership. They are all treated equally. In addition, there is one general partner with unlimited liability, often a limited company set up by the private equity firm/partnership. Typically, an additional limited partner is created as a vehicle for the "carried interest" (see below) for the executives in the private equity firm. The general partner appoints the private equity partnership/company as the manager/operator of the fund (an entity that is regulated in the UK and in some other jurisdictions). This legal environment is suitable for the small number of institutional investors who usually comprise the limited liability partners of the fund since minimum subscriptions are high (*e.g.* between GBP 0.5 and 1 million). This helps ensure that the investor base is professional/expert and avoids direct retail investment with all its regulatory implications.

Taxation is also an important consideration (Box 3) in structuring private equity transactions. There are two elements. The first is the corporate tax paid by the target company and whether there are limits on tax deductibility. Second, there is the taxation of the private equity partners whose income is normally structured as capital gains. This is also an issue for investors. (Some estimates of its overall incentive effects are given in Section V.) Private equity is hampered in Japan by the tax treatment of limited liability partnerships, which are taxed as though they were a legal entity. By contrast, in the UK they do not have legal personality. In Europe, taxation and legal issues have been progressively liberalised to encourage venture capital but it is impossible not to extend the incentives to private equity more generally.[25] For example, in France pension funds and insurance companies can invest freely in private equity, management fees are exempt from value-added tax and tax breaks encourage investment in companies that the state deems to be highly "innovative".

25. For a detailed review of the legal and tax issues and reforms see European Private Equity and Venture Capital Association (2006).

Box 3. Taxation regimes and private equity vehicles

Tax relief on interest payments is a significant part of virtually all taxation systems around the world but legislation covering the taxation of private equity vehicles differs from one country to another and can encourage or discourage private equity investment activity. Anti-avoidance provisions are in place in the UK, Spain, France, Germany, the Netherlands, the USA and Japan to determine the validity of tax deductions, for example, the maximum rate of interest for which a tax deduction is available (Devereux *et al*. 2006).

In the UK the *Finance Bill of 2005* extended the existing transfer pricing rules to private equity transactions, thus disallowing some tax deductions. It also delayed tax relief payments related to interest on debt. Both of these changes were seen as negative by the private equity industry.

The tax situation has been considered unfavourable in Germany for some time. For example, the tax regime imposes very high taxes on investments in certain types of foreign investment funds. By the year 2000, private equity managers had moved their funds out of Germany and set up funds in Jersey, Luxembourg and Switzerland where tax treatments were well-established and understood. The new German coalition government is in the process of reforming the legislation, in the shape of the *Private Equity Act.* The forthcoming German 2008 tax reforms could bring Germany somewhat into line with the USA with regard to anti-avoidance regulations.

Canada introduced a new Tax Fairness Plan in October 2006 that removed the tax advantages of publicly traded income trusts and partnerships compared to conventional Canadian publicly traded corporations. The move may impact the private equity community in the US and Canada as many firms divest their portfolio companies into the Canadian income trust public market. This may force private equity firms to look at alternative exit strategies.

Source: Centre for Management Buyout Research (CMBOR), Devereux (2006)

It is often asserted that the incentive structure for private equity is based, as in hedge funds, on a management fee of around 2% with a profit interest of 20% of capital gains, rather than 20% of the value added. Such a structure could place investors at risk since it provides incentives for the general partners to use capital quickly (*i.e.* to call up commitments) in order to reap the management fee. Incentives to use capital quickly might lead to sub-optimal investments.[26]

An FSA study points to a frequently much more complex structure of incentives, suggesting that investors (limited partners) have considered the incentive structure (Box 4). Management fees are based on commitments. All that matters, therefore, is that the fund is fully subscribed and closed so there is less incentive for fast investments that might also damage reputation. However, the success fee (transaction fee in Box 4) means that depending on the deal, partners might receive a front-loaded charge of some 3% early in the life of an investment. Performance fees are paid only after the investment is sold. This gives an incentive to the general partner not only to exit as soon as possible but also to give special emphasis to growing the company and reducing its debt load prior to sale. It should also be noted that the private equity partners usually also commit a significant amount of their own money in an investment, thereby aligning their incentives more closely with their investors At the time of writing, the Secretariat had found no such similar detailed analysis for the US.

26. For example see Plender (2007).

Box 4. Private equity is subject to powerful incentives

The fee structure for private equity funds comprises a variety of different component parts including but not always limited to the following:

A priority profit share payable to the general partner, who will then use this to pay the private equity firm a management/advisory fee. These payments are typically set at approximately 1-2% of committed capital during the initial investment period (of about five years). These payments then usually fall back to a (sometimes lower *e.g*. 1%) of the total of un-drawn capital plus the acquisition cost of investments still held (*i.e.* not the capital already returned to investors). The fees are usually payable from the outset of the fund's life. To avoid individual funds being churned to increase management fees, the fee may be reduced further or removed if a younger but concurrent fund is set up.

Transaction fees can amount to 0.5% to 1% of deal enterprise value. These fees represent a success fee for identifying and completing a transaction. Such fees are usually credited to the fund or split with the fund and the general partner on a prearranged basis. Abort fees (*i.e.* fees to recover expenses involved in deals which are eventually not consummated) traditionally have been charged to the fund. However, this can be a point of negotiation between the limited and general partners, with limited partners increasingly seeking to have abort costs netted against transaction fees.

Monitoring fees may be charged for continuing to ensure that the transformation process of a company acquired by the fund is going according to plan. These tend to be relatively small.

Carried interest that is similar to a performance fee usually equates to 20% of capital gains. This is typically not paid out until all limited partners' capital has been returned and a specified rate of return on their investment has been achieved). This is designed to incentivise the fund manager but delays the moment at which a fund becomes profitable from the fund manager's perspective, thereby, driving them to a timely sale, all other things being equal.

Source: FSA (2006)

Another key aspect of the incentive system, as with hedge funds, relates to a private equity firm's need to establish and maintain a good reputation. A private equity firm relies on a relatively small number of investors for commitments. They often make new commitments at frequent intervals. A deal or fee structure that exploits their commitments, such as a pattern of fast investments and/or exits under questionable conditions to earn performance fees, likely will quickly reduce the inflow of new funds. The need to maintain and guard reputation also leads fund managers to refuse offers of new commitments. It is also believed in the market that reputation also has important consequences when it comes to dealing with PTP companies that are in difficulty, an issue that is discussed in Part IV.[27]

27. For example, Sevin Rosen, a prominent venture capital firm raised USD 200 million in 2006 but has now returned the money to investors saying that it could not invest the cash productively because there were already "too many deals funded in almost every conceivable space". The firm cited a weak exit environment for their investors hoping to cash out through an IPO. Knowledge Wharton (2007).

III. Behaviour of Activist Hedge Funds and Their Impact on Corporate Governance

This Section of the Report describes the typical strategies that activist hedge funds use to try to influence the corporate governance of the publicly held companies in which they invest with a view to increasing the value of their investments. Although the discussion draws on a number of studies and other publications, the aggregate sample set is not universal. Most of the examples focus on US-based or UK-based companies and activist hedge funds because these are the companies and funds that the existing studies have used.

1 Activist hedge funds' corporate governance-related objectives for their investments

Managers of activist hedge funds likely would say that they are pursuing the same overall objective that many other active shareholders pursue, namely to persuade publicly held companies to take actions that increase the companies' short and long-term value. Such an objective is, of course, fully consistent with the objectives underlying the Principles.

For analytical purposes, this overall objective can be sub-divided as follows:

- Influencing board and management decisions about the company's capital structure and its use of capital (*e.g.* encouraging changes to the company's debt-equity ratio, calling for an extraordinary cash dividend or increases in regular dividends, and/or promoting or opposing new issues of equity or debt securities).
- Influencing the company's operational strategies (*e.g.* calling for the company to dispose of non-core businesses, recommending ways in which the company can reduce its expenses, and/or opposing proposed acquisitions of assets or companies).
- Intervening in the market for corporate control (*e.g.* calling for a company to put itself up for sale, supporting a proposed takeover, agitating for a higher premium for shareholders of the offeree company (where the fund is invested in the offeree), or opposing a proposed takeover or merger (where the fund has invested in the acquirer and believes the proposed transaction over-values the offeree).
- Seeking changes to the company's governance structures or processes (*e.g.* nominating or supporting the nomination and election of board members other than those proposed on the management slate, proposing amendments to company by-laws to enable shareholders to directly nominate candidates for election to the board, calling for the separation of the offices of chair and CEO, demanding that the company replace a plurality voting rule with a majority voting rule for board elections, opposing a shareholder rights plan, demanding that key executives be replaced, or objecting to executive and board remuneration practices).

The pursuit of other corporate governance-related objectives occurs, but the four sub-categories noted above represent the most commonly cited categories. Three of the four sub-categories noted above (*i.e. (1)* seeking to influence decisions about capital; *(2)* seeking to influence operational strategies; and *(3)* seeking to influence corporate governance structures) are present in the case study focusing on Wendy's International Inc. (Wendy's), set out in Box 5 below.

Some commentators argue that activist hedge funds' objectives are different in some important respects from those of traditional (albeit active) institutional investors. Kahan and Rock (2006) for example, suggest that the following differences exist:

- Hedge fund activists usually focus on persuading companies' managements and boards to change specific aspects of their business operations and strategies (*e.g.* selling off non-core assets, buying back shares, paying extraordinary dividends, putting the company up for sale).
- By contrast, traditional institutional investors tend to seek changes in companies' corporate governance structures and policies (*e.g.* separating the roles of CEO and Chair).
- Traditional institutional investors tend to identify a particular issue and seek to effect a relatively small change in corporate governance policies and structures across a range of companies (often as part of a campaign coordinated with other institutional investors).
- By contrast, activist hedge funds tend to pursue big changes at a small number of companies.

Although the distinctions the authors have drawn between activist hedge funds and traditional institutional investors are useful, it should be kept in mind that these statements are generalisations and may be somewhat out of date, since the behaviour of both groups of investors continues to evolve. For example, it is clear that some traditional institutional investors are now pursuing the kinds of large-scale operational changes proposed by activist hedge funds. Likewise, some hedge funds have pursued policy/structural changes in the corporate governance of certain companies.

Box 5. Engagement with Wendy's

In separate, sequential initiatives beginning in mid-2005, two hedge fund groups sought to persuade the board and management of Wendy's to implement a range of operational initiatives and make share repurchases. Later, one of the fund groups sought and obtained representation on the board.

Engagement by Pershing Square Capital Management (Pershing Square)

Pershing Square began to accumulate a stake in voting securities of Wendy's in the spring of 2005. It publicly disclosed a 9.3% interest in the voting shares on 26 April 2005 in a report on Schedule 13D filed with the US Securities and Exchange Commission (SEC). In that report, it stated that the "Reporting Persons" covered by the Schedule 13D had acquired the securities because they believed that the market price of the voting shares was lower than the intrinsic value of Wendy's on a per share basis. The Schedule 13D also stated that the Reporting Persons intended to meet with representatives of Wendy's to discuss one or more proposals relating to potential changes in the company's capital, operations or business strategy in an effort to enhance shareholder value. Pershing Square disclosed in an amended Schedule 13D filed on 9 June 2005 that it had retained The Blackstone Group (Blackstone), a private equity group, to provide financial advisory services in connection with the exploration of strategic alternatives and development and pursuit of alternative transactions that might enhance shareholder value.

In an amended Schedule 13D submitted on 12 July 2005, Pershing Square reported that it had sent a letter to the CEO of Wendy's on 11 July. In that letter, William Ackman of Pershing Square stated that they had tried numerous times to set up meetings with company management and its representatives but that such requests had been denied. The letter also outlined a proposal (Pershing Proposal) for enhancing value at Wendy's in an exhibit attached to the amended Schedule 13D. Pershing Square recommended that Wendy's refocus and restructure its operations by:

- spinning off Tim Hortons, a high-profile restaurant chain based in Canada, as a stand-alone publicly traded company;
- re-franchising a significant portion of Wendy's-operated restaurants;
- repurchasing Wendy's shares using the proceeds from the re-franchising; and

- refraining from pursuing any significant acquisitions (such as the proposed acquisition of certain fast food businesses from Allied Domecq) until it had completed the three preceding steps outlined above.

Box 5 Engagement with Wendy's *(cont.)*

Later in July, Wendy's announced a package of strategic initiatives, including: *(a)* the sale of 15-18% of Tim Hortons in an initial public offering (IPO) to be completed in early 2006; *(b)* rebalancing the mix of Wendy's-operated and franchised stores in the United States with a view to reducing the number of Wendy's-operated stores from 22% to 15-18% over a two-three year period; *(c)* closing 40-60 under-performing Wendy's restaurants in the United States; *(d)* pursuing the sale of approximately 217 sites currently leased to franchisees; *(e)* reducing annual capital expenditures by slowing down the rate of new store development and focusing on improving restaurant-level economics; *(f)* authorising (at board level) an additional USD 1 billion for share repurchases; *(g)* increasing the annual dividend rate by 25%; and *(h)* repaying USD 100 million of debt due in December 2005 (instead of repaying or refinancing the debt, as originally contemplated).

Engagement by Trian Fund Management (Trian) and Sandell Asset Management (Sandell)

These initiatives, however, did not satisfy Trian and Sandell, which went public with a joint, strategic proposal for Wendy's in December 2005. Their initial Schedule 13D filed on 13 December 2005 disclosed that, in early December 2005, one of their representatives tried to contact John Schuessler, the Chair and CEO of Wendy's several times. The filing also stated that, after several messages were left for Mr. Schuessler, John Barker, the Senior Vice President (Investor Relations and Financial Communications) contacted Trian/Sandell. The Schedule 13D stated that Trian/Sandell told Mr. Barker that they had established a significant stake in Wendy's just below the Schedule 13D 5% filing threshold, that they came "in peace" and that they wished to meet with Mr. Schuessler at a convenient time and location to discuss their "value creation" plan. They also told Mr. Barker that if their plan was discussed and agreed to, they would "possibly maintain their ownership level below 5% (and not file a Schedule 13D) since their intention was not to wage a battle in the press". They reported in their Schedule 13D that Mr. Barker informed them on 6 December that Mr. Schuessler was currently too busy "managing the brand" to meet with them. One week later, after accumulating a stake that crossed the 5% threshold, Trian and Sandell filed their joint Schedule 13D and attached to it a detailed proposal ("A Recipe for Successful Value Creation").

While acknowledging that the strategic initiatives previously announced by Wendy's were "directionally correct", Trian and Sandell expressed the view in their Schedule 13D that management's action plan did not go far enough toward maximising shareholder value. They recommended, among other things, that Wendy's:

- immediately commence a corporate cost reduction programme and work with Trian and Sandell representatives having relevant industry experience to reduce store-level and corporate general and administrative expenses;
- re-consider its proposal to sell 4-7% of the company-owned stores because Trian and Sandell were concerned that the sale prices might reflect a significant discount to their intrinisic value;
- immediately cease operating as a holding company and announce an immediate, 100% spin-off of Tim Hortons;
- sell off its ancillary brands (*e.g.* Baja Fresh, Café Express and Pasta Pomodoro) and focus management efforts on improving the operating performance of Wendy's core business (the Old Fashioned Hamburgers chain); and
- use the net cash proceeds from the recommended asset sales and other initiatives to buy back more Wendy's stock.

Box 5. Engagement with Wendy's (cont. II)

Apparently dissatisfied with Wendy's management's response to their proposals and the progress of change, in the spring of 2006 Trian and Sandell took further action by indicating that they intended to contest management's nominees for election at the annual meeting. In early March 2006, however, Wendy's entered into an agreement with Trian and Sandell providing, among other things, that Wendy's would: *(a)* expand its board to fifteen and appoint three individuals selected by Trian and Sandell to fill the new vacancies; *(b)* nominate for re-election the Trian/Sandell nominee whose term would expire at the 2006 AGM; *(c)* nominate for re-election the Trian/Sandell nominee whose term would expire at the 2007 AGM; *(d)* appoint one of the Trian/Sandell nominees to each of the Compensation Committee and the Nominating and Corporate Governance Committee; and *(e)* offer one of the other three nominees the opportunity to serve on other board committees. Trian and Sandell agreed to vote their shares in favour of Wendy's nominees at the 2006 AGM, agreed to a standstill (with respect to the further acquisition of shares) and made certain other commitments, all of which were subject to early termination if Wendy's did not satisfy certain commitments, *e.g* regarding the board appointments, or did not complete the spin-off of Tim Hortons by December 2006.

Source: Wolosky (2007); documents filed by Pershing Square and Trian/Sandell with the SEC; documents filed by Wendy's with the SEC. Documents filed with the SEC reflect the views of the filers, not the SEC.

2 Selecting companies for engagement

The first step for managers of activist hedge funds is to identify companies ("target companies") that present high-value opportunities for engagement. Sometimes, one or more of the manager's funds will already have an investment in the company in question, *e.g.* as part of a diversified, basic portfolio. In other cases, the manager will identify a company for potential engagement before acquiring a stake in the company. (The acquisition of stakes is discussed below in Part 3 of this Section.)

Various publications have tried to identify the factors that appear to attract engagement by activist hedge funds.[28] Frequently mentioned factors include the following:

- Size of the Company: A number of authors suggest that, at least until recently, smaller publicly held companies were selected for engagement more often than larger companies.[29] Generally speaking, the smaller the company (in terms of market capitalisation), the lower the value of the investment that needs to be made by a hedge fund to accumulate a large enough voting stake to be considered a credible threat and, therefore, to be capable of influencing the company's board and management. Also, the costs of pursuing certain strategies (*e.g.* dissident proxy solicitations) are correlated to some extent with the size of the company's shareholder base. On the other hand, some observers have suggested that larger companies are increasingly becoming the subjects of engagement strategies as hedge funds increase the value of their assets under management and, therefore, have sufficient capital to invest large sums in larger companies. As discussed in more detail below in Part 3, hedge funds can also borrow shares, use derivatives and hedge their

28. See, *e.g.* Bratton (2007), De Rose and Houlihan Lokey (2007), Kahan and Rock (2006) and Kislin (2007).

29. See, *e.g.* Bratton (2007). In his sample of 114 cases involving hedge fund intervention, he found that 61% of the target companies had small market capitalisations (defined as less than US$ 1 billion), 26% of the companies had medium market capitalisations (between US $1 billion and US$ 5 billion) and 13% of the companies had large market capitalisations (exceeding US$ 5 billion). Bratton's sample comprised US companies that were cited in the business press between 1 January 2002 and 30 June 2006 as being the target of an "activist" hedge fund.

purchases to leverage their investments. These lower cost investment strategies make it easier to build an adequate stake in a company with a large market capitalisation.[30]

- Cash-Rich Companies**:** Some studies indicate that companies selected for engagement by activist hedge funds tend to have significantly more cash than their peers. This is because such funds often seek to realise immediate value by pressuring companies to use excess cash for share buybacks or to increase the amount of cash dividends.

- Leverage Ratios: Some studies indicate that companies selected for engagement by activist hedge funds often have relatively low leverage ratios. These low leverage ratios make it practicable for such companies to buy back their stock and/or facilitate leveraged buyouts by private equity vehicles or other acquirers.

- Stock Performance: Target companies' long-term stock return performance often lags behind the performance of their industry peers. This factor suggests that there may be opportunities to increase value through changes to the company's operational strategies, capital structure or otherwise. Good stock market returns, however, do not preclude engagement, however, since there may be other factors that make the company attractive to value investors.

- Perceived Discrepancies between Asset and Market Values: Companies in certain industries, such as the retail, hotel/hospitality and energy exploration/production are often selected for engagement due to the perception that the companies' underlying assets have a greater intrinsic value than is reflected in the market price of the company's stock. Conglomerates also often attract activist hedge funds on the grounds that the share price of conglomerates can reflect as much as a 15% "diversification discount" to the aggregate value of the assets that make up the conglomerate.[31]

- Management/Governance Weaknesses: Companies that exhibit certain weaknesses in their management and governance structures or practices or that have recently experienced crises or problems in these areas appear somewhat more likely to be selected for engagement by activist hedge funds, provided that these weaknesses are also accompanied by other indicators suggesting that there are short-to medium-term opportunities to realise the increase in long term value. In other words, for activist hedge funds, weak management and governance processes and structures are relevant but not sufficient reasons to select a company for engagement. These factors are relevant because they can be invoked by activist hedge funds to attract other investors to support the activist's campaign and because improvements to governance structures and processes often facilitates improved operational performance and increases investor confidence in the company, which are likely to result in better stock market performance.

30. For example, Bratton (2007) found that the percentage of shares a fund holds in a given company is negatively correlated (-0.21) with the company's market capitalisation. He goes on to state (at 15), however, that: "What most impresses about this statistic, however, is less the negative result than its small magnitude. Restating, in the 39 percent of the cases involving large or mid capitalization firms, the hedge funds did not fully compensate for the larger numbers by reducing the proportion of shares outstanding purchases. They instead stake materially greater sums."

31. Bratton (2007) at 19-20.

- Excessive Premiums in Proposed Acquisitions*:* A company's announcement of a proposed acquisition (*e.g.* of a company or of a significant amount of assets) can attract activist hedge funds. If market participants conclude that the company is proposing to pay too much for the other company or other asset, the stock price of the proposed acquirer is likely to fall, thereby attracting activists who now consider the acquirer's stock to be undervalued..[32]

3 Strategies

To achieve their objectives, activist hedge funds employ various strategies, sometimes in sequence and sometimes simultaneously. Among hedge funds, a pattern of escalating activity from private discussions to public campaigns and from collaborative to more confrontational strategies (*e.g.* proxy contests) is often observed in some jurisdictions, such as the United States. (Currently, there is insufficient data to determine whether this pattern exists in other jurisdictions.) Strategies appear to be significantly influenced by the regulatory environment. A selection of these strategies is described below.

3.1 Building a voting and/or economic stake in the company identified for engagement

3.1.1 Reasons to build a stake

As noted above, a hedge fund or group of hedge funds might already hold a small investment in a company (*e.g.* as part of a diversified portfolio) before deciding to become more actively engaged in the company's affairs. However, a hedge fund manager's decision to engage with a company is often associated with a decision to increase the fund's interest in the company's voting shares.

There are several reasons why an activist hedge fund manager might wish to build a stake before employing other strategies such as privately initiating contact with company representatives (discussed in Part 3.2 below) or commencing a public campaign (discussed in Part 3.3 below). First, the larger the hedge fund's economic and voting interest in the company, the more likely it is that the company's management and board, as well as fellow investors, analysts, proxy advisory services and media, will take the hedge fund's proposals seriously. This is because voting power can affect decision-making where shareholders have a power of decision, *e.g.* where a significant minority shareholder has the capacity to block a transaction by voting against it (or refusing to tender shares to a takeover bid). Furthermore, a meaningful economic exposure to the company indicates to the company and market participants that the hedge fund has "put its money where its mouth is", adding credibility to its proposals. Last but not least, the greater the stake, the greater the return if the engagement strategy succeeds.

Kahan and Rock (2006) suggest that, generally, this stake-building strategy differentiates activist hedge funds from traditional institutional investors. They suggest that:

> " … mutual fund and pension fund activism, if it occurs, tends to be intermittent and *ex post*: when fund management notes that portfolio companies are under-performing or that their governance is deficient, they will sometimes become active. In contrast, hedge fund activism is strategic and *ex ante*: hedge fund managers first determine whether a company would benefit from activism, then take a position, and then become active."

32. Bratton (2007) at 18 mentions six companies (in his sample of 114 companies) where a proposed acquirer of another company or a significant asset attracted the attention of an activist hedge fund, which sought to change the proposed outcome on the basis that the proposed deal's terms overvalued the company or asset to be acquired.

Regulatory restrictions (*e.g.* portfolio diversification requirements and/or restrictions on the use of derivatives) in various jurisdictions preclude many traditional institutional investors from building large voting stakes. There are some investors, however, who, like activist hedge funds, pursue activism as a profit-making strategy and take positions for the purpose of becoming active.[33]

3.1.2 Disclosure requirements and their impact on stake-building strategies

Before engaging directly with the company, many managers of activist hedge funds will aim to acquire the largest stake possible without exceeding the threshold that would trigger a duty to disclose the hedge fund's interest either to the company, the authorities and/or the public (in accordance with various regulatory regimes applicable to the company and/or the hedge fund). Disclosure thresholds vary from country to country, as do the kinds of information that an investor must disclose when it crosses the threshold and the deadlines for disclosure. In some countries and in certain circumstances, eligible institutional investors whose holdings of a company's securities exceed the threshold for public disclosure are permitted to use an alternative reporting system, *e.g.* reporting periodically (*e.g.* at the end of a month or quarter) instead of within a time period (*e.g.* "forthwith" or "within 10 days") measured from the date of acquisition. In some jurisdictions, these alternative disclosure regimes require less detailed disclosure than the regimes applicable to active, significant blockholders.

Some countries also define a term "insider" to include persons or groups who hold a specified percentage of a publicly held company's voting or equity securities and require such insiders to report any transactions in relation to the company's securities within a specified time period. For example, in Canada, such reports must be filed within 10 days of the date the person becomes an insider and, thereafter, within 10 days of the transaction that triggers the reporting requirement.

In some jurisdictions, there may be regulatory schemes in addition to corporate/securities legislation that require timely or periodic public disclosure of significant holdings of voting or equity securities. For example, in the United States, an activist hedge fund might have to publicly disclose its interest in a company under the *Hart-Scott-Rodino Antitrust Improvements Act* (HSR Act) even before it acquires more than 5% of a class of equity securities registered under the Exchange Act (which would trigger disclosure obligations under federal securities laws) if the market value of its investment exceeds USD 56.7 million and it cannot rely upon the "passive investment exemption" in the HSR Act.

3.1.3 Other regulatory provisions that can affect stake-building strategies

In some jurisdictions, there are other regulatory provisions that may restrict stake-building by activists. For example, the takeover laws in many jurisdictions define a "takeover" to include the acquisition of an interest in or control or direction over sufficient voting and/or equity securities that, taken together with the investor's existing holdings, exceed a specified threshold. The thresholds vary from country to country. Generally, to ensure equitable treatment of shareholders, a person whose acquisition of securities crosses the takeover threshold must make a formal takeover bid or tender offer to the remaining shareholders, unless an exemption is available. Not surprisingly, activist hedge funds keep their stakes below the applicable takeover/tender offer threshold, unless, of course, they wish to make a formal takeover bid/tender offer.

33. For example, the Hermes UK Focus Fund (HUKFF), whose activities are described by Becht *et al.* (2006), acquires stakes in companies for the purpose of engaging in activism.

3.1.4 *Use of derivatives and other financial instruments as part of a stake-building strategy*

Historically, voting power with respect to securities was closely linked to owning the corresponding economic interest in them. The derivatives revolution in finance (especially the growth in equity swaps, other over-the-counter equity derivatives and the related growth of stock lending), however, has made it increasingly easy to decouple economic ownership from voting power (Black and Hu, 2006a). Through the use of derivatives and other financial instruments, it has become possible to have control over more votes than one's corresponding economic interest in the related voting shares, or vice versa.

Not surprisingly, activist hedge funds sometimes use derivatives and other financial instruments as part of their stake-building strategies. Derivative instruments can be used to enhance returns. They can also be used to boost the "equity ownership" reported in regulatory filings and the press and thereby gain credibility for holding a significant interest in the company. This is because the disclosure requirements often provide that shares that a person or group has a right to acquire within a certain time period should be included for purposes of determining the number of shares and percentage of voting rights held by the person or group. For example, in the amended Schedule 13D that Pershing Square filed with respect to Wendy's, it disclosed that, in effect, 8.7% of its 9.9% ownership stake in Wendy's consisted of shares issuable under options.

Some concerns have been expressed that some hedge funds that seek to influence company behaviour or corporate outcomes (*e.g.* a tender offer or shareholder vote on a proposed merger) are not providing sufficient disclosure about the extent of their voting power and economic interests in the company (or companies) involved. This issue is discussed in Part 3.4 below.

3.2 Private engagement with company representatives

After building a stake in a company, activist hedge funds often commence (and sometimes limit themselves) to private engagement with the company's management and board. If a hedge fund finds that the company is receptive to its proposals and is satisfied that the company is proceeding in a timely way to implement initiatives consistent with its recommendations, its engagement might remain a private matter.[34] This may raise issues about consistency with outcomes advocated by the Principles regarding market transparency and the equitable treatment of shareholders if, for example, the hedge fund comes into possession of material/price-sensitive, non-public information and makes use of that information or selectively discloses it to others.

Not surprisingly, there is very little publicly available information about the extent to which activist hedge funds pursue purely private engagement strategies and whether or not such strategies are successful. However, the recent study by Becht *et al.* (2006) analysing HUKFF's engagement has some relevance, even though HUKFF is a focus fund of a wider pension fund management enterprise, not a hedge fund. HUKFF has an activist mandate. Like activist hedge funds, it has strong incentive structures for its staff and appears to employ many of the same strategies as activist hedge funds. Therefore, its engagement

34. This might not be possible if, for example, the hedge fund's interest in voting securities of the company exceeds the threshold for public disclosure and it is required to disclose its engagement with the company. In some jurisdictions, for example, an investor that has exceeded the threshold for disclosure and filed a report regarding its interest in a company and its intentions regarding its investment must file an amended report if there is a material change in the information it previously disclosed. If its prior report did not specify that it might engage with the company, a strong argument could be made that any such engagement would have to be disclosed on an amended report

practices are likely to be of interest to those studying hedge fund activism. This study is of particular interest because the authors were given extensive access to HUKFF's files and, therefore, were able to analyse HUKFF's private activities as well as its public activities.

The authors found that HUKFF's pattern of engagement with the companies comprising its portfolio consisted primarily of private interventions. Of the 41 companies in which it invested during this period, it engaged with thirty of them.[35] All thirty engagements involved some form of direct private engagement with the companies. Six of the engagements were exclusively private. Only eight of the engagements involved disclosure by HUKFF of its holding in the company together with concurrent media coverage picking up on HUKFF's engagement with the company.

The study also describes the range of private engagement activities pursued by the Hermes Focus Fund in the period 1998-2004. These activities generally consisted of writing letters to and/or holding meetings with various company representatives, principally CEOs, board chairs and CFOs. HUKFF representatives also sometimes met with heads of investor relations, senior independent board members, other non-executive board members and senior executives and often visited company sites.

3.3 Public campaigns

Sometimes, a hedge fund will publicly disclose at an early stage of its investment that it is considering or planning to develop proposals to enhance value for shareholders and to engage in dialogue with the company. In other cases, the hedge fund may pursue a private, collaborative approach first and turn to a public campaign only if its initial overture to the company is rebuffed or, at a later stage, if it is dissatisfied with the company's progress toward implementation of the hedge fund's proposals. These two different approaches were used by Pershing Square and Trian/Sandell, respectively, in their engagements with Wendy's (see Box 5)

Hedge funds use various media to publicise their engagements with companies. Press releases and press conferences are often used. In the United States and Canada, respectively, the EDGAR and SEDAR systems for making securities regulatory filings available quickly and at no cost on the internet enable activist investors to widely disseminate their proposals, attract media and market attention and thereby put pressure on companies. In the US, activist investors often attach as exhibits to their Schedule 13D filings such documents as correspondence with company management, detailed strategic proposals and financial advisory opinions. Some funds have even established websites relating to engagements with specific target companies to facilitate dissemination of key messages.

Public campaigns can help activist hedge funds achieve their objectives, *e.g.* by attracting like-minded investors who might support the hedge fund's proposals for specific target companies. Public campaigns also attract media attention, which can increase the pressure on company management and boards to respond in some way to the hedge fund. Creative, high profile and successful campaigns can also help hedge fund managers "build their brand", enabling them to attract (and retain) investors. Such campaigns can also increase the influence of hedge funds with respect to future engagements. Company management and boards can be expected to take more seriously an activist hedge fund's warning that it will go public

35. Of the remaining eleven investments: *(a)* three were made shortly before cut-off point for the study (31 Decembe 2004) and, therefore, engagement had not yet started; and *(b)* HUKFF disposed of its investment in eight companies relatively soon after investment and before engagement started, following a sudden upward movement in stock prices prompted by exogenous events.

with its proposals and that it has the support of other investors, if the hedge fund's prior, public track record supports its claim.

Two studies support the view that US publicly held companies often respond to activist hedge funds' public campaigns by implementing at least some of the requested changes. Klein and Zur (2006) found that in 41 situations where a hedge fund expressed a demand for board representation in its 13D filing, the hedge fund obtained such a position 30 times (a success rate of 72%). Brav *et al*. (2006) found that in approximately two thirds of the observed cases, hedge funds were fully or partly successful in achieving their stated goals (as reflected perhaps imperfectly in their Schedule 13D filings). Companies fought back in roughly half the cases where a hedge fund publicly and aggressively pursued particular objectives, with the hedge funds achieving their main stated goals in about one third of these "hostile" cases and achieving partial success (*e.g.* a concession) in an additional one third of the hostile cases.

Although OECD Principle II.G and the related annotation stress that shareholders should be allowed to consult with and communicate with each other on issues regarding their basic shareholder rights, there is a risk that some investors will attempt to manipulate markets. Some people have expressed concern that unscrupulous hedge funds may publicly announce a plan of engagement with a company for the purpose of creating short term value opportunities. For example, the UK FSA indicated in a 2005 discussion paper that, based on its market impact review, there were concerns that some hedge funds were "pushing at the boundaries of acceptable practice" in relation to trading based on non-public information and market manipulation.[36] The FSA also said "it was suggested" that some larger hedge fund managers might be tempted to use their size, or start market rumours, to deliberately move the market to benefit from advantageous prices. Taken to an extreme, it is conceivable that a hedge fund (or another influential investor) could launch a public campaign based on false information or proposals that the investor did not intend to pursue and then take a profit when the market responded to that information. In some circumstances and depending on the jurisdiction in question, such conduct might fit within the definitions of prohibited conduct such as market abuse (*e.g.* creating a false or misleading impression or market manipulation).

Others, however, point out that activist hedge funds operate subject to constraints. Even if some aspects of their activities are subject to less extensive regulation than certain other financial market participants, hedge funds are still subject in many jurisdictions to laws of general application that require disclosure about their behaviour and prohibit market abuse. Furthermore, market discipline operates as a constraint upon hedge funds who seek to attract and retain investors. For example, Bratton (2007) points out that "an alternative business plan must persuade the wider community of institutional investors and informational intermediaries, which can be counted on to reject unsound, short term interventions."[37]

3.4 Activities in relation to shareholder meetings and proposed extraordinary transactions

Activist hedge funds may take action, or at least threaten to take action, in relation to annual general meetings (AGMs) or extraordinary general meetings (EGMs). This Part of the Report discusses hedge fund activism with respect to: (a) board elections at AGMs; (b) shareholder proposals at AGMs; (c) proposed mergers, acquisitions and takeovers that require shareholder approval at an EGM.

36. FSA (2005) at 53.

37. Bratton (2007) at 6.

3.4.1 Proxy contest-general

Some commentators suggest that activist hedge funds in the United States increasingly are using the *threat* of contesting management's slate of board nominees at the AGM as a tactic in an escalating strategy to increase pressure on companies to implement the hedge funds' proposals. For example, if a hedge fund's overture to a company is rebuffed or it is dissatisfied with the company's progress toward implementing the hedge fund's proposals, the hedge fund might advise the company privately (*e.g.* by telephone or in writing) that it plans to contest management's slate of board nominees by proposing its own nominees to fill one or more board positions. If the company does not respond to this news in a manner satisfactory to the hedge fund, the hedge fund may go public with its threat of a proxy fight, *e.g.* through press releases and/or an amended Schedule 13D filing. Sometimes, the private or public threat of a proxy contest is sufficient to induce company management to accede to the hedge fund's proposals. In other cases, the hedge fund might find it necessary to take further steps, including: *(a)* preparing proxy solicitation materials (including a detailed information circular); *(b)* submitting the documentation to the SEC and resolving any comments that the SEC might have with respect to the documentation; and *(c)* carrying through with its stated intentions and actually soliciting proxies in favour of its own nominees. In still other cases, activist hedge funds lend their public support for other activists' proxy contests, rather than initiating their own proxy contests.

The SEC amended its proxy solicitation rules, effective in 2000, to make it easier for investors to communicate with each other, an outcome advocated by the Principles. Both written and oral communications are permitted before the filing of a proxy statement, provided that:

- all written communications relating to the solicitation are filed on the date they are first used;
- all such written communications contain a prominent legend advising security holders to read the proxy statement when it becomes available;
- proxy solicitors make information about participants available by including with written communications a prominent legend advising security holders where they can obtain a detailed list of the names, affiliations and interests of the participants in the solicitation; and
- no form of proxy can be furnished to an investor until a definitive proxy statement is filed.

The principal difference between the old regime and the new regime is that a person who is considering or intending to solicit proxies no longer has to prepare and pre-clear proxy solicitation materials with the SEC before starting to communicate with investors. It should be emphasised, however, that all written communications under the new regime are subject to the anti-fraud laws in federal securities legislation.

Bratton (2007) notes that, under this liberalised regime, "the line separating a proxy threat from a proxy contest is not very clear". An activist hedge fund might first indicate privately or publicly that it might solicit proxies in opposition to management (at an AGM or with respect to an extraordinary event requiring shareholder approval at an EGM) if it is dissatisfied with management's response to the concerns the hedge fund has raised in its private (or public) statements. If such a threat does not produce a response satisfactory to the hedge fund, it might follow up with a public statement of its "intention to solicit" proxies. Such an announcement entails a shift in the pattern of compliance with SEC disclosure and filing requirements: statements and documents formerly submitted as part of Schedule 13D filing will now be filed as preliminary 14A proxy solicitation materials. Therefore, it is easier and less costly for an activist

investor to attract attention and support among market participants, analysts and the media for its threatened proxy solicitation – without having to go to the significant expense of actually soliciting proxies.

3.4.2 Morphable Voting Rights

Some people have expressed concern about the potential for activist hedge funds, to disguise their interest in a company until they wish to exercise their rights as shareholders, *e.g.* to vote at a meeting. They often refer to the fact situation involving Perry Corp., a hedge fund, and Rubicon Ltd. (Rubicon), a publicly held New Zealand company, to support their argument. In June 2001, Perry Corp. disclosed that it had ceased to hold 5% or more of the Rubicon's shares. Just prior to Perry Corp's disclosure, it had disposed of the voting rights but retained an economic interest in Rubicon by selling 31 million shares to Deutsche Bank and UBS Warburg while simultaneously taking the long side of equity swaps covering these shares. A year later, in July 2002 and just before Rubicon's AGM, Perry Corp. disclosed that it held 16% of the shares. It acquired the shares by terminating the swaps and buying the shares back from Deutsche Bank and UBS. Another Rubicon shareholder challenged Perry Corp.'s right to vote. Perry Corp. lost at trial but won on appeal. It argued that its equity swap position fell outside the scope of New Zealand's disclosure requirements.

On the one hand, Perry did not have a right or obligation to acquire the shares. Therefore, the equity swap arrangement would seem to fall outside the scope of disclosure rules that treat people as beneficially owning any shares that they have a right or obligation to acquire, even upon conditions. On the other hand, Perry could be fairly certain that it could, at any time, reacquire and vote the Rubicon shares. This is because the two banks would have had to hedge their exposure on the swaps and Perry could have expected them to do so by holding the shares they had bought from Perry. In the circumstances, where there was a thin market for Rubicon shares, other means of hedging were unlikely.[38]

Responding to similar events, authorities in some jurisdictions have amended, or are considering whether or not to amend disclosure requirements applicable to significant holdings of publicly held companies' securities to capture situations like the one described above.[39]

3.4.3 Shareholder proposals

OECD Principle II.C encourages the development of mechanisms that facilitate effective shareholder participation in shareholder meetings, including with respect to key corporate governance decisions. In the United States, SEC Rule 14a-8 enables shareholders owning a relatively small amount of the company's securities to have their proposal placed alongside management's proposals in that company's proxy materials for presentation to a vote at an annual or special meeting of shareholders. It is less expensive for a shareholder to raise issues through a shareholder proposal than to prepare its own proxy solicitation materials and then solicit proxies. A shareholder that has held at least 1% or USD 2 000 worth of the

38. Black and Hu (2006) discuss (at 836-842) a number of other situations where individuals or companies (including, but not limited to, hedge funds) appear to have used derivatives to avoid disclosure or other requirements (such as takeover bid requirements). These transactions did not necessarily involved a breach of the relevant laws, since questions often arose as to the application of the relevant laws to the arrangements and transactions involved.

39. See, *e.g.* UK Takeover Panel (2005a, 2005b and 2005c). Although the UK Takeover Panel focused on the issue of disclosure of dealings in the context of takeovers, the analysis in these discussion papers is nevertheless relevant and useful to the analysis of disclosure requirements applicable to significant acquisitions or significant holdings of securities.

relevant voting securities for at least one year prior to the date of submitting the proposal can submit a proposal. The rule generally requires the company to include the proposal unless the shareholder has not complied with the rule's procedural requirements or the proposal falls within one of the rule's thirteen substantive bases for exclusion. A company that receives a request from a shareholder to include the shareholder's proposal in the company's proxy materials can choose to do so or it can choose to exclude the proposal so long as it files its reasons with the SEC. However, companies generally seek a "no-action letter" from the SEC if they intend to omit a proposal because they can face an enforcement action if they improperly omitted a proposal.

More than a thousand shareholder proposals are submitted to companies each year[40] and SEC staff consider several hundred requests from companies for no-action relief. Although available information is incomplete, it appears that although shareholder proposals are a popular tool among traditional institutional investors (*e.g.* pension funds) and individuals, activist hedge funds use them less frequently. The reasons for this are unknown, although it might be because some of the bases for exclusion of shareholder proposals deal with the very decisions and processes that activist hedge funds often wish to influence. For example, a company can exclude a proposal that:

- deals with a matter relating to the company's ordinary business operations (as noted above, when activist hedge funds engage with companies, they often seek to influence decision-making about the company's operations);
- the proposal relates to specific amounts of cash or stock dividends (as noted above, when activist hedge funds engage with companies, they often call for the company to pay an extraordinary cash dividend or to pay regular dividends at a higher rate); or
- relates to an election for membership on the company's board of directors or similar governing body.

Recently, however, a hedge fund (Seneca Capital Partners LLP) submitted what is sometimes referred to as a "proxy access" proposal, *i.e.* a shareholder proposal that the company change its procedures (such as those set out in its by-laws) to enable shareholders to directly nominate candidates for election to the board by including their candidates in the company's proxy statement. (Generally, shareholders who wish to nominate an individual for election either: *(a)* submit the recommendation to the company board for its consideration and decision; or *(b)* contest one or more of the management slate of nominees by conducting, at their own expense a "solicitation in opposition".) It asked Reliant Energy Inc. (Reliant) to include in its 2007 proxy statement a proposal asking shareholders to vote in favour of amending the company by-laws to permit holders of at least 3% of the company's stock to be able to nominate a candidate for the board of directors. In mid-January 2007, Reliant filed a request for no-action relief with the SEC so that it could omit Seneca's proposal from Reliant's 2007 proxy materials. In late January, Reliant went a step further and applied to the District Court in Texas for a declaratory order that its interpretation of Rule 14a-8 was correct and that it could omit Seneca's proposal. In late February 2007, Seneca decided to withdraw its proposal and, therefore, has sought to dismiss Reliant's lawsuit on the grounds of mootness.

Although Seneca ultimately decided to withdraw its proposal, this case suggests that some activist hedge funds may be starting to use shareholder proposals as part of a longer-term strategy to effect change in certain companies. For example, a hedge fund might pursue a proxy access proposal if its earlier efforts

40. See, *e.g.* Gillan and Sharks (1999), which provides a detailed review of the use by activist institutional investors and others of the shareholder proposal mechanism for the period 1987-1994. The study is of somewhat limited value, since it only covers the period up to 1994.

to obtain representation on the board or to change the company's strategic direction are not effective. Box 6 below, which outlines several cases involving proxy contests and shareholder proposals, indicates that hedge funds do occasionally submit shareholder proposals to companies. Shareholder proposals also might constitute relatively inexpensive ways to escalate a public campaign and thereby increase pressure on companies to make the changes recommended by the hedge fund. Such a strategy could backfire, however, if, for example, a company decides to raise the stakes (and likely increase the hedge fund's out-of-pock expenses) by initiating a lawsuit to challenge the hedge fund's request.

Box 6. Recent proxy contests and shareholder proposals

The Topps Company

Activists:

- Crescendo Partners and Pembridge Capital Management

Allegations:

- Poor operating and stock price performance
- Failure to take action to overhaul management and reduce cost structure
- Failure to maximise full value of Bazooka brand over past 20 years
- Should hire an investment banking firm to explore strategic alternatives

Action:

- Nominated three directors
- Shareholder proposal to eliminate classified board
- Proposal to allow shareholders holding at least 15% of shares to call special meeting

Result:

- Settlement reached on morning of AGM

KT&G Corporation (South Korea)

Activists:

- Carl Icahn and Warren Lichtenstein

Proposals:

- Sell real estate assets
- Spin off ginseng unit
- Raise dividends

Action:

- Icahn and Lichtenstein commenced a proxy battle for three board seats
- In late February 2006, they announced an unsolicited offer to buy the outstanding shares of KT&G at a 17% premium to the pre-announcement closing price of KT&G shares

Result:

- Icahn and Lichtenstein won 35% of the vote at the AGM, entitling them to one seat on the board.
- They did not proceed with the tender offer

Source: Wolosky (2007); Kislin (2007); Kahan and Rock (2006); documents filed by activist investors and respondent companies with the SEC. Documents filed with the SEC reflect the views of filers, not the SEC.

3.4.4 Mergers, takeover bids and other extraordinary transactions

Hedge funds have been particularly active in relation to proposed M&A transactions. As some of the examples mentioned earlier in this paper illustrate, activist hedge funds sometimes privately or publicly encourage or support an acquisition of the target company. They sometimes take an even more active role by employing their own financial advisers and investment bankers to solicit and evaluate offers from third parties and provide opinions that back up the hedge fund's opinion that a sale of the company is the best value-maximising option.

Where the target company has proposed a M&A transaction, hedge funds often speak out about the merits (or disadvantages) of the proposed transaction. If they believe that the proposed transaction is not one that maximises value for shareholders, they may oppose it, solicit alternatives to the proposed transaction or seek to persuade the parties to the transaction to improve the terms. Box 7 below sets out some examples of situations where hedge funds have intervened with respect to proposed mergers and takeovers, sometimes in opposition to private equity funds.

Box 7. Recent Examples of Hedge Fund Intervention in the Market for Corporate Control

Proposed leveraged buyout of Masonite International Corp. (2004-2005)

- Kohlberg Kravis Roberts & Co. (KKR), a private equity firm, proposed to acquire Masonite, a Canadian company, in an arrangement that valued Masonite at CND 40.20 per share
- Eminence Capital LLC opposed the proposed merger, stating that the shares were worth at least CND 50
- The parties to the transaction subsequently amended the terms to provide for consideration of CND 42.25 per share and KKR succeeded in acquiring the company.

Proposed merger of Deutsche Börse and the London Stock Exchange (2004-2005)

- Deutsche Börse proposed to make a takeover bid for the London Stock Exchange, whose management twice rejected the proposed offer as insufficient.
- Several hedge funds with investments in Deutsche Börse, including UK-based The Children's Investment Fund Management (TCI), US-based Atticus Capital and US-based Jana Partners, opposed the proposed takeover, arguing that Deutsche Börse should pay out the bulk of its cash to shareholders instead. The funds threatened to elect a new supervisory board at the company's annual meeting. Other hedge funds and investors expressed the view that a merger with Euronext would be a better option than acquiring the LSE.
- Deutsche Börse withdrew its preliminary offer when several other major institutional investors joined the hedge funds in opposing the proposed takeover.

Proposed Merger of Mylan Laboratories Inc. (Mylan) and King Pharmaceuticals, Inc. (King)

- In July 2004, Mylan announced a proposed stock-for-stock merger with King. The deal valued King at USD 16.66 per share, a 61.8% premium over its day-before market price. Mylan's stock price dropped significantly upon the announcement, since many traders thought the deal over-valued King.
- Carl Icahn, however, started purchasing Mylan shares, investing USD 307 million to acquire a 6.8% stake over the next six weeks. In a Schedule 13D and preliminary proxy solicitation materials filed when his acquisitions crossed the 5% threshold, Icahn indicated that he considered Mylan stock to be undervalued and that he intended to solicit proxies in opposition to the proposed merger.
- In subsequent filings (backed by a consultant's report), Icahn expressed the views that: *(a)* Mylan should be sold (and he would be willing to buy it for USD 20 per share); *(b)* the company's board needed more outside directors; *(c)* the CEO was paid more than his performance record justified. He also announced his intention to run an opposition slate of directors at the 2005 annual meeting.
- In January 2005, Mylan announced cancelled the merger, citing adverse information discovered during the due diligence process.
- Mylan's management responded to Icahn's threat to run an opposition slate of directors by delaying the AGM and amending the company's by-laws to include an "advance notice provision" that would operate to prevent Icahn from doing so. Icahn sued Mylan in February 2005.
- In June 2005, Mylan announced a USD 1.25 billion share repurchase to be funded by a billion dollar line of credit. Icahn responded that the repurchase offer price "for the most part" fell below his (informal) USD 20 offer, but he tendered shares to the issuer bid, dropped the proxy contest, dropped the informal offer to purchase the remaining shares and sold his remaining investment in Mylan into the market.

Box 7. Recent Examples of Hedge Fund Intervention in the Market for Corporate Control (cont.)

Proposed Acquisition of VNU Group b.v. (now known as The Nielsen Company) (Netherlands)

- In November 2005, VNU, a conglomerate, called off a merger with IMS Health after shareholders claiming to represent nearly 50% of VNU's outstanding shares said they would not support the transaction. One of these shareholders was Knight-Vinke Asset Management (KVAM), a hedge fund manager.
- KVAM retained the Boston Consulting Group in late 2005 to review VNU's business strategy and evaluate the potential for cost savings that could be achieved under new management.
- In early 2006, a consortium of private equity firms (including Blackstone and KKR) negotiated a friendly buyout of VNU at EUR 28.75 per share.
- KVAM publicly opposed the proposed sale and expressed the view that the offer under-valued VNU by as much as EUR 7 to 12 per share. It stated that neither it nor, to its knowledge, any other large shareholder of VNU had called for a sale of the company. Instead, they had been seeking to persuade the company to set aside its temporarily its "highly acquisitive acquisition strategy", which in KVAM's view had resulted in the company under-performing its peers for several years. KVAM also criticised the sale process employed by the VNU boards, stating that they should have acceded to its request to permit qualified bidders to bid not only for VNU as a whole but also for its major constituent assets. KVAM also criticised the VNU boards' appointment of VNU's outgoing CEO, who also was a member of the supervisory board of ABN Amro (VNU's "house bank" as well as an adviser to the private equity consortium), to lead the sale process.
- Several other major shareholders also expressed opposition to the proposed buyout. In May 2006, however, they accepted a raised bid.

Source : De Rose and Houlihan Lokey (2007); documents filed by activist investors and respondent companies with the Canadian Securities Administrators (CSA) and/or the SEC. Documents filed with the CSA and/or SEC reflect the views of the filers, not the CSA and SEC.

Bratton's review of 25 cases in which a merger announcement triggered intervention by activist hedge funds suggests that they influence results.[41] According to his analysis, only five transactions in the group closed with the terms of the deal unaltered. Seven of the remaining 20 closed only after concessions, usually a price increase, while the other 13 were terminated.

In recent years, some concerns have been expressed about activist hedge funds' use of derivative instruments in conjunction with engagement strategies, particularly in relation to proposed M&A transactions. A widely-cited case involved the actions of hedge fund manager Richard Perry and his firm Perry Corp. (a registered investment adviser) in relation to the proposed Mylan-King merger (described in Box 7 above). Icahn's direct, public opposition to the proposed merger may have put him at odds with risk arbitrage traders. Bratton notes that, "in the wake of a merger announcement, the more usual 'risk arbitrage' move is to buy shares of the target (so as to benefit from any increase in the merger price) and simultaneously sell shares of the acquirer short (so as to benefit from any further decline in its price due to the merger).[42] Perry employed this strategy but went one step further. To protect the merger (and his investment in King), he also purchased Mylan stock in an amount equal to his short position, thereby gaining control of 9.9% of the votes at the upcoming meeting. His interest in Mylan, however, was fully hedged through equity swaps and other instruments, leaving him with a zero net economic interest in

41. Bratton (2007) at 49.

42. See also, generally, Block (2006).

Mylan (and a long position in King). Icahn objected to Mr. Perry's strategy, arguing in a lawsuit brought against Perry and Perry Corp. that they should not be allowed to vote the Mylan shares because they lacked an economic interest in Mylan. The lawsuit became moot when Mylan cancelled the merger in January 2005, citing adverse facts discovered during the due diligence process.

Perry's behaviour also raised some concerns because some people believe that he did not fully disclose the extent and nature of its voting and economic interests in Mylan and King on the Schedule 13Ds that he filed.[43] Some would argue that the existing disclosure regime did not require full disclosure in the circumstances, so this wasn't necessarily a question of non-compliance with the law.[44]. Some people have suggested that Perry Corp's strategies attracted so much negative publicity that many hedge fund managers have concluded that the potential reputational damage associated with such a strategy is so great that it is not worth the potential benefit. Many hedge fund managers receive funding from traditional institutional investors, many of whom would not wish to place their money with a hedge fund manager involved in a regulatory scandal. At the same time, the Mylan-King scenario points to some potential concerns about "grey areas" in securities regulatory disclosure requirements, not just in the United States but also in many other countries, applicable to significant holdings.

In addition to private equity vehicles, some hedge funds have emerged as potential or actual bidders for companies (Box 8).

Box 8. Hedge funds that have bid or announced bids for companies

Date Announced	Offeree Company	Bidder	Value (USD MM)
July 2006	Phoenix Technologies	Ramius Capital	115
June 2006	Bairnco Corp.	Steel Partners II	73
June 2006	Houston Exploration	JANA Partners	1,579
June 2006	Stratus International	Steel Partners II	104
May 2006	Atmel Corporation	RDG Capital	2700
April 2006	Keweenaw Land	Opportunity Partners	156
April 2006	Gyrodyne Co.	Opportunity Partners	50
March 2006	American HomePatient	Highland Capital	59
February 2006	Wilshire Enterprises	Mercury Real Estate Advisors	69
February 2006	Circuit City	Highfields Capital Management	3250
January 2005	Beverly Enterprises	Appaloosa / Franklin / Formation	1530
November 2004	Mylan Laboratories	Carl Icahn Partners	5400

Source: De Rose and Houlihan Lokey (2007)

43. The initial Schedule 13D did, however, disclose, among other things, that Perry and the other persons reporting on the Schedule 13D: *(a)* owned shares of King common stock; *(b)* subsequent to the announcement of the proposed merger, acquired additional shares of King common stock as well as shares of Mylan common stock; and *(c)* had hedged the shares of Mylan common stock through transactions mentioned on the Schedule 13D as well as security-based swap agreements. He did not, however, disclose the extent of his interest in King nor the precise extent to which his positions in Mylan and King were hedged.

44. See Table 3 in Black and Hu (2006), which summarises the authors' interpretation of how current U.S. ownership disclosure rules apply to long positions in shares or equivalents (including shares, exchange-traded derivatives, equity swaps and other OTC derivatives), short positions in shares or equivalents, stock lending and stock borrowing.

Bratton (2007) notes that although activist hedge funds made offers to purchase companies in the sample he studied, none of those offers led to a merger with the hedge fund offeror. Only three of the hedge funds' offers to purchase proceeded to the stage of filing a formal SEC Form TO (General Motors, Acxiom and Whitehall). Some commentators have suggested that some of the other bids announced by hedge funds were strategies designed to put the company in play. This strategy might not work in some jurisdictions, however, where takeover proposals need from the outset to be more developed.

3.4.5 Concerns about integrity of voting systems

Some commentators believe that, to the extent there are more contested board elections and/or contested votes with respect to extraordinary transactions such as mergers, concerns about the integrity of voting systems could become acute.[45] For example, Kahan and Rock (2006) describe how overvoting can occur.[46] Their hypothetical example focuses on the United States, but in theory it would apply in any jurisdiction that employed similar systems and practices. They note that, in the United States, individual brokerage firms have accounts with the Depositary Trust and Clearing Corporation (DTCC), in which customers' holdings of securities are commingled in a single, fungible mass. DTCC's records indicate that one broker (M) has, for example, 20 000 shares of Company X, without indicating how many shares specific customers hold. It is M's responsibility to keep track of its customers' holdings as they change. In connection with a vote at Company X, Company X (and any person planning to solicit proxies in opposition to management) will retain a firm (or firms) to handle the distribution of proxy materials, the solicitation of proxies and the tabulation of votes. These firms will receive a list of holdings by brokerage firm from DTCC and a list of customers' accounts from the brokerage firms that participate in DTCC. The firms will send out proxy materials and proxy cards to those who appear on the brokers' lists.

Kahan and Rock note that the system can break down if there is significant short selling (covered by stock borrowing). In a short sale, a brokerage typically arranges for a short seller to acquire shares from a custodian bank, which holds shares (in a fungible mass) for its clients (*e.g.* pension funds), subject to an obligation to return the shares at a later date. The short seller then sells the shares to a third party who takes full title and may not be aware of the source of the shares. (Furthermore, the clients of the custodian bank may not be aware that their shares have been delivered to the short seller and sold on to a third party.) Consider what happens if a hedge fund "borrows" 5 000 shares of Company X from M and sells them short to a customer of Broker G, which prior to this transaction held 30 000 shares in its account with DTCC. Following this transaction, DTCC's records will show that G holds 35 000 shares while M holds 15 000 shares. DTCC's omnibus proxy will transfer the right to vote 15 000 shares to M and inform the proxy soliciting firms of this. M, however, will give the proxy soliciting firms a list of all its customers' holdings in Company X for a total of 20 000 shares, while G will give them a list of all its customers' holdings for a total of 35 000 shares. The proxy soliciting firms will send out proxy materials to M's customers and G's customers, for a total of 55 000 shares (even though these firms only hold, in the aggregate, 50 000 shares). Because the shorted shares are often not attributed to specific customers' accounts, it is unclear which customers are entitled to vote shares. If fewer than 15 000 shares associated with M's clients are voted, then the problem likely is "shoved under the table" by pretending that the M customers who returned proxies were all entitled to vote and some of those who did not return proxies were not entitled to vote". But if proxies representing more shares than were entitled to vote are returned

45. In early 2007, a shareholder proposal received 50.8% of the votes cast raising questions about the accuracy of voter registration.

46. See also Kahan and Rock (2007b) for a more detailed discussion of the US voting system for corporate elections.

(*e.g.* because the level of short-selling is high and the abstention rate is low), then it is unclear what should be done.

In a close vote in such circumstances, concerns might arise about whether or not the votes cast for and against the matter under consideration truly represent the wishes of the shareholders entitled to vote. Kahan and Rock cite the example of the proposed MONY/AXA deal, where a controversial buyout was approved by a margin of 1.7 million votes out of a total of 50.1 million shares (3.4%) in circumstances where it is believed that 6.2 million shares had been shorted. One can also imagine that, in a situation where an activist hedge fund solicits votes in opposition to management's slate of candidates for election to the board, disputes about the validity of voting results might occur with some frequency. Some commentators have suggested that, to the extent companies that currently use plurality voting introduce majority voting systems, the likelihood of close votes (and, therefore, of disputes about the validity of voting results) could increase dramatically. Such disputes could adversely affect investor confidence in the integrity of voting systems where over-voting is possible. Voting systems in some other jurisdiction such as in Spain and France do not encounter similar problems in dealing with share lending.

3.5 Parallel behaviour among investors, communication and joint action

Hedge funds are sometimes accused of engaging in "wolf pack" behaviour, a colourful term meant to convey the image of an aggressive group preying on a vulnerable company by simultaneously or sequentially trading in its securities (*e.g.* building voting stakes or, conversely, selling the company's stock short), often while publicly and vociferously criticising the company's management. A neutral way of characterising and describing such behaviour would be to speak of "parallel behaviour", investor communication and "joint/concerted action".

3.5.1 Parallel behaviour

Many investors, including hedge funds, sometimes engage in deliberately parallel behaviour, *i.e.* behaviour that mimics or follows the behaviour of another. For example, after one activist hedge fund discloses that it has acquired a significant stake in a company, revealed its proposals for change and/or indicated its support for or displeasure with management initiatives, some other investors (including traditional institutional investors) are likely to react to such information, *e.g.* by engaging in similar behaviour (such as trading in the company's securities, disclosing their support for the first investor's proposals or expressing concern about management's performance). The OECD Principles do not suggest that such activity should be prohibited or restricted. In fact, as some institutional investors have been very careful to point out in their regulatory filings, it is consistent with an institutional investor's obligations to its own clients to monitor carefully any publicly available information about the behaviour of other significant investors in the company's stock. Likewise, it is consistent with an institutional investor's obligations to its clients to respond, as appropriate, to new developments such as news of such another significant investor's dissatisfaction with a company's management or stock price performance.

3.5.2 Communication among investors and other interested market participants and advisers

Activist investors, including activist hedge funds, often contact other equity and/or debt holders, as well as other relevant market participants and advisers, as part of their engagement strategy with respect to a company. Such communication can take place at various stages during the life cycle of the activist hedge fund's engagement with a company. For example, near the outset of its planned intervention, a hedge fund manager might discuss its concerns about the company and/or the fund's proposed strategy with another hedge fund manager or other significant institutional investors. Such discussions enable it to better evaluate

the extent of other investors' concerns about the company, gauge potential support for the hedge fund's proposals and perhaps identify alternative proposals or strategies for enhancing value. Sometimes, an activist hedge fund and one or more other investors will decide to cooperate with each other to request a meeting or call (and possibly participating in such a meeting or call) with the company's management, board and/or advisers. They might also participate in meetings or conference calls with analysts, including equity analysts, credit rating agencies and/or proxy advisory services, such as ISS. These communications (among investors and between investors, companies, advisers and analysts) might take place privately (although the outcomes of such contacts might end up being reported in regulatory filings).

OECD Principle II.G states that "Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse." The associated annotation provides that investors "should be allowed, and even encouraged, to co-operate and co-ordinate their actions in nominating and electing board members, placing proposals on the agenda and holding discussions directly with a company in order to prove its corporate governance. More generally, shareholders should be allowed to communicate with each other without having to comply with the formalities of proxy solicitation."

In many jurisdictions, communications between the company's representatives and advisers, on the one hand, and investors, on the other, likely are subject to laws that prohibit: *(a)* selective disclosure by companies or persons acting on their behalf of material/price-sensitive, non-public information; and *(b)* misuse of material/price-sensitive, non-public information. For example, selective disclosure laws may operate to prohibit companies from disclosing material, non-public information to activist hedge funds in meetings with company management and boards. Furthermore, in some countries, the fact that a hedge fund manager intends to initiate or escalate an engagement with a publicly held company could, in some circumstances, be considered material/price-sensitive information if the hedge fund's plans are reasonably likely to have a significant impact on the market price or value of the company's shares. While it might be permissible for the hedge fund manager to disclose its intentions to another investor, *e.g.* for the purpose of gauging support for its plan, it likely would be illegal under such a regime for the other investor to trade on that information.

In other cases, activist hedge funds might contact other investors or analysts as part of more public and confrontational strategy. The contacts might relate to soliciting public support in connection with a press campaign, soliciting votes in a proxy contest, soliciting support for a shareholder proposal or to requisition an extraordinary general meeting or soliciting support for the hedge fund's opposition to a proposed transaction or takeover.

Depending on the laws of the jurisdiction in question, some or all of the activities described above may fall within the scope of corporate and securities regulatory provisions governing proxy solicitations. For example, in Canada, the *Canada Business Corporations Act* (CBCA) used to provide that, subject to certain limited exceptions, no one could solicit proxies from Ontario security holders of a "reporting issuer" (*i.e.* a company considered to be publicly traded in Ontario) unless the person delivered a proxy information circular to the person whose proxy was solicited concurrently or before the solicitation. The terms "solicit" and "solicitation" were defined very broadly to include, among other things, any request for a proxy, any request to execute or not execute a form of proxy, any request to revoke a proxy, sending a proxy and/or the sending or delivery of "any communication" to a security holder in circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy. This broadly worded definition of solicitation raised concerns among market participants that it was impeding shareholder communications, even communications that simply involved the expression by a shareholder

of how it intended to vote and why. Subsequently, the definition of "solicit" was amended in the CBCA to exclude, among other activities: *(a)* a public announcement in prescribed form by a shareholder of how the shareholder intends to vote and the reasons for that decision; and *(b)* a communication for the purpose of obtaining the number of shares required to be eligible to submit a shareholder proposal.

3.5.3 Joint or concerted behaviour

Sometimes, activist hedge funds go beyond communicating with other investors and coordinating certain activities (such as attendance at a meeting) to form an agreement or understanding with one or more other investors about acquiring, holding, voting or disposing of a company's securities. For example, Trian and Sandell agreed to jointly submit a proposal for enhancing value at Wendy's (see Box 5).

In many jurisdictions, corporate and/or securities legislation provides that persons who form an agreement or understanding with one or more other investors about acquiring, holding, voting or disposing of a company's securities are considered to be "acting jointly", "acting in concert" or a similar term. For the purposes of this Report, the term "joint actors" will be used. In many jurisdictions, acting jointly or in concert to acquire, hold, vote or dispose of a company's securities is not, in itself, illegal. There may be consequences, however, associated with such a characterisation. For example, joint actors' holdings of a company's securities are often aggregated for the purposes of the laws governing:

- disclosure of significant holdings (including determination of whether or not thresholds for disclosure have been crossed);
- takeover bids and tender offers (including determining whether or not a threshold relating to the definition of a takeover bid or tender offer has been crossed, which could mean that the joint actors become obliged to make a bid or offer or are considered to have illegally acquired securities in breach of takeover bid / tender offer laws);
- insider dealing and insider reporting (*e.g.* persons or companies who, individually, own less than the threshold percentage of shares might have be considered to meet the definition of insider if their holdings are aggregated with joint actors); and/or
- control share, anti-greenmail and similar provisions.

Consequently, a hedge fund whose interest in a company is not, by itself, sufficient to trigger an obligation to disclose (or make a tender offer or disgorge a short-swing profit) might find, if it is considered to be a joint actor whose holdings are aggregated with those of other joint actors, that it has triggered (and perhaps breached) the law.

In addition, companies sometimes include provisions in articles of incorporation/association, by-laws or shareholder rights plans that are triggered when the holdings of a person or of joint actors exceed a specified threshold percentage of the company's voting securities. Because the consequences of becoming a joint actor can be significant and, at times, adverse, investors often are very cautious about communicating with other investors and/or engaging in coordinated activities.

3.6 Litigation

As part of an escalating strategy, activist hedge funds sometimes initiate or join lawsuits during their engagements with companies. Some examples are mentioned below:

- When allegations about self-dealing by Conrad Black and other members of Hollinger International's management started to circulate in 2003, Cardinal Value Equity Partners (Cardinal) brought a lawsuit in Delaware to obtain access to Hollinger's books and records. Six months later, it commenced a derivative action for breach of fiduciary duty against Hollinger's board of directors. Cardinal's action was stayed to permit an independent investigation of the alleged misconduct. In 2005, Cardinal negotiated a USD 50 million settlement with the board members not directly implicated in the allegations of misconduct, with Hollinger pursuing the self-dealing claims against Conrad Black and others in a separate lawsuit. More recently, it publicly criticised the Hollinger board for not removing some of the settling board members.[47]

- In 2005, Jana Partners sued SourceCorp in the lead-up to the company's AGM. Jana Partners alleged that, without prior notice to the shareholders and only five weeks before the scheduled AGM, the company's board of directors had amended the company's by-laws to: *(a)* eliminate a provision that previously had permitted shareholders holding at least 25% of the company's stock to call a special meeting; and *(b)* place "onerous and elaborate restrictions" on shareholders' ability to act by written consent. Jana Partners also objected to the board's adoption of a shareholder rights plan that was not scheduled to expire until 2015 and that did not contain an annual shareholder renewal requirement. At the same time as it announced its lawsuit, Jana Partners also announced that it would deliver shortly a formal notice of its intention to solicit written consents to replace current board members.

- In the Netherlands, activist hedge funds have resorted to litigation in 2007, successfully arguing that the sale of a US subsidiary by ABM-AMRO should be approved by shareholders since it constituted a material transaction in the context of a contested takeover offer. Hedge funds have also resorted to litigation in the case of Stork and to support their claim for a seat on the board in order to ensure a change in corporate strategy. An aspect of the case is that they claimed that agitating for a change in corporate strategy did not constitute a takeover attempt so that the use of takeover defences by the company to thwart the demand was illegitimate.

Kahan and Rock also noted that some hedge funds have sought to be appointed as lead plaintiffs in securities fraud class actions under the *Private Securities Litigation Reform Act*. The authors note that courts have often rejected the appointment of hedge funds on the grounds that, because the funds in question engaged in short selling during the relevant period, they did not rely on the integrity of the market price, which is essential to the establishment of a "fraud on the market".[48]

4 Implications for corporate governance

4.1 Company responses

Companies and shareholders in many countries are of course free to decide how they will react to hedge funds' proposals and demands. A number of advisers to publicly held companies are encouraging company management and boards to prepare in advance for the possibility that an activist hedge fund will

47. These cases are described in Kahan and Rock (2007) at 7-8.

48. Kahan and Rock (2007) at 8, especially footnotes 55-58. For example, in *Re Critical Path, Inc. Securities Litigation*, 156 F.Supp. 2d 1102 (N.D.Calif. 2001), the Court held that a hedge fund that had shorted stock of the company was an "inadequate class representative" in a fraud on the market class action because the shorting strategy was premised on a view that the market price of the stock was inaccurate.

target the company for engagement. For example, the Conference Board has set up a group where companies can discuss how to identify when hedge funds are taking an interest in them and how to react. Law firms and investment banks are offering similar services as part of a market-driven response to activism.[49] Interestingly, many of the recommendations to companies regarding "advance preparation" recommend that management and boards address a range of matters that fall squarely within the key functions specified in OECD Principle VI.D. For example, one checklist[50] recommends that companies take the following steps to prepare in advance for an activist campaign:

- Assess corporate vulnerabilities with an activist's eye. Conduct a review of the industry sector and benchmark the company. Consider performance and valuation trends. Develop compelling explanations for differences vis-à-vis peers or past performance. Any signs of financial weakness should prompt immediate action.

- Assess all realistic and strategic and financial alternatives. Focus on both short- and long-term shareholder value.

- Consider portfolio optimization. Focus on core competencies. Monetise low growth assets.

- Conduct a capital structure review. Determine the optimal leverage structure / cost of capital. Consider implications of share repurchases, increasing ongoing dividends or paying extraordinary dividends. Consider liquidity needs and alternative sources of capital.

- Monitor trading, research and the shareholder base. Keep track of debt and derivatives securities holders, as well as long and short positions. Monitor regulatory filings to identify changes in investors, objectives and holdings. Review analyst reports regarding the company and the industry. Review industry publications and other media for industry trends and criticism of the company. Monitor corporate governance "focus lists".

- Have an effective corporate communications programme. Consider roadshows for major institutional investors. Educate rating agencies, ISS and other proxy service firms. Stay in contact with securities analysts as they might provide insight on investor concerns.

- The board should become and stay informed. The board should periodically review the company's business plan, operating performance and competitive position. It should consider potential alternative strategies for maximising short-term and long-term shareholder value. It should receive updates from financial advisers and counsel as to the activist environment and the board's obligations. It should be aware of the results of company monitoring and communication programmes.

Another recommends that companies in the M&A context be proactive in explaining the reasons for and the benefits of a transaction, ensure that the board's position be accurately understood, and engage in early and open communications with significant stockholders.[51] All these points correspond to what is regarded as good corporate governance, so that hedge fund pressure seems to be drawing out an

49. Lipton (2006).

50. De Rose and Houlihan Lokey (2007).

51. Lipton (2006).

appropriate response from companies. In this respect, activist hedge funds appear to have been much more effective in achieving good corporate governance than institutional investors more generally that have often lacked the incentives and the regulatory possibilities to influence companies[52].

A charge frequently levelled against activist hedge funds is that they pressure companies to make concessions that result only in short term gains by the shareholders at the expense of crucial long-term investments that would also benefit other stakeholders. The empirical evidence reviewed in Section V does not appear to lend support to this proposition although it is extremely difficult to find independent measures of foregone investment opportunities. More generally, the key analytical point concerns the degree of market myopia: to what degree does the market undervalue long-term investments relative to short term realised investments. If the market does not suffer from a bias, the interests of activist hedge funds (and other similar investors) with relatively short-term trading horizons will not conflict with those investors (and stakeholders) with long-term trading horizons. While the existence of activist hedge funds can be taken as a sign of myopia (since potential gains are not already incorporated into share values), the more general evidence points to share values incorporating long term expectations so that the extent of myopia might be limited[53].

Nevertheless, the research reviewed above does point to the possibility that activist hedge fund behaviour, under some circumstances, can lead to poor corporate governance practices (using the OECD Principles as a reference point). The exercise of shareholder rights (Chapter II) might be distorted, there are clear possibilities for insider trading and market abuse (Chapter III, The equitable treatment of shareholders), stakeholder interests might be overlooked (Chapter V) and board members might not exercise adequately their fiduciary duties to the company and to all shareholders.

52. For a review of the generally disappointing corporate governance impact of most institutional investors see OECD (2004), Black (1991), and Kahan and Rock (2006). However, Becht et al (2006) show how appropriately incentivised and empowered institutional investors can also achieve similar results to activist hedge funds.

53. For example, price/earnings ratios indicate expectations over a 10-15 year period by the markets as a whole. Share values have also been found to respond positively to R&D and investment expenditures, and even more so if accompanies by information about the company's strategy and prospects. See OECD (2006) and Kahan and Rock (2006) for a fuller review of the in part conflicting evidence.

IV. Behaviour of Private Equity Investors and Company Responses

This Section of the Report describes the typical strategies that private equity investors use in PTP buyouts and how their behaviour is influenced by the corporate governance framework.

1 Takeovers and management of companies: the business model and the target companies

Studies suggest that private equity firms that engage in PTP buyouts seek to identify companies that have longer-term prospects, making them suitable for resale after several years. In Europe, one study indicated that the average ownership period is 3½ years but this data might also include the holding period for acquisitions of non-listed companies. Another study indicates an *ex ante* holding period of five years.[54] Ordinarily, private equity investors carefully plan the acquisitions, which sometimes do not take place until after several years of research, including contacts with target management. One study indicates that for every deal a private equity firm completes, it actively pursues two, appraises four and screens forty.[55] Another study indicates that top quartile private equity firms had teams of analysts working with them and consulted widely about a target and about its growth prospects.[56] Perhaps as a result, one study found that private equity investors were successful in 75% of competitive auctions, since a plan to create business value was already apparent (Ernst & Young, 2006).

Although private equity investors plan some of their proposed acquisitions well in advance, they also respond to opportunities that arise and some transactions can be finalised in several months. A survey of recent, large PTP transactions in the US and the UK indicated that deal premiums were in the range of 20-25% on the one day and 30 day average before the announcement but that over the target company's 52 week high stock price, the premium was only a modest 6%.[57] This would suggest that at least the timing of some PTP buyout opportunities might have emerged after disappointing stock market results for the target company. In comparison with potential acquisitions planned over the long term, only 25% of auctions were won by private equity investors responding opportunistically to a company being offered for sale.[58]

Private equity firms sometimes approach other private equity firms to form a club for a transaction. While such arrangements are not inherently problematic, they can pose risks for market integrity, which is important for corporate governance. This is because the greater the number of institutions involved in *ex ante* structuring of finance for a buyout, the greater the likelihood of information leaking and consequently leading to insider trading, selective disclosure and other forms of market abuse. The annotations to OECD Principle V emphasise that shareholders and potential investors require access to regular, reliable and comparable information about companies and that weak disclosure and non-transparent practices can contribute to unethical behaviour and a loss of market integrity at great cost, not just to the company and its shareholders but to the economy as a whole. The Australian Stock Exchange has expressed such

54. Ernst & Young (2006), based on 67 exits.

55. Mankins (2007). By contrast it is claimed that corporate buyers cast smaller nets with about 4-5 targets in the M&A pipeline, reflecting no doubt their greater industry focus.

56. Beroutsos (2007). This is also confirmed by another study, Meerkat and Rose (2006).

57. Premiums of around 40% have been found in another study including a longer time span and more mid-sized companies (Renneboog *et al.*, 2007).

58. Ernst & Young, *op cit*.

concerns about some recent transactions and the FSA also has its concerns (FSA, 2007). The Technical Committee of IOSCO has established a task force to identify and evaluate securities regulatory risks associated with private equity and it is likely that market integrity issues will be considered in the context of that review.

During due diligence and after acquisition, the lead partner of a private equity fund usually establishes a 100 day programme with experts and often management. The purpose is to identify costs to slash, new markets and profit pools to pursue and portfolio changes to make. The outcome is a value creation plan that identifies the major risks and further opportunities. This plan is then used to set key performance indicators that are focused, comprehensive and binding, with frequent review by the owner. Slippage thus shows up before it appears in the financial results. One European study covering the 100 largest exits in 2005 from PTP buyouts noted that in 25% of the companies, the business fell behind plan. In every instance, the investor responded quickly and decisively, in part due to the leveraged environment. Where necessary, plans were redrawn, management changed and sometime investment increased. As a result, two thirds of these businesses recovered and achieved their original targets (Ernst & Young, 2006). The same study also noted that although private equity both challenges and supports management, in 45% of the cases management was changed. Most changes were made during the period of private equity ownership rather than at the outset.

These value creation plans have been controversial. There are often cries of "asset stripping", which will be discussed further below. On the other hand, several studies report that value creation plans can also include investment in research and development (R&D), new technology and acquisitions or expansions that would serve to increase the company's value at sale even though the full benefits might arise only after the three to five year window in which private equity investors tend to operate. One study argued that the earlier growth is built into the plan, the better the final sales price. It also should not be overlooked that one reason for private equity to buy companies from another private equity firm (secondary sale), a practice that has raised some concerns (see below) is to integrate them into their own companies as part of the value enhancement plan.[59]

Private equity investors generally establish significant performance-related incentives for management of the acquired company. For example, managers will be granted significant incentives in the form of equity stakes, co-investment opportunities and bonus opportunities for meeting key objectives, which are often quite different from public company financial indicators. One study concluded that top managers typically owned 5-19% of the equity but also had invested a significant amount of their own net worth to obtain it. Other studies find even higher participation at the mid-cap companies. Another study found that management had as much as one to two years' salary invested in the business (and therefore bore significant downside risk) but could expect to receive 8 to 12 times the amount invested if the exit went according to plan (Meerkatt and Rose, 2006). This means that the private equity fund, its limited partners (*i.e.* the investors) and management of the company bear upside and downside risks so that their incentives are better aligned.

59. Leverage build-ups (LBUs) involve the development of a corporate group based on an initial buy-out or buy-in, which serves as a platform investment to which are added a series of acquisitions. LBUs developed as private equity firms sought new means of generating returns from buy-out type investments. The initial platform deal may need to be of a sufficiently large size for it to attract management with the skills and experience to grow a large business through acquisition. LBUs may be attractive in fragmented industries with strong demand prospects. The potential problems with LBUs relate to the identification, purchase and subsequent integration of suitable acquisition candidates. Several private equity firms in Germany have being pursuing such as strategy for a number of years integrating purchased Mittelstand private engineering companies into bigger groups.

Another key component of the governance model is a focused board. Typically, board size is reduced to about six members. Apart from a lead partner from the private equity firm who remains closely connected with company management and has his or her own analytical staff, other board members are specialists who the private equity firm considers important for execution of the strategy. The board members also receive incentives. By contrast, in many listed companies, non-executive directors are often CEOs or CFOs of other enterprises rather than specialists appointed to fulfil a specific need of a company, and receive little in the way of direct incentives. It is also often argued that they are less demanding of another CEO, something which the private equity-established board avoids.

This governance model presents some actual and potential problems and challenges. In particular, it might fit a USD 400-800 million company but is it useful for a USD 30-40 billion one? This issue is important since, for the larger transactions, clubs of private equity firms are more common and to some extent they replicate the normal collective action problems faced by shareholders and companies in the listed company model. Moreover, the management fees in large private equity transactions might become so great that it could blunt the edge for close monitoring by a single owner/investor, arguably the key to the private equity governance model. However, these governance forms have arisen spontaneously and future evolution in response to emerging signs of problems should not be ruled out. The investors in such funds are sophisticated with concerns and obligations of their own. Accordingly, it could be expected that the contractual terms of private equity's relationship with their investors could evolve to address any problems that arise with private equity's governance model for acquired firms. Arguably, it is already evolving.

2 The leverage side of the transaction

2.1 Banks and new financial instruments

Target company leverage and the corresponding incentive structures are an important part of the private equity business model for PTP buyouts. Commercial banks and investment banks are very active lenders to private equity funds and receive significant fees for their services[60]. Banks generally do not keep these loans on their books for very long. An FSA study reported that, on average, banks distribute 80% of their exposures to their largest transactions within 120 days of finalising the deal.[61] This debt is increasingly being sold to non-banks (including hedge funds) as collateralised loan obligations (CLOs) and collateralised debt obligations (CDOs). These transactions raise questions about financial market stability and the insolvency system that are outside the remit of this Report.

However, the nature and extent of the leverage have implications for acquired companies' corporate governance. Debt is often assumed to impose discipline on corporate management not only because of the contractual nature of debt service obligations and the threat of bankruptcy, but also because major creditors might also act as monitors. This may no longer be true, however, where the debt consists of CDOs and CLOs and in environments where creditor rights are uncertain and often untested. Moreover, whereas before banks might have refused to lend more than it was judged the company could bear, this is arguably no longer the case since the exposure of banks is passed quickly to a more diffuse group of creditors. These developments in the credit markets also affect the corporate governance framework of listed companies more generally.

60. One European study showed that 70% of LBO-related income is derived from corporate finance and advisory fees as of June 2006. ECB (2007)

61. FSA (2006). The same paper also reported that 13 responding banks to a survey had a combined exposure to leveraged buyouts at June 2006 of EUR 67.9 billion, an increase of 17% over June 2005.

Issues sometimes arise when a club member handles the leverage side of the transaction. Unless the club member also has a significant investment in the private equity fund, the incentives to complete the transaction itself to gain fees by providing debt financing might be greater than the incentives for ensuring that the fund pursues buyouts that are likely to deliver value in the future. It is not known how many transactions are of this type although some recent examples have attracted attention. Of course, in conventional M&A transactions, advisors and bankers also have a similar set of incentives to close the transaction and earn the fees, and have no other interest in the transaction other than reputation.

2.2 Treatment of creditors and other stakeholders

Chapter IV of the OECD Principles emphasises that the competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a wide range of different resource providers, including investors, creditors, employees and suppliers. For example, Principle IV.A calls for the rights of stakeholders established by law or mutual agreement to be respected. Principle IV. B provides that there stakeholders should have the opportunity seek redress for violations of rights protected by law. Principle IV.C performance-enhancing mechanisms for employee participation (*e.g.* employee involvement in governance processes) should be permitted to develop. Principle IV.F recommends that "the corporate governance framework should be complemented by an efficient insolvency framework and by effective enforcement of creditor rights".

Recent developments in PTP buyouts indicate that many bondholders have been disadvantaged when a company has been taken private, their debt being downgraded below investment grade since the new company is more highly leveraged.[62] Bond holders might also incur a capital loss due to reduced liquidity of the old bonds. These outcomes might have been avoided if the bondholders had negotiated loan covenants to address this contingency, for example by prohibiting companies from entering into highly leveraged buyouts, but such protective covenants have become less common.[63] In any event, a study by the Association of British Insurers suggested that in some jurisdictions, such covenants might be unenforceable.[64]

Some people have also expressed concerns that, in the context of the restructurings that take place following PTP buyouts, the rights of the acquired companies' employees protected by law or through mutual agreements are not being respected and/or that previously established mechanisms for facilitating employee participation in corporate governance are being adversely affected. Industrial relations, and by implication performance-enhancing mechanisms, are also said to deteriorate (Thornton, 2007). However, one of the very few studies of the issue covering both the UK and the Netherlands over the period 1994-1997 indicated that although recognition of trade unions for collective bargaining declined immediately after a buyout, in both countries the incidence reverts to its original level over time (Bruining et al 2005). The same study also notes widespread changes in remuneration systems and in how the company is run, arguing that buy-outs affect employee relations positively. A potential problem with such

62. Another potentially troublesome issue has arisen in respect of credit derivatives. In some transactions, the private equity consortium has repaid some bonds in order to restructure the debt and to lock in low rates. This has resulted in "orphaned bonds": credit derivatives amounting to many times the size of the original issue have been orphaned by the disappearance of the underlying security, causing potential market volatility. However, the problem applies to any issuer of bonds and not just private equity.

63. In 2006, bond holders in British Airports Authority demanded a covenant to cover a possible takeover and de-listing by a highly levered company.

64. ABI/BVI Bondholders' Dialogue (2006).

studies is that they can only register changes as observed by managers and that the reactions of employees at the outset might be quite different later in the private equity period as the employees might have changed.

Employee rights established by mutual agreements might also be an issue in a public-to-private transaction as such rights are by their very nature subject to continued negotiation. The acquired rights include agreed health and pension provisions as well as performance-enhancing mechanisms. The issues are often complex, especially in those cases where a company is in financial difficulty and is being acquired by private equity to be restructured. The question facing employees might be either to renegotiate the pension or health agreement or force the company into bankruptcy in the hope that claims will be protected. Much evidently depends on the specifics of the jurisdiction including the insolvency regime. In some jurisdictions, performance-enhancing mechanisms are enshrined in labour or corporate law and therefore, like other rights established by law, do not change even in the event of a change in ownership.

3 Takeovers, squeeze outs, conflicts of interest and related parties

3.1 Takeover process

Principle II.F calls for a transparent market in corporate control, and Principle VI.A provides that board members should act on a fully informed basis, in good faith, with due diligence and care and in the best interests of the company and its shareholders. Principle VI.B provides that, where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly. Principle VI.C calls more generally for boards to take into account the interests of stakeholders. These Principles are put to the test in the M&A market, with private equity-led buyouts presenting particular challenges.

For example, like many other potential acquirers, private equity firms often seek to improve the chances of success in negotiating a PTP buyout by obtaining from significant shareholders irrevocable commitments to accept the private equity firm's price before the offer is made public. Gaining these commitments sends a signal to other non-committed shareholders that the deal is a good one. The announcement of substantial irrevocable commitments may also make other potential bidders less likely to enter the contest with an alternative bid. The initial commitment ensures that, without any higher alternative bid, the agreement to sell the shares becomes binding.

The legal framework is an important factor determining behaviour. For example, , the UK Takeover Code requires disclosure of the full terms of any irrevocable undertaking and the signing of such a commitment makes the counterparty an insider to the offer. Perhaps because of the larger shareholder base of large firms, irrevocable undertakings are mainly used for smaller companies where there might be only a few significant shareholders, and one study indicated that soft undertakings are more usual for large firms.[65]

Many of the practices used in the US cannot be used in other jurisdictions where the regulatory environment, generally speaking, does not permit public offers to be launched without a full financing commitment and with extremely limited conditionality. For example, in some jurisdictions an offer cannot be launched if deal terms include a "go shop" clause enabling the target company's board and management to seek a better offer for a specified period of time. In the US, such conditionality is important. One study found that among recent transactions, "go shop" provisions appeared in 24% of transactions and that such a

65. A soft undertaking is binding only if no higher competing offer is made. The range for semi-soft undertakings was between an offer price being between 2 and 10% higher than the original offer (Weil Gotshal, 2007).

clause does allay shareholders' fears that the company is being sold too cheaply. However, a significant majority of transactions allowed the boards of directors to change its recommendations solely due to the receipt of a superior proposal (Weil Gotshal, 2007).

Although large PTP transactions have now become more common in the European market, the rules regarding treatment of minority shareholders continue to vary quite markedly across the region and between Europe and North America. For example, in the UK, Ireland, Norway and Sweden, rules relating to the squeeze-out of minority stakes make it relatively easy to de-list a company if the acquirer obtains 90% of the target company. In Ireland the threshold is lower at only 80%. The Austrian Takeover Act sets out a minimum level of acceptance of 90% while France, Germany, the Netherlands and Belgium set it at 95%. Italian law makes it more difficult to conduct a PTP because the acquirer must obtain 98% of the shares before a compulsory purchase can take place. In Denmark and Finland, a stock exchange will not de-list a company unless an acquirer holds 100% of the shares. In Spain, it is difficult to force out minority shareholders and the lack of a squeeze-out procedure has kept PTP buyouts low.

Another issue that has arisen concerns the formation of clubs of private equity funds to spread the risk for large transactions. Concerns have been expressed that some clubs might be colluding to keep the share price of a tender offer low by limiting the bidding. On the other hand, competition from other potential acquirers in the sector remains significant. A recent major transaction worth some USD 39 billion (Equity Office) was contested to the end by a company in the sector (with its private backers). Second, some sellers of companies such as GE set the conditions for an auction and can refuse a clear attempt to reduce bidding. Third, as the discussion in Section III made clear, activist hedge funds are not shy about publicly criticising transactions (and soliciting alternatives) where they believe that the companies in which they have invested are not maximising value. As discussed in more detail below, however, going private transactions are linked with additional issues, in particular, conflicts of interest on the part oftarget management, among others.

3.2 Conflicts of interest and related parties

The strength of private equity is how it often retains and motivates existing management following a buyout. The potential for significant problems can arise, however, if existing management and board members play a significant role in setting the terms of and recommending the transaction. The potential problems are particularly acute where existing management and the board have a financial interest in the transaction's success (*e.g.* if they are to continue with the company after the buyout and are given a stake in the company). For example, in connection with the proposed PTP buyout of Qantas, the private equity group expressed its intention to keep the existing management and give them an equity interest in the firm. As this put the management team in a conflicted position, the independent chair moved to control all aspects of the negotiation and restrict the role of management, even insisting that counsel answerable to her be present at any meetings concerning the private equity club and existing management.

In some jurisdictions, laws, governance codes and/or well-established standards regarding the conduct of boards and management in related party transactions or insider bids require or recommend that the board establish an independent sub-committee to supervise the deal negotiation process. In some jurisdictions, more extensive disclosure (including possibly independent valuations) is required where related parties participate in a buyout. For example, in the UK and in Australia, Takeover Panels require extensive information, including business plans and purchase conditions, from bidders. Detailed disclosure about any favourable treatment for managements and boards are also a part of the required documentation. Some jurisdictions also may require that the proposed transaction be approved by a majority (or special majority) of disinterested shareholders.

Nevertheless, for the fifty large US private equity-led PTP buyouts taking place between October 2005 to December 2006, 34% of target company boards did not form an independent committee to evaluate, negotiate and approve the proposed transaction. This is important since directors and management might often have relations with the buyout group and agree to take a stake and jobs in the new entity. The same study warned that "the private equity sponsor must keep in mind that it is normally "buying" the litigation that may, and often will, accompany going private transactions. Accordingly, it is in the interest of private equity sponsors to ensure that the target is following a defensible process in selling the company to reduce the settlement value of any litigation" (Weil Gotshal, 2007).[66] The same study also observed that only a small minority of transactions had special voting arrangements requested by the special committee to ensure that significant target shareholders participating in the transaction could not undermine the ability of the public stockholders to approve or disapprove of the transaction.[67]

Another aspect of the takeover process, which applies to all M&A transactions and not just PTP buyouts, concerns the existing incentive schemes for management and for boards. It is sometimes claimed that the existence of options that vest if there is a successful takeover bid disposes boards and management to favour accepting takeovers and "throwing in the towel". This would be a violation of the spirit of Principle VI.A defining the duties of the board to both the company and to the shareholders. It should also be added that investors such as pension funds and mutual funds, which are the ones ultimately responsible for approving a transaction, might also be subject to such incentive structures (*i.e.* to lock in the cash gain now). No evidence was available to the Secretariat at the time of writing to support these claims.

4 Exits by private equity

Private equity firms are under significant pressure to achieve their target returns and hence work towards a timely exit from their investment. Exits have been running at the rate of around 300 a year in the UK and 200 in Continental Europe. However, with the recent surge in deals some concerns have been expressed about a potential oversupply of exits in 4-6 years time.

The common forms of exit are trade sales (*i.e.* sales to non-financial corporations), flotations on public markets, secondary buyouts and bankruptcies or receiverships. The popularity of the different types of exit depends on the prevailing economic conditions and has varied over the last 15 years. Until recently, trade sales were the most common form of exit except in the early 1990s when the recession led to receiverships. Flotations were often chosen in the late 1980s, when the stock markets were relatively healthy, but have been less popular since then and are still not a strong path for exit in the UK and in Europe. They are more important, however, in North America. In 2006, 42% of IPOs in the US involved exits from private equity deals, down somewhat from the previous year due to secondary buyouts (*i.e.* sales to other private equity funds).[68] Currently, trade sale opportunities are growing again and conditions for

66. In this respect it is important to note that the Delaware Chancery Court is accumulating a body of decisional authority. In a recent decision (Topps), Vice Chancellor Strine said that going-private transactions raised questions about how to address potential conflicts of interest and balance deal certainty against obtaining price competition in a very different market dynamic. In March, he postponed a shareholder vote to approve a USD 155 million buyout of business software provider Netsmart Technologies until the company provided shareholders more information about future cash flow projections and why its board didn't pursue strategic buyers.

67. Such arrangements could include increasing the vote required by stockholder approval, nullifying the "super" voting rights of a particular class of shares held by insiders and requiring the transaction to be approved by a majority of the minority stockholders.

68. See Annex I for more details.

flotations have become more favourable, which has helped to allay concerns from institutional investors about the recycling of capital (secondary buyouts) that has been evident in recent years.

Secondary buyouts have gained importance since the mid 1990s. They now account for almost a third of all exits in the UK and are the main exit route in Europe. In the US, one source estimates that secondary buyouts increased from 15% of deals in 2003 to 23% in 2004.[69] In a secondary buyout, an initial buyout deal is refinanced with a new ownership structure including, typically, a new set of private equity financiers while the original financiers and possibly some of the management exit. Such deals account for a large proportion of the value of the U.K and European markets. Moreover, as buyout markets mature, there appear to be more tertiary and quaternary deals. At the end of 2006, 16 companies in the UK (20 across the rest of Europe) had gone through at least three buyouts. These tend to be mid-range deals that are cash generative in mature sectors, such as the retail sector, which can be easily re-leveraged. The growing number of large secondary buyouts, for example the recent sale of United Biscuits by a syndicate including Cinven to Blackstone Group for GBP 1.6 billion and the sale of the German company Brenntag by Bain Capital to BC Partners for EUR 3.5 billion, provides useful liquidity for the buyout market at a time when alternative exit routes have been difficult. There are anecdotal examples of the effects of secondary buyouts (Robbie and Wright, 1990), and Nikoskelainen and Wright (2007) provide initial evidence that returns to exits through secondary buyouts are lower than for flotations and trade sales (see below).

The changes in ownership, management and financing that occur each time may enable acquired companies to achieve a new long term organizational form, as argued by Jensen (1993). However, these transactions raise important and challenging unresolved issues relating to performance evaluation. In particular, if the original private equity financiers were effective, how likely is it that further performance gains can be achieved?

Financial distress and receivership represent the negative aspect of exits. The failure rate in the UK of buyouts completed during the first half of the 1990s was approximately 12% by September 2005. However, the large majority of receiverships occur in smaller firms. CMBOR data (see Annex I) indicates that 94% of the receiverships were from buyouts with initial deal values of less than GBP 20 million.

As traditional forms of exit have become more difficult, re-financings and partial sales have become more frequent since they enable private equity firms to cash out part of their investments while at the same time keeping control of their portfolio companies. Exiting through refinancing may involve the private equity firm having the business borrow more and then causing it to pay the private equity investors special dividends from the borrowings. The funds are then normally used to repay debt of the private equity fund. Alternatively, it might involve a sale and leaseback of assets to a third party, with the proceeds from the sale transferred to the private equity investors in the form of a dividend. In the UK, for example, total re-financings in 2005 accounted for over a third of the total value realised, compared to a little over a tenth in 1997 (Annex I). Between 55 and 90 recapitalisations per year have been recorded recently in the UK**.** The total value returned through recapitalisation in 2005 was EUR 19 billion, significantly adding to the EUR 33 billion realised through full exit. In Continental Europe, refinancing also accounted for just over a third of total exit value in 2005. Partial sales accounted for less than 5% of the total in 2005. The effect of these forms of exit on returns to private equity investments have yet to be analysed.

69. McKinsey & Company (2005). However, this figure appears to be on the high side due to a high value cut-off point for transactions.

Refinancing (also known as leveraged recapitalisation) is highly controversial in some countries. For example, some unions have been concerned that payment of special dividends especially from companies' cash reserves or financed by borrowings might make their employment positions more vulnerable. The public reaction has been particularly marked in countries where there is a minimum capital regime in place to protect against insolvency rather than a false trading regime as in many other countries. It is also acute in countries with an aversion to what is considered to be consumption of capital, which is also reflected in highly conservative accounting standards. On the other hand, share repurchases are common and any recapitalisation that excessively weakened a firm leading to its insolvency would normally render the owners liable.

V. Assessing the Impact of Alternative Investors on Companies and Shareholders

The preceding Sections of this Report have discussed what is generally known about the structure and behaviour of activist hedge funds and private equity firms that engage in PTP buyouts, using qualitative studies and making extensive use of examples. However, many of the questions can only be answered and judgements formed after considering some empirical questions. This Section reviews the existing empirical work. With respect to private equity activities, while there is a voluminous literature covering buyouts, much of it relates to the 1980s in the US and might therefore not be relevant to the newer models of PTP buyouts. Moreover, there also appears to be important differences across countries in line with company and insolvency law and ownership arrangements. A great deal of the literature also focuses on MBOs, including smaller transactions, and not on PTP buyouts, the focus of this Report. This review therefore focuses on more recent studies and as much as possible on PTP buyouts.

There are still only very few empirical studies of activist hedge funds. There is an extensive literature on the impact of institutional investors dating back to the 1990s, but these are really of limited use given the focused strategy of hedge funds..

1 Private equity: what happens to the companies and the investors?

Annex 1 briefly reviews the empirical literature covering private equity and this Part of the Report is largely based on its findings. Overall, the empirical work points to an enormous heterogeneity in the companies involved in LBOs or MBOs and this also probably extends to PTP transactions. Moreover, the empirical work points to differences across countries in both the characteristics of the target companies and the resulting effects. Clearly, different institutional arrangements and not just tax treatment are at play. Seven key questions need to be considered.

1.1 What types of companies are acquired in PTP buyouts?

The simple interpretation of the free cash flow hypothesis does not seem very useful but a more nuanced approach has greater explanatory power. Thus several US studies from the 1990s find that leveraged buyouts are more likely to exhibit only the combined characteristics of low Tobin's Q (low market valuation relative to replacement or book value) and high cash flow than firms remaining public. Looking at the UK, Weir and Wright (2007) find that firms subject to PTP had somewhat poorer corporate governance standards, lower valuations and greater board ownership prior to the buyout than traditional acquisitions of corporations, suggesting managerial private information. Changing the corporate governance structure through a PTP would thus unlock this value and so is in line with Jensen's hypothesis.

A turnaround motivation has also been put forward as the reason for a PTP but the evidence differs between the UK and the US. Those differences might reflect different approaches to bankruptcy and reorganisation. Sudarsanam *et al.* (2007) find that 20 out of their sample of 199 UK PTP buyouts completed in the period 1997 to 2005 were in the high risk of default category.Controlling for all other factors, they also found that PTP companies had a significantly higher default probability prior to the buyout than other companies that were not acquired. By contrast, in the US, financial stress appears to deter a PTP buyout.

1.2 What are the returns to the shareholders?

The older literature covering the US reported an abnormal gain for shareholders of approximately 40%, with tax benefits in the early 1980s accounting for some 21-72% per cent of the premium. A recent study for the UK covering the period 1997-2003 reports that large premiums have been sustained in the more recent wave of buyouts. Renneboog *et al* (2007) investigate the sources of these anticipated value gains. They identify a number of potential causes: tax benefits, incentive realignment, control reasons, free cash flow reduction, takeover defences, under-valuation and wealth transfers. The chief sources in the UK appeared to be undervaluation of the pre-transaction target company, tax benefits and incentive realignment. Another study confirms the effects of undervaluation, attributing this to the significant numbers of PTPs completed where the founder had retained a significant equity stake. There is also some evidence that pre-transaction creditors lose wealth but those with protective covenants gained.

1.3 What are the returns to investors in the private equity fund?

A recent study covering a sample of 199 US buyout fund investments from 1984-2004 finds a positive and statistically significant alpha[70] for buyouts in comparison with equally risky levered investments in the S&P 500 Index (Groh and Gottschalg, 2006). Looking at the entire universe of private equity transactions, a significant level of risk is apparent. The authors find that buyout investors select transactions in industries with low operating risk while successfully leveraging their investments and transferring transaction risks to lenders. Distinguishing between general partners (*i.e.* fund managers) and limited partners (*i.e.* fund investors) and not correcting for risk, Kaplan and Schoar (2003) found that over the period 1980-1997, average fund returns net of fees roughly equalled the S&P 500 but with wide and persistent differences between funds run by different private equity firms. This suggests that private equity partners have, on average, captured the rents. This raises the question of what is in it for investors. However, there is a significant difference between the best and worst performers with no apparent differences in fees so returns are significant for some investors. This is a sign of an efficient, dynamic financial market.

Another study takes a broader approach to investor returns by examining the return on enterprise value, measured as an internal rate of return (IRR) discount rate that equates the present value of a series of cash flows to zero (Nikoskelainen and Wright, 2007). The IRR differs from the return on equity (ROE) that is often examined. Indeed, the correlation between the two concepts is only 0.62. The IRR is adjusted for market movements so that the value enhancing nature of the private equity investment can be isolated. The authors of this study also investigate the role of corporate governance in enhancing the real returns to exited buyouts from the investor's perspective. The authors report an average (median) return of 22.2% (- 5.3%), net of market index returns, based on a sample of 321 exited buyouts in the U.K. between 1995 and 2004. The ROE, the driving force for investors, was 70.5% (median -17.8%) indicating that investor and overall target company returns moved in the same direction, one not being at the expense of the other. The negative median value illustrates the risk taken in these investments. IPO exits substantially outperform trade sales and secondary buyouts, although both of the latter show positive returns. The overall figure was reduced by a number of companies in the sample entering receivership.

Creditors are also important investors in the private equity model and a number of studies have examined their returns. However, in view of the rapid change in the credit markets discussed in the previous Section, the empirical work needs to be kept in perspective. The return to creditors warrants

70. Alpha is return to an investment in excess of returns obtained in the general. The measure is sometimes adjusted for risk. For a more detailed discussion in the general context of hedge funds see Bernstein 2006.

attention when private equity deals become distressed. Distress regimes, however, vary across institutional environments. In the US, costs appear to be low if the firm is highly leveraged. This suggests that leverage reduces the creditor coordination problems, at least up to the mid 1990s. An important research question has been whether high leverage is associated with buyout failure. No clear relationships have emerged, although PTPs starting with a high default probability were more likely to default.

As mentioned earlier, there is less empirical data available about the impact of private equity-led PTP buyouts in the current environment on other stakeholders, such as employees and stakeholders. It is hoped that focused, systematic and cross-jurisdictional studies in this area will be available in the near future.

1.4 What drives returns to private equity on transactions?

Fund characteristics are important for returns. For instance, more established funds achieve higher returns (see also Kaplan and Schoar (2005) for consistent evidence based on a US-only sample). Funds that invest in fewer projects per fund manager achieve higher returns. This is consistent with other work discussed in the preceding Sections showing smaller portfolio sizes per manager imply improved screening and greater value-added provided by the investor to the investee, especially in the form of strategy and tight monitoring of progress towards strategic goals (Kanniainen and Keuschnigg, 2003, 2004; Schmidt, 2006; Cumming, 2006). There is an implication that partner talent is scarce, so that rapidly increasing the number of transactions that has occurred recently might meet with diminishing returns.

The effects of monitoring mechanisms introduced in buyouts are revealedwhen alternative organisational forms are compared. For example, leveraged recapitalizations, which simply substitute debt for equity in publicly held companies, have been shown to raise shareholder value (Denis and Denis, 1992). They do not, however, appear to have the same performance impact as LBOs**,** which also involve managerial ownership and institutional involvement (Denis (1994) Thompson *et al* (1992b) found that the management team's equity stake had by far the larger impact on relative performance in UK MBOs. Similarly, Phan and Hill (1995) found that managerial equity stakes had a much stronger effect on performance than debt levels for periods of three and five years following the buyout.

Nikoskelainen and Wright (2007) found that a balance of interrelated firm-level corporate governance mechanisms (including gearing, syndication and management ownership) is critical for value increase in buyouts (both economic value and ROE). The importance of these mechanisms for enhancing returns is context-dependent in relation to transaction size, among other things. The authors also show that return characteristics and the probability of a positive return are mainly related to the size of the buyout target and acquisitions carried out during the holding period. Furthermore, they also find that the return characteristics between insider-driven buyouts and outsider-driven buy-ins are different. For middle-sized buyouts, gearing and debt coverage are positively related to value increase but surprisingly not to ROE. For larger buyouts, ROE is negatively related to leverage, the opposite to the expectation that gearing would result in a proportionately higher ROE when enterprise value increases. Unlike US studies, they also find no conclusive evidence that the disciplinary nature of debt results in EBIT margin improvements. As with other studies, they find that operating improvements, both in terms of revenue and EBIT margin are unrelated to divestments of assets or acquisitions but rather are of an organic nature (*e.g.* the corporate governance system and management quality).

At a time when private equity clubs are becoming increasingly important, it is important to note that the above-mentioned study found a significant relation between the number of participants in the equity syndicate and enterprise value change. For middle sized buyouts, syndicates with more participants appear to be positively related to value increase. However, with larger buyouts there appear to be monitoring

problems and difficulties in making exit decisions or alternatively in identifying a simultaneous need and will for investment realisation.

1.5 What happens to profitability and cash flow measures?

The vast majority of buyouts (mainly MBOs) show clear improvements in profitability and working capital management. Earnings manipulation, however, appears to have been evident in some transactions, so that caution is required when accounting performance is assessed.

1.6 What are the real effects of leverage and managed buyouts?

In this area there appear to be no empirical studies of private equity and especially of PTP transactions. One study found that MBO establishments were less productive than comparable plants before the transfer of ownership (Harris, Siegel and Wright, 2005). They also reported that MBO plants experienced a substantial increase in productivity after a buyout (+70.5% and +90.3% more efficient in the short and long run, respectively) and that these post-buyout productivity gains were pervasive across industries (the average manufacturing plant experienced a substantial increase in TFP in 14 out of 18 industries). The results imply that the improvement in economic performance may be due to measures undertaken by new owners or managers to reduce the labour intensity of production, through the outsourcing of intermediate goods and materials. This evidence suggests that MBOs may be a useful mechanism for reducing agency costs and enhancing economic efficiency.

PTP transactions often raise the question of the employment effects for the individual companies. Research in this area is complex since employment can be expected to vary over the period of the private equity transaction (i.e. from the initial cost cutting programme to the growth phase prior to sale) and is also related to wage developments in the company. There are also serious econometric issues since the decision to undertake a PTP transaction cannot be taken as an exogenous event but rather is endogenous to the economics of the company (i.e. including employment levels). One study that attempts to account for these issues uses a sample of 1350 UK LBO (not only PTP) and finds that 60% of buyouts record an increase in employment over the full term of the investment (Amess and Wright, 2007). Employment often dips initially after the buyout but then begins to rise above pre-buyout levels, being some 20% higher on average by the fourth year of the buyout compared to the year before the buyout. Perhaps reflecting the type of company involved and the associated nature of the restructuring, simple management buy-ins (MBI) show lower employment growth.

Caution is, however, required when forming judgements about the aggregate effects on employment. For instance, as the age composition of companies in the hands of private equity will vary over time so will any derived employment estimate. However, there are severe methodological problems involved in so deriving an aggregate figure. For example, should the closure of a problematic company and the disposal of its assets be taken as a negative feature of private equity when it just represents only one path out of many in dealing with a company in difficulty. Moreover, even if a simple aggregate figure could be derived, it is not at all clear that this is an appropriate metric when considering employment policy.

The public perception of “reducing the size of assets” is often that of asset stripping. Divestiture of ill-fitting divisions (often bought by private equity and/or management) should not be seen in these emotive terms since, from a macroeconomic viewpoint, it is a transfer of assets that hopefully will be better used under new management. Indeed, the fact that they are of value indicates this potential. ***[Shifted from old paragraph 179]***

1.7 What happens to the companies after they have been re-listed by a private equity fund?

It is often claimed that companies return to the public market weakened and over-indebted, and indeed there are examples such as Refco, which collapsed in 2005 shortly after its IPO. However, the bulk of the evidence points to the contrary. One study examined 496 private equity-led IPOs in the US over the period 1980-2002 and found that these companies, and especially the larger ones, significantly outperformed the market and other IPOs (Cao and Lerner, 2006). The exception to this trend concerned "quick flips", such as when a company is returned to the market within one year. Such companies underperformed the S&P 500 by 5% in the following three years. Fortunately, quick flips are uncommon even though they receive strong press coverage (*e.g.* Refco and Hertz in the US, Debenhams in the UK and Celanese in Germany). The study speculated that the strength of the IPOs was due to effective reporting systems and strategic planning. The study also found no evidence that more leveraged IPOs performed worse than their peers. Importantly for corporate governance, the study found that the private equity firm maintained a large equity stake in the company after the IPO (on average about 35%) and maintained a presence on the board. The companies remained more highly indebted than others, the total debt to asset ratio being 9% above the industry median.

2 Hedge funds: impact on the companies and the corporate governance system

The key empirical question is whether activist hedge funds improve corporate governance of the target companies and whether this improved governance is reflected in improved performance along several dimensions. Since hedge funds have also been active in seeking to change balance sheets, the corporate governance issue of free cash flow is also raised. This question is especially important in the current cycle when investment is relatively low and questions about the efficiency of M&A decisions are still relevant. The more general question is whether market forces are sufficient to lead activist investors to improve governance. If there is no monetary return for the individual investor, even when working in a loosely coordinated group, then collective action problems might have to be looked at again. There are in the meantime many studies that show that good corporate governance does matter for valuations and for EVA (economic value added). From the point of view of market processes, the key question is whether it may pay for individual shareholders to seek to improve corporate governance.

2.1 What happens to the company in the case of successful hedge fund pressure?

The public perception is that the company's long term interests are often hurt in favour of short term benefits even though, unlike green mail (for which there is no evidence, at least in the US), all investors will benefit financially. If companies were damaged by acceding to demands, this might raise questions about whether directors are fulfilling effectively their fiduciary duties.

Klein and Zur (2006) found that the companies in their sample (mainly smaller companies) did not decrease R&D and investment increased in the following year, even though the firms increased dividends and took on more debt. Bratton (2007) also looked at R&D but noted that only 13 of the 52 firms in his sample had significant R&D. This supports an observation from other studies that hedge funds tend to avoid high tech companies "in favour of those they understand". In 7 of the 13 companies, R&D expenditures actually went up and in four firms where they declined, management had already been cutting back on this expenditure. To the extent that investment and R&D are good indicators of longer run strategy, the available evidence suggests that the companies are not being "sacrificed" to short term considerations.

Bratton's (2007) sample includes more large-cap companies than Klein and Zur (2006). He concludes that large cash payouts have been made by only a minority of firms and that borrowing had been the mode of finance in only a small minority of the payout cases. This finding reflects, at least for smaller companies, that targets tend to be profitable and financially healthy firms, although this is less true for the large companies (*e.g.* TimeWarner). Another study (Brav *et al*, 2006) indicates that hedge funds maintain their investment for at least a year after the activism. Bratton's study (2007), which has more coverage of larger companies, indicates holdings of around 3 years (or three annual general meetings). Presumably, hedge funds also remain active monitors of company behaviour during this time.

The empirical work therefore suggests that hedge fund intervention might be tackling the free cash flow issue that could have become more pronounced in the last several years as indicated by cash holdings and the marked rise in cash financed M&A. But if it is having such a beneficial effect, is it a sustainable market model: are there returns for investors in undertaking the activism rather than simply tracking the stocks in a passive manner?

2.2 Are investors rewarded for activism?

The question is approached by looking at excess returns to a market baseline over an observation period extending before and after the intervention. The results for activist hedge funds are mixed. Brav *et al* (2006) examine announcements (*e.g.* Regulation 13d filings) and find positive shareholder returns totalling 6% (median 4.8%) over a 21 day period straddling the announcement. Klein and Zur find returns of 7.3% for a window beginning 30 days before the announcement and five days after. Bratton, however, finds a very mixed picture depending on the assumptions that are made with respect to the "market".

Some activist hedge funds appear to succeed and others don't, something which one could expect over time in efficient capital markets where the easiest possibilities (*i.e.* the low-hanging fruit) disappears over time. However, there is also another dimension, at least fornow. Brav *et al* find that activism aiming to provide finance or sell the target generates abnormal returns of 16.8% and 10.4%, respectively. Business strategy-related activism also generates a significant abnormal return of some 6%. However, activism targeting capital structure (*e.g.* taking on more debt) and governance issues such as composition of the board etc. exhibits near zero abnormal returns. It needs to be stressed again that event analysis is very sensitive to the number of observations, which are still rather small in the case of all studies and cover only a short time period.[71] It might indicate that corporate governance reforms might take a while to affect valuations, although this is contradicted by other studies quoted below.

Several general studies indicate the positive valuation effects on companies of improved corporate governance, although many of these studies are cross-sectional and thus open to questions of interpretation. In addition, several studies now follow actual portfolio performance when the investor intends to be an activist. The Hermes Study by Becht *et al* (2006) documents the activities of HUKFF Hermes UK Focus Fund. The authors were able to determine the exact dates and types of activism. Even though the HUKFF is not a hedge fund, its objectives were similar. Like the US hedge funds, HUKFF was often successful at achieving its objectives. As a result, the study shows that HUKFF obtained abnormal returns net of fees of 5% a year against the FTSE all-shares index over the period 1998-2004. Around 90% of the abnormal

71. For a review of event analysis in the area of corporate governance see Bhagat and Romano (2005).

return is due to activism and not to stock picking. Hermes has reported that it judges the returns to their European focus fund of HUKFF to be similar and that the share price stayed higher a year later.[72]

Unlike the studies of the US funds, the Hermes Study indicates that there were positive returns associated with pure corporate governance activities such as changes of the CEO and chair. These results, however, could be conflated with results due to restructurings. The authors found that the size of assets and the number of employees were substantially lower after HUKFF intervened.[73]

72. The frequent criticism of events studies is that they focus on the short run impact of events. It is therefore important to note that the post event price one year later was higher. A study of a highly criticised hedge fund in Korea (Sovereign) that sought to remove the President of a company, but which later settled for other reforms, also showed a high return with prices remaining high a year later after the fund sold its stake.

73. Barber (2006) also finds significant returns to Calpers over the period 1992-2005 and especially where they focused on improving shareholders rights at their focus list firms. He also warns against non-economic interventions.

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