Gap Filling, Hedge Funds, and Financial Innovation

By Frank Partnoy and Randall Thomas

Abstract

In this paper, we examine changes in financial instruments and institutions by contrasting the successes and failures of institutional shareholder activism during the 1990s with more recent developments in hedge fund activism and the use of financial innovation. We find that although institutional investor activism was the watch word of the 1990's, overall traditional institutional activism has been of marginal importance at targeted firms. In contrast, there is evidence of real monitoring in the more aggressive recent activism of hedge fund managers, in part because financial innovation has generated a host of new opportunities that did not exist a decade ago.

To illustrate these points, we compare institutional activism and hedge fund activism with respect to voting, litigation, and change of control contests. We also categorize the costs and benefits of four major types of strategies activist hedge funds recently have pursued: information asymmetry and convergence trades; capital structure motivated trades; merger and risk arbitrage; and, most controversially, governance and strategy. We conclude with a discussion of the policy implications of our work, pointing out some of the regulatory challenges created by this new wave of investor activism.

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Introduction

During the early 1980s, corporate raiders represented a potentially important monitoring mechanism of corporate management in the U.S. They bought large stakes in target companies and caused significant restructuring of U.S. businesses. Many companies responded to this hostile takeover wave by adopting stronger defenses; others implemented management-sponsored leveraged buyouts. The bulk of financial innovation during this period was defensive in nature.

During the 1990s, institutional investors moved to the forefront and accumulated increasing percentages of U.S. equity securities. Much ink was spilled over how this shift in ownership structure would lead managers to adopt more shareholder-friendly corporate governance structures. Yet, after twenty five years, institutional shareholder activism appears to have had relatively little impact on U.S. corporate governance.

Instead, a new player has emerged: the activist hedge fund. Hedge funds recently have shaken up boardrooms and forced radical changes at many publicly-traded firms by leveraging their large pools of capital to push successfully for restructurings, sales, increased dividend payments and other corporate actions that have directly benefited themselves and other shareholders. This hedge fund activism, while in evidence for several years, reached a crescendo in 2005-06 with an unprecedented flood of funds taking on a broad spectrum of corporate targets. Today, financial innovation has shifted from defensive to offense. Many hedge funds use novel financial techniques that were unknown to 1980s corporate raiders.

In this paper, we begin by documenting the successes and failures of institutional shareholder activism in recent years. In section I, we focus on those areas where shareholders are most able to exert influence: voting, litigation, and change of control transactions. We find that on balance institutional activism has been of marginal importance at targeted firms, and that many institutions, such as mutual funds and pension funds, have not been as successful as some initially had predicted.

Section II contrasts institutional investor activism with the more aggressive recent activism of the hedge fund managers. We cover a range of issues related to the recent growth of hedge funds, and discuss the costs and benefits of hedge fund activism for each of four broad strategies these funds have pursued: information asymmetry and convergence trades; capital structure motivated trades; merger and risk arbitrage; and, most controversially, governance and strategy. Our analysis shows that although there are major benefits derived from hedge fund activism, there are clear costs as well.

In section III, we turn to the challenges presented by hedge funds and their innovative financial strategies in the areas of voting, litigation, and change of control transactions. We conclude that, although hedge funds have better incentives than other institutions to play an activist role in these areas, their activism also raises novel challenges for regulators.

I. The Traditional Institutional Investor Role

In the early 1990's, institutional investor shareholder activism was praised as a promising means of reducing the agency costs arising out of the separation of ownership and control at American public corporations.[1] The theory was straightforward: shareholder monitoring was an important method of limiting managers' divergence from the goal of shareholder wealth maximization, and institutional shareholders were well-positioned to act as effective monitors. Institutions held larger blocks of stock than most other investors, and collectively held well over 50% of the stock of most large public companies. Acting collectively, these shareholders would have the power and the incentives to push for good corporate governance and to nudge managers to pursue wealth-maximizing strategies.

The idea captured the attention of federal regulators. To facilitate shareholder collective action, the SEC made two major changes to the proxy voting system that favored institutional investor voting efforts. First, in 1992, the SEC adopted several rule changes that had the effect of making it easier for institutional investors to act collectively in opposition to management proposals or in favor of shareholder proposals.[2] Later, in January 2003 the SEC mandated that mutual funds disclose how they were voting their proxies at firms in which they held shares. This change was meant to lead mutual funds to be more even handed in their voting practices by exposing potential conflicts of interest at funds with closer ties to management.[3]

Along the way, however, criticisms of institutional activism emerged. Most institutions were reluctant to incur significant monitoring costs that would depress portfolio returns, while benefiting not just themselves but also their competitors.

[1] Black, 1990; Roe, 1991.
[2] Black, 1992.
[3] Davis and Kim, 2005.

Collective action problems proved more difficult than first thought because the costs of communication and coordination were higher than hoped. Free riding by other institutional shareholders on the efforts of the activists persisted, while other institutions had significant conflicts of interest in engaging in activism at companies with which they had commercial relationships.[4] Furthermore, critics claimed that institutional activism created its own set of agency costs because public pension and labor union funds were pursuing self-interested agendas in conflict with those of other shareholders.[5]

Although not necessarily in response to these criticisms, existing legal rules place some barriers to collective action by institutions. For example, Securities Exchange Act §13(d) and the accompanying rules require any "group" holding more than 5% of any class of equity securities to file a disclosure document. This obligation can discourage institutional investors wishing to keep the size of their stakes quiet from accumulating large positions in any one company. Such concerns are increased by the short swing trading rules in §16(b) of the Securities Exchange Act which limit the ability of large block holders to trade in and out of the stock of a portfolio company. Similarly, the insider trading laws embodied in the federal securities laws affect institutions' ability to trade in a company's stock if they are in possession of material nonpublic information. These rules inhibit institutions from designating candidates to serve on boards of directors, or getting too involved in the business of their portfolio companies.[6]

Many legal barriers apply to change of control transactions as well, including the insider trading rules. In addition, an institutional investor that launches a control contest, such as a proxy fight, would have to bear the substantial expenses associated with that

[4] Rock, 1991.
[5] Romano, 1993.
[6] Black, 1998.

effort without a guarantee of reimbursement, especially if unsuccessful. Further, if an institution was to obtain a control block of stock in a portfolio company, state law would impose fiduciary responsibilities on it in favor of the other shareholders in the company.[7] Not surprisingly, institutional investors have rarely become involved in control contests.

Despite all of these difficulties, some activist institutions engage in shareholder monitoring. Institutional shareholder activists have focused their efforts on a number of well-defined fronts, ranging from using their voting power to push for corporate governance changes to filing securities fraud class action lawsuits to punish and deter corporate wrongdoing. Some investors have been quite vocal about their activism, publishing and distributing detailed descriptions of their objectives and policies, while others have been quiet and operated behind the scenes. For example, CalPERS, one of the largest state pension funds, has published "focus" lists of underperforming firms since 1992. They have targeted these firms for corporate governance reform and by some estimates generated substantial shareholder wealth through their efforts.[8] In the remainder of this section, we discuss voting, suing and selling, the main areas for institutional shareholder activism.

A. Voting

Shareholders are the only corporate stakeholder that is routinely given the power to vote. They must be allowed to vote to elect directors to their offices, to approve or to reject proposed extraordinary business transactions, and to recommend certain types of

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[7] Bainbridge, 2005.
[8] Barber, 2006.

corporate actions. They may also have the power to remove directors from office, to call special meetings, to cumulate their votes in favor of directorial candidates, to amend the corporate bylaws and a variety of more unusual matters. Institutions are the largest stockholders in most large American corporations, and control well over the majority of the voting stock. Are they using their voting power to bring about corporate governance changes?

1. Shareholder Proposals and Negotiated Corporate Governance Changes

For the past twenty years, Rule 14a-8, the SEC's shareholder proposal rule, has been one of the main vehicles by which institutional investors have pushed for corporate governance changes at public companies in the U.S. Using this rule, shareholders can, subject to certain limitations, force corporations to place in their proxy materials a proposal for shareholder approval and short accompanying statement of support. These proposals are not binding on the corporation, even if approved by a majority of the shareholders.

Beginning in the 1980's, institutions proposed a broad variety of different actions, including the removal of corporate anti-takeover defenses, reductions of executive pay and changes in board composition. Overall, such proposals were targeted at poorly performing companies.[9] While shareholder support for many of these proposals has been low, external corporate governance measures, such as the removal of the classified board and redemption of the company's Rights Plan, have long enjoyed substantial shareholder support. Many of these types of proposals garner a majority of the votes cast on the

[9] Romano, 2001.

proposal, thereby passing an important threshold of shareholder support and creating more pressure on corporate boards to take action on the proposal.[10]

More recent data show that shareholder support levels for external corporate governance proposals remains high, while executive compensation proposals have attracted increasingly high levels of shareholder support.[11] However, the public pension funds that offered many such proposals in the past have largely been supplanted by private individuals and labor unions as the most frequent sponsors of shareholder proposals of this type. While there was been no statistically significant stock price impact from shareholder proposals on corporate governance issues, there is evidence that boards of directors have become increasingly responsive to corporate governance proposals to remove takeover defenses that are supported by a majority of the shareholders.[12]

Shareholder proposals appear to have a discernable impact on corporate policies if they achieve unexpectedly high levels of shareholder support.[13] In addition, some institutional investors, such as TIAA-CREF, have been able to negotiate agreements for corporate action to achieve their objectives even without a shareholder vote on their proposals.[14] These negotiated proposals rely on quiet diplomacy, backed by the threat of more vocal opposition if the proponents are unsatisfied with the target company's response.

[10] Bizjak and Marquette, 1998.
[11] Cotter and Thomas, 2005.
[12] Cotter and Thomas, 2005.
[13] Thomas and Martin, 1999.
[14] Carleton, Nelson and Weisbach, 1998.

Overall, optimistic assessments of shareholder activism using Rule 14a-8 claim that it has had a very limited positive impact,[15] while more pessimistic observers believe it is actually harmful to shareholder interests.[16] While there is some evidence that shareholder proposals have had more impact on boards in recent years, they are still having only a limited effect on the corporate governance structures of targeted firms.

2. Directorial Elections: The Proposed Shareholder Nomination Rule, "Vote No" Campaigns and Majority Voting Initiatives

The most direct way for institutional investors to influence corporate policy is to elect corporate directors they believe will support their interests. Under state corporate law, however, shareholders generally have little or no ability to nominate candidates for election to the board. In 2003, the SEC proposed a rule that would have permitted large shareholders to place on the corporate ballot a small number of director candidates in a limited set of circumstances. The idea was to give shareholders a way to bring about change in unresponsive corporate boards.

This proposed shareholder nomination rule provoked a firestorm of strong reactions, ranging from wholehearted support from many institutional investors to outraged denunciations from corporate management and its supporters. After extending the comment period for several months, the SEC ultimately did not take action on the proposed rule, much to the disappointment of many institutional shareholders.

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[15] Karpoff, 2001.
[16] Romano, 2001.

Deprived of the shareholder nomination rule, institutions have continued to use alternative mechanisms to try to force directorial change at unresponsive firms. One popular technique has been to organize a "Vote No" campaign at companies that are unpopular with activist shareholders. These campaigns attempt to communicate shareholder dissatisfaction by having shareholders mark their ballots to withhold authority for particular director nominees.[17] For example, at Disney Corporation's 2004 annual meeting, institutional investors organized a strong "vote no" campaign against CEO Michael Eisner with over 43% of that company's shareholders withholding their votes to reelect Eisner to signal their objections to his stewardship of that company and its corporate governance structure. Eisner still won re-election, although the Disney board subsequently took away his title as Chairman of the Board.[18]

These campaigns have had some impact. Del Guerico, Wallis and Woidtke find that "vote no" campaigns are correlated with unusually high CEO and director turnover at targeted companies, and that such CEO turnover is accompanied by stock price increases.[19] They also find that outside directors at target firms suffer reputational damage. Overall, they conclude that "vote no" campaigns appear more effective in causing corporate change than shareholder proposals, but are still only indirect mechanisms for doing so and only function episodically.

A second important recent tactic is the majority vote bylaw amendment. After the demise of the shareholder nomination rule, institutional investors began sponsoring majority vote bylaw amendment proposals at major corporations. These proposals would eliminate the current plurality voting system, in which directors need only receive one

[17] Del Guerico, Wallis and Woidtke, 2006.
[18] Burr, 2004.
[19] Del Guerico, Wallis and Woidtke, 2006.

vote in favor of their election, and replace it with one that requires directors to receive a majority of the votes cast at the annual meeting, or in some cases, a majority of votes of the total shares outstanding. In response to strong shareholder support for these proposals, some companies, including Disney, have unilaterally agreed that any director that does not receive a majority of the votes cast at a meeting will be deemed not (re)elected. There is a strong trend toward voluntary adoption of these bylaws, although their fine print often limits their impact.

Even if majority vote proposals are widely adopted, however, they offer little hope to proponents of strong institutional shareholder activism. At present, there are no instances at major public companies where shareholders have withheld more than 50% of their votes from any director nominee. Even if this were to change, most boards will still retain the power to replace any director that was not elected by a sufficient percentage of the shareholders, and could even choose to name the very same person to fill the vacant director position. There is therefore little reason to expect strong institutional shareholder activism to come out of the majority vote concept, at least for the foreseeable future.

3. Third Party Voting Advisors: Helping Improve Corporate Governance or Creating Unregulated Agents?

Activist institutional investors must address several problems in their quest to bring about favorable corporate governance at portfolio companies, including the cost of informing themselves about the issues at these companies, and the difficulty in communicating with other institutions about taking joint action on these issues. Cost-effective activism requires solutions to these problems. In addition, all institutional investors, activist or not, face fiduciary obligations to inform themselves about how to vote their shares at portfolio companies, and need to find a way of doing so on a cost-effective basis.

Against this backdrop, as early as the mid-1980's, a number of third party voting advisors began offering their services to institutional investors. Today, several companies, including most prominently Institutional Shareholder Services (ISS) and Glass Lewis & Co., offer proxy advisory services to institutional investors to help them decide how to vote their shares. Institutions that subscribe to these services are given recommendations on how to vote on a broad range of issues, including shareholder proposals, corporate elections, mergers and acquisitions, auditor ratification, and a host of other topics.

The use of third party advisors allows institutions to pool their resources to generate research and analysis they can use in their activism. It also helps to solve the free rider problem because the advisors' costs are prorated over all member institutions thereby taxing otherwise free riding institutions to help facilitate shareholder action.[20] Not surprisingly, these third party advisors have had a significant impact; their recommendations against management proposals have been found to be outcome determinative.[21]

Critics of the third party advisory services claim that they are unregulated agents that have their own agenda they pursue even at the expense of investors. One prominent commentator has charged that institutions delegate their voting decisions to third party

[20] Coffee, 1991. (at 1358)
[21] Bethel and Gillan, 2002.

advisors because they "don't want to think."[22] If this is true, it raises the question of who is monitoring third party advisors. Given their enormous power, if their clients are not paying close attention to why the third party advisors are making their recommendations, there is the potential for the advisors' power to be abused. This might be particularly true for non-economic issues where the returns to shareholders from activism are suspect. Furthermore, some third party advisors, such as ISS, have been accused of selling their services to both institutions and their portfolio companies, thereby creating the potential for conflicts of interest in the advice that they offer.

4. Labor Union Activism at the Ballot Box: The Two Hats Problem

Since in the early 1990's, labor unions and labor affiliated pension funds have been the most aggressive institutional shareholders, using their vast shareholders and voting power to push for corporate governance changes at targeted companies.[23] Unions and their pension funds have been at the forefront of innovative methods of using corporate and securities laws to pressure companies to bring about the changes they desire. These include mandatory by-law amendments to try to force companies to eliminate their takeover defenses, and introducing shareholder proposals on the floor of the shareholder meeting.[24] They have also supported, or initiated, "Vote No" campaigns at a number of other companies, such as the Disney Corporation.

Although unions frequently pitch their activism as pursuing traditional shareholder objectives, targeted companies have been quick to point out that their

[22] Strine, 2005.
[23] Schwab and Thomas, 1998.
[24] Schwab and Thomas, 1998.

initiatives sometimes implicate labor's interests as workers. Thus, union activists have sometimes used shareholder activism to further corporate campaigns targeting companies engaged in collective bargaining negotiations.[25] In these cases, labor acts qua worker, rather than as an investor. This raises a potential for conflict between investors' interests in firm value maximization and workers' interests in gaining a larger share of corporate income.

One example of the "two hats" problem is in labor's use of traditional shareholder activism techniques, such as Rule 14a-8. In the 1990's, for example, unions were the most successful group in attracting high levels of investor support for their shareholder proposals. At that point in time, labor shareholder proposals largely targeted the removal of anti-takeover defenses, a very popular idea with other shareholders that was generally viewed as value increasing for all investors.[26] In more recent years, unions have concentrated their shareholder proposals on topics related to executive compensation, which have attracted less shareholder support and seem less likely to raise firm value. They do, however, focus public attention on an embarrassing topic for corporate management. A possible explanation for this shift is that unions are more concerned with their roles as workers now.

Union activism's potential conflict of interest is undeniable, but perhaps overstated in the heat of particular disputes. Like many institutional investors, labor unions and pension funds hold diversified portfolios, rarely holding more than a small percentage of a target company's stock. To win at the ballot box, labor therefore needs to convince other shareholders of its beliefs. If other investors are rational in voting in their

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[25] Schwab and Thomas, 1998.
[26] Thomas and Martin, 1998.

own self-interest, this will limit labor's ability to engage in self-interested conduct in these dual role situations.[27]

B. Suing

When faced with suspected corporate wrongdoing or mismanagement, shareholders have the right to file suit against the firm's officers and directors. These suits commonly take one of three forms: federal securities fraud class action lawsuits, state court derivative actions, and state court direct actions challenging the terms of mergers or acquisitions. As we discuss below, institutional investors have taken an active role in the federal litigation, but done very little in the state courts.

1. Securities Fraud Litigation: Taking the Lead Plaintiff Position

Institutional investors' litigation role has been most apparent in federal securities class actions, largely after 1995 when Congress passed the Private Securities Litigation Reform Act (PSLRA). This statute was designed in part to encourage institutional investors to step forward as lead plaintiffs.[28] Prior to that time, agency costs were widely seen as pervasive in these class actions with entrepreneurial attorneys having free rein to file, prosecute and settle suits with little regard to the interests of the shareholders they claimed to represent. PSLRA was intended to reduce these agency costs by insuring

[27] Schwab and Thomas, 1998.
[28] Cox and Thomas, 2005.

that the holder of the largest claim, usually an institutional investor, was named the lead plaintiff and placed in control of the litigation by the court.

While at first institutions were quite cautious about appearing as lead plaintiffs, in the past few years, institutional lead plaintiffs have been appearing in steadily greater numbers. Some studies estimate that institutions are now lead plaintiffs in about 30% of all recently filed securities fraud class actions.[29] However, many institutional investors remain cautious about acting as lead plaintiff, preferring to pursue any legal claims that they have on an individual basis without bringing along smaller investors. Still others appear to completely ignore shareholder litigation, not even bothering to file claims to receive their portion of the settlement in many securities class actions.[30]

When institutions become lead plaintiffs, they appear to have a significant effect. Two recent studies have found that institutional lead plaintiffs are successful in winning larger settlements, controlling for other factors, than other lead plaintiffs.[31] On the cost side of the equation, institutional lead plaintiffs have successfully negotiated lower attorneys' fees' awards in many cases.[32] Anecdotal evidence suggests institutional investors have also brought about corporate governance improvements and sharpened the deterrent effect of securities litigation by insisting that individual director defendants contribute personally to settlements in high profile settlements at WorldCom and Enron.

Yet, shareholder litigation is an episodic experience for most companies. One study estimated that only a small fraction of public companies experience a shareholder

[29] Cornerstone, 2005.
[30] Cox and Thomas, 2002.
[31] Cox and Thomas, 2005; Choi, Fisch and Prichard, 2005.
[32] Perino, 2006.

suit,[33] although more recent reports by consulting firms claim that companies face a 10% chance of a federal securities class action lawsuit over a five year period.[34] Out of this set of cases, institutional investors still only appear in about one third of the cases. Therefore, even with greater institutional investor involvement in securities fraud litigation, the overall impact of these suits seems relatively small.

Moreover, there is a potential dark side to the drive toward institutional lead plaintiffs. Some plaintiffs' law firms have been accused of making campaign contributions to elected officials that are decision makers at certain public pension funds.[35] These "pay to play" allegations raise doubts over whether appointing institutions as lead plaintiffs will reduce the agency costs associated with securities fraud class actions.

2. State Court Class Actions: Derivative Suits and Direct Class Actions

Historically, derivative lawsuits were one of the principal mechanisms by which shareholders attacked corporate mismanagement. Over time, their importance as a monitoring device has diminished both because of the increased importance of other corporate governance devices, such as independent directors, and because of procedural impediments created by state legislatures alarmed at the prospect of allegedly frivolous claims. Reflecting this change, a relatively small number of these cases are filed annually, about 45 a year in the Delaware Chancery Court, the most important corporate trial court

[33] Romano, 2001.
[34] Miller, Foster and Buckberg, 2006.
[35] Weinberg and Fischer, 2004.

in the country.[36] About one third of these cases result in some form of recovery for shareholders, while the other two thirds are dismissed without an award.[37] Institutional investors, however, do not appear as lead plaintiffs in these cases, or otherwise take active roles in them.

The other important form of representative litigation in state court, class action litigation by shareholders, almost always involves challenges to the terms of proposed mergers and acquisitions.[38] These cases mainly attack control shareholder acquisitions, MBO type transactions, third party friendly transactions, and hostile acquisitions. These cases result in substantive relief for shareholders in a substantial percentage of the cases challenging transactions involving control shareholders, MBOs and friendly third parties.[39] Only a "handful" of these cases are filed by institutional investors though.[40]

In sum, it does not appear that institutional investors have been very active in filing state court litigation challenging corporate managers' actions.

C. Change of Control Transactions: Buying and Selling

A third route that institutional investors could have taken in their activist efforts would be to engage in change of control transactions. As we noted earlier, there are significant corporate and securities law barriers, such as the insider trading laws, facing institutional investors that wish to buy control positions in portfolio companies. However, there are a variety of other reasons that institutions do not engage in these

[36] Thompson and Thomas, 2004a.
[37] Thompson and Thomas, 2004a.
[38] Thompson and Thomas, 2004b.
[39] Thompson and Thomas, 2004b.
[40] Id. at 187.

acquisitions. For example, many institutional investors are subject to the prudent investor standard, a rule that mandates diversification of their investments so that no one position puts their returns to their beneficiaries at risk.[41] This need for broad diversification, and the relatively low cost of buying and holding long positions in stocks, has led many institutions to index substantial portions of their portfolios, and effectively prohibits them from taking too large a position in any one company.

A number of other barriers to institutional control contests exist. Some institutions, such as banks, are limited in how much of a company's stock they can own. Other institutions, such as mutual funds, face adverse tax consequences if they put more than 5% of their assets, or own more than a 10% stake, in any one company.[42] Poison pills and state antitakeover statutes also effectively limit institutional investments to well below control positions.

On the sell side, institutions are quite willing to facilitate change of control transactions by selling their stock. The Williams Act and subsequent SEC rules and regulations provide these investors with time and information about takeover offers.[43] The one caveat is that because they are diversified investors, they frequently hold positions in both the acquirer and target companies and therefore evaluate bids based on their overall impact on their portfolio. However, institutions are not the real agents for change when they are selling into change of control transactions, but followers of other investors that instigate the transaction.

Institutions have also done little by themselves to thwart management sponsored change of control transactions, such as leveraged buyouts. While sometimes grumbling

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[41] Black, 1990, at 553.
[42] Black, 1990, at 552.
[43] Thompson and Thomas, 2004b, at 1754.

over the terms of these deals, institutions in the 1980s and 1990s were unwilling to expose themselves to potential negative publicity and to spend the money necessary to organize unified opposition to these deals. However, with the rise of hedge funds, and to a lesser extent, this appears to be changing. As we will discuss further below in section , hedge fund event risk arbitrageurs frequently target leveraged buyouts, or squeeze out mergers, and use their positions in target companies to negotiate for better terms. Institutional investors have generally tagged along behind the hedge funds, free riding on their efforts to raise the prices paid in these transactions.

4. Summary: Institutional Investors Have Had Limited Success as Activists

Two points emerge from this discussion: first, institutional investors can make a difference in corporate governance at the margins at targeted firms; and second, institutions have been unable, or unwilling, to get heavily involved in forcing more significant corporate changes, such as control changes at undervalued firms. In section III of this paper, we look at the potential for hedge funds to fill in some of the gaps in institutional activism.

II. The Role of New Institutions and Instruments and the Rise of Hedge Funds

During recent years, hedge funds have emerged as a new and important player in financial markets. Although hedge funds have existed since the late 1940s, the industry has grown dramatically during the past decade. Hedge funds play numerous roles, and it is impossible to paint them with one brush. Nevertheless, it is apparent that hedge funds play an increasingly important role in corporate governance.

In this section, we discuss the unique background of hedge funds and assess the ways in which hedge funds can act to fill the gaps left by other institutional investors. This discussion requires us to take a step back, and assess the different types of hedge fund approaches. Our analysis suggests what generically has been described as hedge fund activism actually can be broken into four quite different strategies. We believe it is important to be analytically precise in describing these strategies, both because the substance of the strategies is quite varied and because the policy implications of different types of hedge fund activism vary considerably.

First, hedge funds engage in what we call information asymmetry and convergence trades. Activism in this area is analogous to the typical arbitrage function in markets, and is not particularly controversial. Although there are behavioral arguments about hedge funds engaging in parallel activities, and related concerns about systemic risk, this first category of strategies is consistent with the general understanding of arbitrage-related trading.

Second, hedge funds engage in capital structure motivated trades. These strategies are more controversial, although not entirely new in concept. Indeed, much capital structured motivated trading is roughly similar to the strategies employed by private equity funds during the late 1970s and early 1980s. However, new elements of these strategies, and the recent literature on financial innovation, suggest that these strategies generate some difficult theoretical questions for scholars who maintain that firms' objectives should be to maximize shareholder, rather than firm, value.

Third, hedge funds have been active in merger and risk arbitrage, and in particular have used new financial techniques to take positions betting on whether deals will be completed. These forms of risk arbitrage are far more complex than the ones used in even the recent past. We consider how they might lead to some problems at the intersection of risk arbitrage and financial innovation.

Finally, and most controversially, hedge funds have become activist in governance and strategy. Hedge funds commonly take substantial long positions in a firm's shares, and then demand changes in governance and strategy. They often use financial derivatives and private contracts, including options and swaps, to reduce costs, increase leverage, and control the release of information about these positions.

To present a more complete picture of hedge funds, we begin by offering some observations about the differences between hedge funds and traditional institutional investors. We then offer a detailed discussion of our four-pronged taxonomy of hedge fund strategies, and discuss the role of financial innovation. In section III, we look at how hedge funds fill the gaps left in the traditional institutional investors' activism.

A. Background on Hedge Funds vs. Other Institutional Investors

There is no generally agreed-upon definition of a hedge fund. The term "hedge fund" does not appear in the federal securities laws. Indeed, when the Securities and Exchange Commission held a roundtable discussion on hedge funds in 2003, one participant cited fourteen different definitions found in government and industry publications.[44]

In our view, hedge funds generally have four characteristics: (1) they are pooled, privately organized investment vehicles; (2) they are administered by professional investment managers; (3) they are not widely available to the public; and (4) they operate outside of securities regulation and registration requirements.[45] Although many private equity or venture capital funds also have these characteristics, those funds are distinguished from hedge funds because of their focus on particular private markets. Mutual funds are more heavily regulated than hedge funds, who manage to avoid those regulations by having a relatively small number of sophisticated or wealthy individual and institutional investors.[46]

Scholars attribute the development of the first hedge fund to Alfred Winslow Jones, a sociologist and journalist who in 1949 established a private investment partnership that reduced risk by buying one stock while shorting another in the same industry.[47] Winslow's approach had several advantages. First, the investment partnership form was flexible and the partnership could trade positions quickly, using leverage to make large bets on the movements of individual stocks. Second, the partnerships were not subject to regulation under the Investment Company Act of 1940, and thus could act outside of government scrutiny. Finally, and perhaps most importantly, instead of

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[44] See SEC Roundtable on Hedge Funds (May 13, 2003) (comments of David A. Vaughan), available at http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm).

[45] See 15 U.S.C. § 77d(2) (Securities Act of 1933 registration requirements); 15 U.S.C. § 80a-2(a)(51)(A) (Investment Company Act of 1940 registration requirements); 15 U.S.C. § 80a-3(c)(7) (Securities Exchange Act of 1934 reporting obligations); 15 U.S.C. § 80b-3(b) (Investment Advisers Act of 1940 registration requirements).

[46] Most hedge funds are exempt from Investment Company Act of 1940, either because (1) they have 100 or fewer beneficial owners and do not offer their securities to the public, or (2) all of their investors are "qualified" high net-worth individuals or institutions. See 15 U.S.C. § 80a-3c(1), (7).

[47] Caldwell, 1995.

charging a fixed fee, Winslow's compensation was set at 20 percent of profits, aligning his interests with those of his investors by giving him strong incentives to maximize fund value.[48]

During the following years, numerous investment partnerships were formed based on Winslow's model. A 1968 survey by the Securities and Exchange Commission identified 140 funds operating at that time.[49] The number of hedge funds has grown rapidly since then to roughly 3,000 by 1998 and approximately 8,000 today. Total assets managed by hedge funds were roughly $300 billion in 1998 and are estimated to be well over $1 trillion today. Although many hedge funds are quite small, the largest have several billion dollars under management.

In general, hedge funds are considered to be active market participants that use leverage aggressively, pursue short-term strategies, and take both long and short positions. However, hedge funds vary considerably in their investment style and the types of financial instruments they trade. Global "macro" funds take positions based on economic forecasts and focus on government bonds and foreign exchange. Risk arbitrage, event-driven, or "special situation" funds take positions based on merger announcements, bankruptcies, reorganizations, and legal developments. Relative-value, convergence, or market neutral funds take long positions in securities they believe are undervalued, while also taking countervailing short positions in securities they believe are overvalued.

Early studies of hedge fund performance suggested that hedge funds offered greater risk, but also greater expected return, than other more common investment

[48] Brown, Goetzmann & Ibbotson, 1999.
[49] President's Working Group, 1999.

strategies, including index-based strategies.[50] However, more recent studies reach more mixed conclusions. For example, a 2005 study estimated the value added by hedge funds (alpha) as 3.7 percent, approximately the same amount as the average fees earned by hedge funds.[51] Other recent studies suggest that once hedge fund data is corrected for various biases, hedge funds do not outperform other investment strategies.[52] Moreover, at least some hedge funds generate an asymmetric risk-reward profile, with a substantial probability that the fund will outperform a particular index, but also a higher probability of ruin. For example, although LTCM had a Sharpe ratio of 4.35 for its first three years, it lost more than 90 percent of its value during 1998.[53]

During the past several decades, hedge funds consistently have charged high fees: typically 2 percent of assets under management plus 20 percent of the fund's annual returns. As a result, hedge fund managers are among the most highly compensated people in the world, and annual compensation of more than $100 million per year is not uncommon for some individuals.[54] Hedge fund managers typically are compensated based on absolute returns, not returns relative to an index, and therefore they have incentives to be more aggressive in their strategies than managers at other institutional investors. As we will see in section III, this has significant implications for their activism.

One purported advantage of hedge funds is that their returns are not highly correlated with other investment vehicles. To minimize correlation, hedge fund

[50] Fung & Hsieh, 1997; Brown, Goetzmann & Ibbotson, 1999.
[51] Ibbotson & Chen, 2005.
[52] Kat & Palaro, 2006; Malkiel & Saha, 2006.
[53] Partnoy, 2004.
[54] In 2005, the top 25 hedge fund managers made more than $130 million. Jenny Anderson, Atop Hedge Funds, Richest of Rich Get Even More So, N.Y. Times, May 26, 2006, at C2.

managers have incentives to follow different strategies from other institutions and other hedge funds. Indeed, sophisticated investors typically assess hedge fund managers on their ability to produce high absolute returns above those they could achieve by simply investing in an index. However, many critics have suggested that hedge funds' returns are more highly correlated than previously believed, both with market indices and among other hedge funds.

Hedge funds differ from other institutions because they typically raise money through private offerings to a relatively small number of wealthy investors and large institutions that are not subject to the same regulations as those of other institutional investors. Moreover, hedge funds typically require that investors "lock in" their investments for a fixed period of time, ranging from six months to several years. By comparison, other institutional investors, particularly mutual funds, are subject to more rapid investor redemptions. Because of these differences, hedge fund managers are more independent of their investors than are managers of other institutions.

Moreover, whereas mutual funds must have independent boards and permit shareholders to approve certain actions, hedge funds can, if they choose, more completely separate ownership and control. The typical hedge fund is a partnership entity managed by a general partner; the investors are limited partners who are passive and have little or no say in the hedge fund's business.

In recent years, critics around the world, particularly in continental Europe, have called for more extensive regulation of hedge funds. In late 2004, the Securities and Exchange Commission responded to some of the criticism by adopting new rules that required hedge funds to register with the agency and imposed limited disclosure requirements.[55]

Whereas most institutional investment advisers had been required to register with the SEC, hedge fund advisers – the general partners – typically were exempt under a special private adviser exemption, because they advised fewer than fifteen “clients.”[56] The SEC’s new rule effectively required hedge funds to register by including in the definition of “clients” the limited partner investors in a fund. Based on the SEC’s new interpretation, if a fund had fifteen or more *investors*, it had to register. Most funds had more investors than that, and therefore the new SEC rule required that they register.

This regulation took effect in February 2006, and it was immediately challenged. It is worth noting that the new regulation was not particularly onerous. Essentially, it required that hedge fund advisors file a brief registration statement and make certain limited disclosures, including their names and addresses. It did not subject them to substantive SEC regulation. Nevertheless, many hedge fund managers, a highly private group, opposed the very notion that they would be required to reveal their existence, names, and addresses to regulators. They argued that the new regulation would have unduly leveled the informational playing field between hedge funds and other institutions in the U.S., and would have led many hedge funds to relocate abroad.

The legal dispute over the rule revolved around the definition of “client.” The SEC’s authority for the new rule stemmed from the language in the Advisers Act exempting “any investment adviser who during the course of the preceding twelve

[55] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004).
[56] The general partner’s only client was the partnership entity itself.

months has had fewer than fifteen clients."[57] But what is a "client"? Is it a *fund*, in which case the adviser is exempt, because it advises only one (or a few) funds? Or is it an *investor*, in which case the adviser is not exempt, because the typical hedge fund has fifteen or more investors?

The appeals court struck down the rule, siding with the hedge funds, and against the SEC. In a nutshell, the court held that the rule was arbitrary because, for example, it would force hedge fund advisors with between 15 and 99 investors to register under the Investment Advisers Act even though the fund itself would be exempt from the more demanding Investment Company Act because it had fewer than 100 investors.[58] The SEC chose not to appeal the case to the Supreme Court.

Hedge funds quickly responded to the case by withdrawing registrations they had filed since the rule took effect in February 2006. They also requested, and obtained from the SEC, a no-action letter indicating that they could withdraw and maintain exempt status even if they had marketed themselves to the public while they were registered, or even had taken on more than fourteen clients.[59]

At the moment, hedge funds remain subject only to the anti-fraud provisions of the securities laws, and the SEC has brought cases against hedge funds alleging securities fraud. Compared to other institutional investors, this is a relatively light burden. For example, hedge funds are not subject to any of the substantive disclosure requirements or governance-related regulations that impact mutual funds. Some regulators favor additional rules governing hedge funds, and countries outside the United States have

[57] 15 U.S.C. § 80b-3(b)(3).
[58] Goldstein v. SEC, No. 04-1434 (D.C. Cir. Jun. 23, 2006).
[59] Paul E. Roth & Jeffrey E. Tabak, SEC No-Act Letter, Aug. 10, 2006.

imposed more onerous regulation. As of September 2006, Congress was considering additional hedge fund legislation.

One final regulatory distinction between hedge funds and other institutions is worth mentioning. Because hedge funds do not fall under Investment Company Act regulation, they are permitted to trade on margin and engage in short sales, strategies that are not available to other institutions, such as mutual and pension funds.[60] These two strategies – leverage and short selling – have become particularly important in recent years for several reasons.

First, although the largest mutual funds and pension funds have more assets under management than hedge funds, hedge funds can and do use leverage and financial derivatives to acquire larger positions. For example, one prominent fund, Long-Term Capital Management, borrowed an amount equal to several times its capital – at one point it was leveraged 100-to-1 – and it held approximately $1 trillion of derivatives positions before it collapsed in late 1998.[61] In 2006, numerous hedge funds had more capital under management than did LTCM, including several hedge fund families with more than $10 billion under management, although the degree of leverage had declined.

Leverage also enhances a hedge fund's ability to focus on particular companies. Because hedge funds are more focused on absolute returns, rather than performance relative to an index, they are more likely to hold concentrated equity positions that are larger than the positions held by traditional institutional investors with substantially more capital under management. This enables them to capture a greater percentage of any target firm value created by their activism.

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[60] See 15 U.S.C. § 80a-12(a)(1), (3).
[61] Partnoy, 2004.

One final effect of heavier leverage is that hedge funds tend to trade more frequently than other institutional investors. As a result, hedge funds account for roughly half of trading on stock exchanges, and are active participants in derivatives markets. Such active trading generates substantial fee income for investments banks. These banks compete for this business by offering prime brokerage accounts to hedge funds and giving them a first choice on any of their proprietary research on potential target companies. Some funds reward the banks that identify the most successful investment opportunities by directing their trading business to them.

Moreover, although regulations prohibit many large institutional investors from taking short positions (or using many other derivative instruments), hedge funds are not restricted from shorting. Because hedge funds can short shares, they can engage in numerous strategies not available to other institutions. They also can obtain concentrated exposure to particular companies at relatively low cost. Recently, the SEC has loosened some restrictions on shorting, and it has proposed to liberalize this market even more. As the cost of shorting declines and the market expands, hedge funds acquire an even greater advantage over other institutions that cannot short.

In addition, hedge funds have shown great facility in using financial derivatives to acquire short positions. They frequently buy and sell exposure to individual stocks by using private options transactions to replicate share trades. They also are active in the share lending market, and obtain favorable treatment on share lending transactions from the financial institutions where they hold prime brokerage accounts. It is easier and cheaper for a hedge fund to get short a security than it is for virtually any other investor. (Interestingly, an alternative method of acquiring short positions in shares, the trading of security futures, was introduced in 2002, but this method never gained sufficient liquidity.)

B. A Taxonomy of Hedge Fund Activism and Financial Innovation

Hedge funds have played an important role in making markets more efficient, but in doing so they have introduced new risks and costs. For example, hedge funds are more flexible than other institutional investors, and therefore can more easily take positions in securities they believe are under- or over-valued. This is particularly important with respect to potentially over-valued securities, because traditional institutional investors – particularly those investors who follow an indexing or buy-and-hold strategy – will have neither adequate incentives nor the ability to make large short-term trades based on perceptions about the relative value of securities.

In this section, we explore the impact of hedge funds on market efficiency. We begin by classifying hedge fund activism in equity markets into several different categories: information asymmetry and convergence trades; capital structure motivated trades; merger and risk arbitrage; and governance and strategy. We go on to examine more closely at the last category – governance and strategy – and find some parallels to the private equity activism during the 1980s. However, we also find some important differences from the earlier activism, particularly with respect to the increased usage of financial innovation.

1. Information asymmetry and convergence trades

Many hedge funds engage in trading strategies to exploit information asymmetry between sellers and buyers of financial assets. In this sense, these hedge funds resemble any arbitrageur who seeks to profit from information not currently reflected in market prices. In general, this kind of arbitrage activity makes markets fairer and more efficient, because it causes market prices to reflect additional information.

The success of these trades rests on hedge funds capturing an informational advantage over other investors, and there is some evidence that such an advantage does in fact exist. First, as we noted above, there is evidence of positive alpha returns to hedge funds, and investors continue to be willing to pay hedge fund managers high fees (even if returns have declined). This suggests that hedge funds actually are successful at exploiting information asymmetry. Second, because of their compensation structure, hedge funds attract top financial talent. If anyone can find and exploit informational advantages, it seems reasonable that these highly skilled individuals would be likely candidates. Third, because of their flexibility, hedge funds are able to move quickly to get into (and out of) large positions in markets, where other institutional investors might not be able to more so quickly or to invest in such large amounts. Fourth, hedge funds are not subject to significant regulation. As a result, they are able to engage in investment strategies that might lead to scrutiny if employed by other institutions.[62]

Information asymmetry-driven hedge fund trading might reduce market volatility as well. For example, the increase in hedge fund activity has been correlated with a decline in volatility, based on the volatility indices traded on the Chicago Board Options

[62] Most recently, some critics have suggested that hedge funds are engaged in extensive insider trading based on their privileged access to information not available to the public.

Exchange. The average of the CBOE Volatility Index, VIX, during 1990 through 2003 was more than 20% and during 2003 the VIX average was 21.99%; during 2004 and 2005 it was 15.48% and 12.81%, respectively. Although this correlation does not establish a relationship between hedge funds and declining volatility, it is consistent with the argument that hedge funds, by reducing information asymmetry, have reduced the substantial swings in securities prices upon revelation of important information. If hedge funds are able to uncover information over time that otherwise would surprise investors all at once, their buying and selling activities would result in a smoothing of financial asset prices by reducing uncertainty.

In particular, hedge funds have been uniquely active in acquiring negative information about companies, and then shorting those companies' securities. Several dozen hedge funds manage billions of dollars based on short strategies. In theory, informed hedge fund shorting should lead to more accurate and less volatile financial asset pricing. To the extent informed hedge fund trading reduces risk, it also should lead to higher equity values overall.

Regulators have been critical of hedge fund shorting, and have investigated several high-profile hedge funds that have shorted a company's shares and subsequently generated and published negative information about that company. Both the New York Attorney General and the SEC have investigated short-selling by hedge funds, including Greenlight Capital, Aquamarine Fund, and Tilson Capital Partners. For example, one hedge fund, Gotham Partners, that exhibited annualized returns of more than 40% for 20 years, has been targeted for such practices. Although Gotham typically takes long positions, it has sometimes taken short positions in companies and soon thereafter published research with detailed information explaining the rationale for its short position. For example, in 2002, Gotham published a 66-page report indicating that MBIA, the AAA-rated municipal insurance company, was engaging in dubious accounting practices. The report contributed useful information not previously available in the market, and led others to investigate MBIA. At the urging of MBIA, New York Attorney General Eliot Spitzer investigated Gotham's report and share trading, but did not bring charges. MBIA's share price fell in response to the Gotham report and as of August 2006 was still at early 2002 levels.

Of course, information asymmetry-driven trades, long and short, are not always successful. Numerous hedge funds believed that Enron was overvalued and took short positions on the stock during 2000 and 2001 as the share price continued to increase. The literature on behavioral finance has shown that timing concerns and restrictions on shorting can also lead to inefficient pricing of securities in the short run.

Hedge funds often act in concert to take concentrated risk positions. Indeed, for decades, hedge funds have been active in so-called "convergence" trades in financial assets other than equities, where the funds would take a long position in what they believed was a relatively undervalued financial asset and a short position in a relatively overvalued asset. Salomon Brothers and later LTCM engaged in such trades in the bond market. George Soros did such trades in foreign exchange.[63]

The risk concentration associated with parallel convergence trades has mixed effects. On one hand, concerted action can be necessary to move prices. Hedge funds that are simply mimicking others are unlikely to generate above-average returns. On the other hand, concerted action can increase systemic risk and liquidity risk. The credit

[63] Partnoy, 2004.

crisis during fall 1998 generated system-wide worries, not only because of the collapse of LTCM, but because so many hedge funds had made the same losing bets, although when some funds learned about LTCM's positions, they took opposite positions in anticipation of LTCM's difficulties.

In 2005, numerous hedge funds lost money on similar trades in synthetic collateralized debt obligations, renewing concerns about systemic risk. Although there were substantial losses among hedge funds from similar trades, most regulators and commentators believed the settlement processes associated with the trades were of greater concern than the systemic financial risks.

On balance, we find that information-driven hedge fund activism is beneficial, and should be encouraged. If there are concerns that hedge funds engage in market manipulation, publish false information, or engage in insider trading, regulators could address those concerns directly. Indeed, recent prosecutions suggest that regulators have the tools to do precisely that.

2. Capital structure motivated trades

Hedge funds also engage in trading strategies directed at changing companies' capital structures. Essentially, hedge funds take equity positions, and then try to persuade managers to change the capital structure of the company (typically to pay substantial dividends, repurchase shares, or take on additional debt) in ways the hedge funds believe will maximize the value of shares. In certain respects, the recent increase in these kinds of strategies resembles the increase in pressure on public companies from private equity investors during the 1980s. Although hedge funds today do not typically seek to take companies private, their capital structure-driven strategies resemble a kind of early-stage leveraged buyout. In addition, at least in theory, hedge funds could take a range of positions, depending on a company's actual vs. optimal capital structure.

Unlike the private equity and leverage buyout approaches of the 1980s, the hedge funds' recent strategies have led some scholars to rethink the theory of the firm and capital structure. For example, whereas many 1980s deals were thought to be driven by the positive returns associated with the disciplining effect of debt, or perhaps tax advantages, more recent capital structure motivated deals are viewed more skeptically, as perhaps no more than a redistribution of corporate resources to debtholders or other slices of the capital structure to shareholders.

Thus, hedge fund activity raises an important theoretical question about the nature of the corporate enterprise. If managers owe duties to maximize share value, hedge funds that opportunistically induce the firm to breach contracts with non-shareholders might generate positive returns ex post that would lead to costly ex ante protections. But if managers owe duties to maximize firm value, rather than share value, they should be able to resist hedge fund efforts to redistribute value.

Some scholars have argued that, given the recent insights from financial innovation, from the perspective of theory, shareholder maximization generates intractable contradictions.[64] For example, a shareholder wealth maximization approach leads to perverse results depending on capital structure. Consider the following thought experiment: suppose two firms, DebtCo and OptionsCo, each are precisely equivalent in

[64] Partnoy, 2006.

every way except capital structure (i.e., they have the same assets and the same potential projects).

Their capital structures are depicted below:

Example 1

DebtCo		OptionsCo	
Debt	$1,000	Equity	$1,000
Equity	$ 500	Options	$ 500

Note that both firms have the same market capitalization: $1,500, which is consistent with the assumption that their assets and future projects are equivalent. If each corporation seeks to maximize the value of shares, the corporate actors will have incentives to behave differently, even though the firms are equivalent in every other way. More concretely, suppose each firm faces two choices. The Risky Strategy pays $10,000 with a ten percent probability and nothing with a ninety percent probability. The Conservative Strategy pays $1,500 with certainty. The firm, and society, is better off if each firm selects the Conservative Strategy.

Now suppose that activist hedge funds hold equity and seek to persuade managers to maximize shareholder value. Assuming risk neutrality, DebtCo will maximize the expected value of equity by choosing the Risky Strategy over the Conservative Strategy, and thus its board should select this option if their goal is to maximize shareholder value. However, OptionCo's board will maximize expected shareholder value by choosing the Conservative Strategy. Note that the Conservative Strategy should be dominant for both firms if their goal is to maximize expected firm value. Thus, to the extent hedge funds are successful in pushing for a goal of maximizing shareholder value only, they will encourage the misallocation of capital.

Jensen, Murphy and Wruck have recognized the problems with the simple approach to the shareholder maximization norm, particularly in the context of executive compensation.[65] They have suggested that the corporate objective should be to maximize firm value. Other scholars have made compatible arguments. Our analysis of hedge fund activism provides a new area of support for these arguments.

Hedge funds also engage in other more controversial capital structure motivated trading strategies that some argue are designed to extract profits without generating benefits. Examples include convertible bond arbitrage, and manipulation of so-called "death spiral" securities. Although these activities often are confined to smaller, less liquid stocks, there have been public disputes surrounding attempts by hedge funds to extract value from these kinds of strategies. For example, a hedge fund might buy convertible bonds and simultaneously short shares. In these cases, it can be difficult to untangle the question of whether the hedge fund is simply trying to arbitrage an under-priced conversion option embedded in a convertible bond, or instead is attempting to manipulate downward the price of shares so that it can profit from a cheap conversion.

On balance, we find that capital structure-driven hedge fund activism is less likely to be beneficial to investors than information-driven hedge fund activism. Although the hedge fund strategies of today might resemble the private equity deals of the 1980s, the technologies they use are more complex and can facilitate manipulative behavior. It can be difficult to ascertain whether a hedge fund is exploiting an arbitrage opportunity

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[65] Jensen, Murphy and Wruck, 2004.

associated with a firm's suboptimal capital structure, or using financial techniques to engage in short-term market manipulation.

3. Merger and risk arbitrage

Hedge funds, and numerous other investors, have engaged in merger and risk arbitrage for several decades. In perhaps the most common trade, a hedge fund takes a long position in a merger target and a short position in the acquirer, and simply waits for the merger to close. The hedge fund makes a spread upfront between the higher value of the short target position and the lower value of the long acquirer position. At the merger closing, the two positions offset.

In theory, such trading strategies should not earn positive risk-adjusted returns because they resemble selling options, where the trader earns a small premium with high probability in exchange for a low probability, high magnitude loss. In fact, although many hedge funds have earned premium income from merger arbitrage over time, they also have experienced substantial losses when mergers are not completed. Indeed, LTCM was a prominent example – it lost money on a risk arbitrage position when the merger was abandoned.

There is, however, a dark side to merger arbitrage. A hedge fund that purchases shares in the target is entitled to vote on the merger, but is not a "pure" residual claimant of the target. Indeed, a hedge fund that owns target shares and is short acquirer shares has an incentive to vote in favor of the merger, even if the merger will result in a reduction in the aggregate value of the acquirer and target. This incentive arises from the fact that the hedge fund makes a small profit if the merger closes, but loses a much larger amount if the merger does not close.

This particular problem has not been studied extensively, and we have not found data that would permit an industry-wide empirical analysis. However, there is at least anecdotal evidence suggesting that the problem is not merely theoretical, and that hedge fund voting has led to suboptimal approval of mergers. Aggregate hedge fund long positions in share exchange mergers are substantially higher than hedge fund positions in companies that have not announced mergers. Several merger votes have been close enough that hedge voting may have determined the outcome. Perhaps the most prominent case was the HP-Compaq merger, a transaction that many commentators regarded as value destroying, where even one hedge fund that faced the perverse incentives described above would have tipped the vote.

In addition, hedge fund incentives have suboptimal second order effects, such as leading companies to prefer share-exchange merger deals to cash deals. Indeed, managers considering a merger – or at least their investment bankers – understand that the voting polity is likely to turnover rapidly just before the merger record date with longer term holders selling out to hedge fund managers, who in turn will vote for even a value-reducing deal. Thus, managers and their bankers have incentives to propose mergers even if they believe they would be opposed by current shareholders.

An opposite, and perhaps equally serious, problem is that hedge funds could engage in anti-merger strategies, taking positions that would benefit if a merger collapsed, and then strategically voting against the merger. Again, there is some evidence of such practices. For example, in the Cadbury acquisition of Adams, hedge funds voted against the merger, surprising Cadbury. Likewise, the Elliott Associates-Woolworth merger presented a battle between hedge funds with substantial (around 7 to 9%), but opposite, stakes.

Perhaps most importantly, hedge funds can use financial derivatives to acquire voting positions at a much lower cost than the cost of the shares. In the King-Mylan merger, Perry Corp. acquired shares at minimal cost by entering into an offsetting equity derivatives transaction with Goldman Sachs. Perry could then vote these "cheap" shares in favor of the deal, which other "pure" shareholders – including Carl Icahn – opposed. To the extent shareholders have hedged the economic risk of their share positions, they likely would vote in ways that are contrary to the interests of shareholders who do not hold any countervailing positions.

It is impossible to know how widespread these problems are at present. For over a decade, hedge funds and other investors have been using equity derivatives to offset share positions for various purposes, including with the aim of avoiding regulation. Because hedge funds are only lightly regulated, and the over-the-counter derivatives they use are almost entirely unregulated, there is no disclosure about how prevalent these strategies have become.[66]

Finally, merger arbitrage is unlikely to generate the same kinds of benefits as other information-driven hedge fund trading. The pricing gaps due to expectations that a merger might not close are relatively small – leading some funds to abandon merger arbitrage, while others have found that it does not generate above-average returns. Moreover, a market for the risk of non-consummation of mergers could be synthetically

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[66] Likewise, there is little information to support or contradict claims that hedge funds have engaged in insider trading in advance of merger announcements.

created by having parties trade separate derivative instruments – which would not have a vote – based on whether the merger closed.

Overall, we believe that the role of hedge funds in merger arbitrage is problematic. The same technologies that generate benefits with respect to information arbitrage create perverse incentives for merger arbitrage. Moreover, at least in the case of strategies promoting merger activity, corporate managers have little incentive to defend against hedge fund efforts to engage in such activities. Indeed, if managers obtain private benefits from such activity, we might expect managers and hedge funds to be complicit in such strategies. Unlike the private equity deals of the 1980s, the more recent instances of merger arbitrage are more likely to be associated with value-destroying mergers.

4. Governance and strategy

During recent years, hedge funds became much more active in strategies that involve buying shares of companies and seeking to profit by persuading the company to change its governance practices, or to implement some new business strategy. This type of corporate governance/strategy activism has the potential to transform the internal structures of targeted companies, and to lead other firms to change their corporate governance structures before they become targets.

As with institutional investor activism, the theoretical justifications behind hedge fund corporate governance activism are easily understood – the agency costs associated with the separation of ownership and control in publicly held firms can be reduced by informed shareholder monitoring. Well-informed, large investors can pressure boards to remove underperforming management and directors, stop value destroying conglomeration strategies, force disgorgement of excess cash and reduce executive compensation. In contrast with institutional investor monitoring – which as discussed in section I has been weakened by collective action problems, conflicts of interest, high information costs, regulatory constraints, inadequate management incentives to actively monitor, and political constraints – hedge fund corporate governance activism is more robust. These largely unregulated funds are run by highly incentivized fund managers whose compensation rests on their success and who operate with few, if any, conflicts of interest with respect to their choice of targets. They are better potential monitors than institutional investors.

Of course, many questions exist about the impact of these funds. For example, are they targeting underperforming companies? Do they create value for themselves or for all shareholders? Are they reducing long term value when management responds to their demands for immediate short term action? Corporate managers in particular have stressed the potential conflict between some of the short term value-creating activities that are recurrently stressed by hedge funds and their possible negative consequences for the long term future of target firms.

In an effort to quantify the amount of this activity, we examined a small data set of Form 13D filings. Form 13D filings are useful because all investors, including hedge funds, must file a Form 13D when they purchase 5% or more of a company's shares. We note that not all hedge funds filing Form 13D's are engaged in corporate governance or strategy type activism, and conversely, that not all attacks on corporate governance or strategy are by hedge funds that have accumulated a 5% stake, and therefore were required to make a Form 13D filing. Nevertheless, the number of such filings should be indicative of the level of hedge fund activism in the area of corporate governance and strategy.[67]

To assess the extent of hedge fund activism in greater detail, we examined every Form 13D filed during a randomly chosen two-week period during the previous year (November 4-18, 2005). We found 319 Form 13D filings during this period. We coded these filings based on the category of filer and category of purpose.

Table 1: Category of Filer

Filer Category	Filings	%
Hedge Fund	68	21.3%
Investment Advisor/Manager or Pension Fund	55	17.2%
Corporate Insider	53	16.6%
Corporation, Operating Company	51	16.0%
Bank	25	7.8%
Individual Investor, Charity	24	7.5%
Venture Capital Firm, Private Equity Firm	16	5.0%
REIT, Real Estate Advisor	9	2.8%
Consultant	2	0.6%
Unclassifiable	16	5.0%
Total	319	100.0%

The frequency of hedge fund filings during this two-week period is consistent with an overall increase in Form 13D filings during 2005 and 2006, and is significantly higher than the frequency in previous years. The hedge fund filers during this period included several of the most frequent filing funds during the previous two years, including Pride Capital Partners LLC, Carl Icahn, Steel Partners II, and Third Point LLC. We believe this data supports the widely held view that hedge fund activism has increased, and is led by a relatively small number of funds.

[67] In a separate article, we and others plan to examine in greater detail the Form 13D filings of activist hedge funds from 2004 and 2005. For our purposes here, we believe it is sufficient to make our argument based on more limited evidence.

We also categorized the Form 13D filings during the two-week period on the basis of the purpose of the investment. The regulations applicable to Form 13D require that each 5% holder include such a description in the filing. Although the non-hedge fund filings were for a variety of purposes, the hedge fund filings were overwhelming for the purpose of shareholder activism, including communicating with management or mounting a proxy contest. Hedge fund filings only rarely stated that they were for other purposes, including investment purposes. A summary of the data is set forth below in Table 2.

Table 2: Purpose of 13D Filer

PURPOSE CATEGORIES	Non-HF	Non-HF%	HF	HF%
1 - Investment Purposes	46	18.3%	3	4.4%
2 - Shareholder Activism, Communicate with Mgt, Proxy Contest	49	19.5%	61	89.7%
3 - Mergers & Acquisitions (including tender offers)	22	8.8%	1	1.5%
4 - Intra-Corporate Transaction, Corporate Partnership	23	9.2%	0	0.0%
5 - Insider Transaction, Executive Compensation	33	13.1%	1	1.5%
6 - Financing Transaction, Loan	33	13.1%	0	0.0%
7 - Self-Tender, LBO, Corporate Restructuring	12	4.8%	0	0.0%
8 - Public Offering	9	3.6%	0	0.0%
9 - Sale of Shares by Filer	17	6.8%	2	2.9%
10 - Estate Administration, Share Distribution	7	2.8%	0	0.0%
Total	251	100.0%	68	100.0%

We are aware of anecdotal evidence that hedge funds have engaged in activism without crossing the 5% ownership threshold that triggers the Form 13D filing requirement. Hedge funds holding less than 5% stakes have sought governance or strategy changes at Time Warner, McDonalds, and Wendy's International, among others. Nevertheless, we believe the From 13D data described above are useful in drawing conclusions about recent hedge fund activism, much of which has involved hedge fund acquiring stakes of 5% or more, particularly in smaller and mid-sized companies.

In general, we believe this increase in activism has the potential to accomplish many of the goals set out for institutional investor activism discussed earlier. As with hedge fund activism in the capital structure area, there is both positive and negative potential for improving firm value. To the extent hedge fund managers succeed in acting as a new shareholders' advocate, the benefits will be substantial. But there also is the risk that hedge fund will increase the returns to shareholders by reducing returns to other firm claimants. As in the capital structure area, hedge funds might simply reallocate returns from non-equity slices of the capital structure to shares. Therefore, we believe that it is too early to draw firm conclusions about the normative effects of this increase in shareholder activism.

Many open questions remain, including the question of whether hedge funds will be able to generate profits from shareholder activism. Some recent commentators have expressed skepticism, and evidence from hedge fund performance in the past suggests support for a behavioral story about some of the recent hedge fund entrants mistakenly believing they can generate abnormal returns from shareholder activism.

Tentatively, we suggest that a combination of the stories is likely true. Some of the increase in hedge fund activism is likely due to increased activity among parties who have been successful in the past playing an activist role. But part of the increase may also be due to new entrants, who might not be as successful in the relatively complex role of shareholder advocate.

III. Hedge Fund Activism and Gap Filling: Policy Implications

What are the policy implications of the changes in hedge funds and financial innovation? In this section, we focus on the issues that activist hedge funds raise in the areas of voting, litigation, and change of control transactions. In particular, we are concerned about whether hedge fund activism is filling in the gaps left by institutional investors. We also look more closely at whether what hedge funds are doing is beneficial to other shareholders or just to themselves.

A. Change of Control Transactions

Hedge funds can have a dramatically different impact than institutional investors in change of control transactions. Recall that institutional investors almost never attempt to initiate change of control transactions for portfolio companies. By contrast, there are several ways that hedge funds can be involved in change of control transactions. As we discussed above, merger arbitrage routinely targets mergers and acquisitions by companies. The fund may invest in the target firm and may seek to negotiate better terms for a sale of their interest. Alternatively, or sometimes simultaneously, the fund may take a position in an acquiring firm, and take a position on the merger designed to maximize its profit.

Hedge funds may also identify undervalued target companies and push them to sell off underperforming divisions, put themselves up for sale, or get them to engage in other value enhancing control related transactions. If the target refuses to take the recommended action, hedge funds may be willing to launch a control contest themselves if their larger stakes in the target firm permit them to capture enough of the potential increase in target firm value to justify the cost. Alternatively, the hedge funds may succeed in attracting other bidders, such as private equity funds, that will ultimately buy the target and pay its shareholders a premium price in doing so. Furthermore, just the potential threat of hedge fund activism may stimulate corporate managers to engage in value maximizing change of control transactions before they become targets.

In most cases, one would anticipate that these types of transactions would have a positive effect on shareholder value, at least in the short term. There is a serious question about whether hedge fund activism has long term value for shareholders,[68] however, there is no empirical evidence either for or against this proposition at present.

Hedge funds also can act as a check on opportunistic transactions, such as leveraged buyouts at lowball prices, by using their voting power to block such deals, or to force the buyer to pay a higher price. Other shareholders can benefit from these actions as their shares are also purchased at the higher price negotiated by the hedge fund. Hedge funds might be willing to file appraisal actions to obtain a fair price for their shares in transactions that they are unable to block. Other shareholders might be able to file parallel appraisal actions and piggyback on the work done by the hedge funds.

Financial innovation and hedge funds can distort the market for corporate control though. As we discussed in section II above, encumbered shareholders might not vote for mergers that would benefit "pure" residual shareholders.[69] Hedge funds with countervailing short positions might favor mergers that would destroy value.

Further, the presence of hedge funds and financial innovation could skew the market for corporate control away from cash-based transactions to share-based

[68] Kahan and Rock, 2006.
[69] Martin and Partnoy, 2005.

transactions. If a company buys another for cash, there is less opportunity for risk arbitrage: hedge funds cannot bet on a deal's completion by purchasing target shares, shorting acquirer shares, and waiting. Because the distortions from trading are not available for cash deals, arbitrageurs will prefer share deals. And if managers understand the difference, they also will prefer share deals. Put another way, fully informed managers would know that they could propose a value-destroying fixed share exchange merger, and stand a good chance of shareholder approval, even if the current shareholders would disapprove of the deal. Obviously, when managers expect hedge funds to oppose their proposals, they will have an incentive to take the opposite approach and structure it as a cash deal to reduce the arbitrage opportunities.

On balance, hedge funds are clearly more effective than other institutions in initiating and pressuring for changes of control. However, there remains the risk that hedge funds will use financial innovation to distort the market for corporate control.

B. Voting

Hedge funds eschew the voting mechanisms used by institutional investors – Rule 14a-8, Vote No Campaigns, Majority Vote Bylaws, and such – in favor of more aggressive uses of the ballot box. All corporate governance hedge fund activism is backed up – implicitly or explicitly – by the threat of proxy contest for corporate control, while merger arbitrage rests firmly on the threat of using the vote to block a proposed merger or acquisition. Voting, in hedge fund investors' eyes, is related to change of control transactions.

However, hedge fund voting raises several novel problems. For example, the canonical view of shareholder voting is that each common share receives one vote – known generally as "one-share/one-vote" – and that this allocation is appropriate because common shareholders are the residual claimants to a corporation's income.[70] State corporate law supports this view, based on the assumptions that "preferences of shareholders are likely to be identical" and that "[i]t is not possible to separate the voting right from the equity interest."[71]

Hedge fund activism illustrates that these assumptions are wrong. Financial innovation enables hedge funds (and other shareholders) to hold claims that do not resemble those of a typical residual claimant. The simplest case is of a shareholder who also holds a countervailing short interest, either through a short position, security futures, a long put/short call, or some other equity derivative. That shareholder has a residual claim on the corporation's income through the share but her incentives differ from those of a residual claimant because of the countervailing position. She is not a "pure" shareholder, yet she receives a vote. Put another way, she holds an economically encumbered share.[72]

This problem is not merely abstract. The Perry-Icahn transaction cited above is one example, and scholars have cited numerous others.[73] For example, parties can engage in record date capture trades, buying shares before the record date to capture a vote, but selling (or selling forward) a few days later.

[70] Easterbrook and Fischel, 1983.
[71] Id. at 405, 410.
[72] One of us has argued in a previous article that such economically encumbered shares should not be entitled to vote. Martin and Partnoy, 2005.
[73] Martin and Partnoy, 2005; Black and Hu, 2006.

Conversely, non-shareholders can acquire residual-like claims through financial engineering. Imagine a corporation that has issued all 100 of its shares to an individual who enters into a derivative transaction with a counterparty to take a short position in all 100 shares? Now, the counterparty holds the residual interest, even though the corporation has no relationship with the counterparty and might not even know its existence or identity.[74]

In addition, the practice of voting shares in "street name" creates distortions in the voting markets. Shares held in a margin account typically are eligible to be loaned to other parties; indeed, brokers earn substantial returns from such share lending. Investors typically have no way of knowing whether particular shares have been loaned, to whom they were loaned, or on what terms they were loaned. Instead, most shareholders assume that because they own shares, they are entitled to vote them.

They are incorrect. Only the final holder of the share in the chain of lending has the legal right to vote the share. The earlier "owners" lose the right to vote by virtue of the loan. An obvious problem is presented when shareholders who have been divested of the right to vote give proxies to their brokers. What do the brokers do?

In the past, brokers quietly have voted the proxies of shareholders who had lost the right to vote because the broker had loaned out their shares, either by submitting more votes than they had the right to vote as record holders (overvoting), or by giving disenfranchised voters the voting rights of some other shareholder who did not submit a

[74] A similar problem arises in the bond and loan markets, where moral hazard is created when banks use credit derivatives to off-load credit risk to third parties with no relationship to the borrower.

proxy (vote switching). Regulators recently have learned of these practices, and their investigations have revealed numerous instances of overvoting.[75]

Traditional institutional investors may be unaware of these practices. If they wished to protect their right to vote, informed institutions could transfer shares from a margin account to a cash account, or otherwise contractually protect their votes. To the extent institutions lock up shares, lending and overall liquidity will decline.

Although hedge funds have tipped regulators to some of the difficulties associated with voting practices, the central problem is not the behavior of hedge funds, but rather the nature of the U.S. system of corporate voting. Indeed, institutions other than hedge funds appear to be exacerbating voting problems; hedge funds are merely reacting to the failure of other institutions to exercise their franchise for the benefit of all shareholders.

Consider, for example, the emergence of Exchange Traded Funds (ETFs). To the extent non-hedge fund institutions have created a gap in governance because of their failure to exercise voting power in the interest of shareholders, ETFs, have substantially widened that gap.

ETFs are investments funds that track financial instruments or indices, but are traded on exchanges. Because ETFs are exchange traded, they can be bought and sold during the day (unlike mutual funds). ETFs do not have sales loads and typically have lower transaction costs than many other investments.

Not surprisingly, ETFs do not have the extensive time and resources to devote to corporate governance and voting decisions. Along the product-service continuum,[76] they are more like a pure product – little or no service is provided. ETFs, like typical

[75] NYSE Deutsche Bank; NYSE.
[76] Partnoy, 2006.

products, are tangible goods that can be inventoried or standardized, whereas services are intangible processes that can be simultaneously produced and consumed.[77] In many substantive areas, both economics and law depend on the product-services distinction,[78] with good reason. Products generally are subject to greater competition and less regulation than services, in part because product markets have lower agency costs and transaction costs than service markets.

Given their product-like nature, one of the most interesting aspects of ETFs is how many of them approach voting. For example, the prospectuses for both Spiders and Diamonds, two prominent ETFs, state that "The Trustee votes the voting stocks of each issuer in the same proportionate relationship as all other shares of each such issuer are voted to the extent permissible and, if not permitted, abstains from voting."[79] In other words, the trustee of the ETFs votes the voting stocks of each issuer in the same proportionate relationship as all the other shares, which is essentially the ETF saying that its votes don't count, and that it is taking itself out of the governance process.[80] This reaction would be rational for a product-like fund: the ETFs are explicitly saying that their involvement in corporate governance and voting isn't worth the cost. Perhaps mutual fund and index funds should and would do the same – if they weren't prevented from doing so by regulation that requires them to be involved in voting and governance.

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[77] See, e.g., J.M. Rathmell, What is Meant by Services, Journal of Marketing (October 1966), at 32-36 (discussing distinctions related to tangibility, inventorying, standardization, production, and consumption). For example, economists have noted that the marketing of services differs considerably from the marketing of products. See John E.G. Bateson, Why We Need Service Marketing, in O.C. Ferrell, S.W. Brown and C.W. Lamab, eds., Conceptual and Theoretical Developments in Marketing, Chicago: American Marketing Association Proceeding Series, 131-146 (1979).

[78] Tax regulations are the most prominent example. See, e.g., Charles E. McLure, Jr., Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws, 52 Tax L. Rev. 269 (1997) (noting the differential tax treatment of products and services). The definition of a "security" also poses issues analogous to the product-service distinction.

[79] DIAMONDS 2004 Prospectus, at 59; SPDRS 2004 Prospectus, at 64.

[80] It is unclear how the ETF managers know what the eventual vote will be when they submit their proxies, or even what proxies that conformed with their policy might say.

As ETFs and index funds become more popular, the policy argument for giving them voting and governance responsibility becomes weaker. Given the cost structure of ETFs, it is unlikely they will exercise independent and informed votes. One alternative is for them to follow a third party's recommendations; we discussed the disadvantages of such an approach in section I. Another alternative is for hedge funds to fill the gap. Notwithstanding the temptation of hedge funds to manipulate the voting process, they are emerging as the perhaps sole constituency with incentives and resources to vote in the interests of shareholders.

C. Litigation

Unlike institutional investors, hedge funds use litigation frequently against target companies. Their larger stakes and more aggressive investment approaches combine to make lawsuits a necessary tactic in some situations. For instance, if a hedge fund is seeking to address allegations of management wrongdoing, excessive executive compensation, it may need to file a books and records cases to obtain internal corporate information, or a derivative suit to seek damages.

Differences in how hedge fund managers are compensated as contrasted to other institutional investors may impact on their willingness to engage in litigation. Suppose both a mutual fund and a hedge fund lost $10 million from a share price decline allegedly caused by a fraud at a portfolio firm. The mutual fund managers, consistent with their fiduciary responsibilities to their clients, would want to collect any cost-justified recoveries for their funds. However, because hedge fund managers receive a percentage of the profits recognized by their portfolios, they have suffered actual out-of-pocket losses from the fraud. This gives them a stronger incentive to become active plaintiffs in shareholder litigation to recover from the company.

Hedge fund litigation raises some novel issues for the courts. One important question concerns whether they should have the same right to bring suit as other shareholders where their long positions in a defendant company are offset by a countervailing short positions. For example, in one recent Delaware case,[81] the court found that a hedge fund was entitled to examine the books and records of a company simply by virtue of the size of its long position, even though the court was aware that the hedge fund held a larger countervailing short position. In other words, the court not only granted legal rights to a "shareholder" without a residual interest; it granted those rights to an entity whose economic incentives were the opposite of those of typical shareholders.

Similar problems have arisen in the now-common battle for lead plaintiff status in securities class actions. Since the Private Securities Litigation Reform Act of 1995, courts have selected lead plaintiffs based in large part on evidence as to which party had the "largest financial stake" in the litigation. Because hedge funds do not file information about negative equity positions, they might appear at first to have a very substantial loss upon a decline in share price, when in reality they profited from the decline. For this reason, some courts have rejected hedge fund's applications to become lead plaintiffs on the grounds that their short selling activities render them inadequate class representatives, although other courts have permitted it.[82]

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[81] Deephaven Risk Arb Trading, Ltd. v. UnitedGlobalCom, Inc., 2005 Del. Ch. LEXIS 107 (July 13, 2005).
[82] Kahan and Rock, 2006.

Financial innovation has other effects on shareholder litigation. Some of these problems are similar to those discussed above with respect to voting. For example, if share lending creates more shares than the company has issued, it also creates more claimants in securities class actions. In some cases, the parties appear to be aware of these challenges, and they address them through the use of damage studies that increase the aggregate amount of damages available to plaintiffs based on estimates of the amount of short interest in the company's shares during particular time periods. In other cases, share lending is ignored. In settlement distributions, parties are not required to establish that they held legal title to the shares, as the last one in the lending chain. They merely must show that they owned the shares – in a cash or margin account – during the appropriate time. As a result, shareholder class action settlements may overcompensate some investors (those with encumbered holdings), while under-compensating others (those with unencumbered holdings).

Some funds could take advantage of financial innovation by creating a "litigation fund." A fund might simply buy a collection of shares and simultaneously short those shares using whatever method it found most efficient. For a relatively small price, the fund could capture the right to participate in any recovery. Although we are unaware of any instances where this has occurred, it illustrates another potential challenge posed by hedge fund corporate governance activism.

Conclusion

During the 1980s, private equity investors placed enormous pressure on corporate managers to maximize shareholder value. Managers responded with a combination of leveraged buyouts and defensive tactics designed to deter these investors. During the 1990s, many commentators imagined that institutional investors such as pension funds, mutual funds, and insurance companies would play the role of activist shareholder. However, those investors faced, and continue to face, numerous constraints, and will not likely play such a role in the future.

Many commentators see hedge funds as the new shareholder activist. We find substantial evidence of hedge funds acting to reduce information asymmetry and to pressure corporate managers to adopt value maximizing strategies. Moreover, the fact that hedge fund managers are so highly paid and are compensated based on absolute performance rather than relative performance versus an index is a sign that many investors believe hedge funds have a capacity to add enormous value.

Overall, we find that hedge funds play a positive role, filling the gaps left by other institutions, particularly in uncovering negative information about companies. However, we also find that hedge funds face perverse incentives in many of their investment strategies. We are particularly concerned that hedge funds have the ability and incentive to manipulate corporate voting.

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