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Hedge Fund Activism Coming to Europe: Lessons from the American Experience

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HEDGE FUND ACTIVISM COMING TO EUROPE: LESSONS FROM THE AMERICAN EXPERIENCE

Alexandros Seretakis[*]

ABSTRACT

Hedge fund activists are the bright new hope of the shareholder empowerment movement. Free from conflicts of interest and with high-powered compensation incentives, activist hedge funds are shaking up corporate boardrooms. The recent surge in activism has provoked criticism against activist investors portrayed as short-term agitators seeking to obtain short-term profits at the expense of long-term value. Although the view of hedge fund activists as short-term speculators has been discredited by empirical evidence, innovative tactics employed by hedge funds allow them to secretly accumulate large stakes in target companies within a short time period. In response to the adverse effects of activist tactics on market transparency and fairness, European regulators have tightened disclosure obligations for major blockholders, with U.S. regulators following suit. While calls for tightening disclosure obligations in the United States have been accompanied by a lively debate between proponents and opponents of tighter disclosure rules, the amendment of disclosure rules in Europe was not preceded by any meaningful empirical analysis of the benefits and costs of tighter disclosure rules. The result is that current European disclosure rules tilt the balance heavily against activist investors seeking to operate in Europe. In line with developments across the other side of the Atlantic, the present Article urges European regulators to reconsider the current disclosure regime by conducting a careful empirical analysis of their benefits for market transparency and fairness and their costs on shareholders and companies as a result of a reduction in the incidence of activist shareholdings.

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INTRODUCTION

Recent years have seen a tectonic shift in the power struggle between corporate insiders and shareholders.[1] Shareholder empowerment has even led scholars to conclude that the shareholder-manager agency cost problem generated by the separation of ownership and control has been largely resolved.[2] One of the reasons behind this development is the rise of a new breed of aggressive shareholder activists: hedge funds.[3] Armed with a growing war chest reaching $65.5 billion for U.S. funds and the support of proxy advisory firms and traditional institutional investors such as mutual

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1. *See Corporate Governance: Shareholders at the Gates*, ECONOMIST, Mar. 9, 2013, at 63, *available at* http://www.economist.com/news/business/21573134-americas-proxy-season-will-pit-management-against-owners-never-shareholders. Indeed, the number of proxy contests has surged from an average of seventeen per year during 1979–94 to fifty-five per year from 1994–2008. *See* Vyacheslav Fos, The Disciplinary Effects of Proxy Contests 1 (Sept. 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=1705707.

2. *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1910 (2013) (claiming that changes in market and corporate practices have brought the problem arising out of the separation of ownership and control under control). Berle and Means first observed that the separation of ownership and control in modern publicly held corporations gives rise to an agency problem as the interests of dispersed shareholder-principals and manager-agents diverge. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301, 304 (1983). Jensen and Meckling defined the costs generated by this separation as "agency costs." Agency costs include the costs of monitoring managers by shareholders, the bonding costs incurred by managers, and the residual loss incurred by shareholders. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

3. *See* Rock, *supra* note 2, at 1922.

funds and pension funds,[4] activist hedge funds are increasing their clout inside corporate boardrooms. Household names such as Apple, McDonald's, Wendy's, and Hess Corporation—previously out of the reach of activist investors, who lacked the financial resources to amass a sufficiently large stake to influence multibillion-dollar companies—have become targets of hedge fund activists, with hedge funds succeeding in changing their operational performance or corporate governance.[5]

Even though the roots of hedge fund activism can be traced back to the corporate raiders and U.S. takeover boom of the 1970s and 1980s,[6] and although the United States remains the most important market for activists, with U.S. funds dominating the global landscape,[7] hedge fund activism has been spreading in Europe, particularly after 2000.[8] Shareholder capitalism advocated by hedge funds has been shaking the traditionally insider-dominated European corporate system. For example, activists have demanded the break-up of Dutch financial institution ABN AMRO,[9] pressured the Italian oil company ENI to restructure its operations,[10] launched a proxy fight against the management of French multinational

4. *See* Jessica Toonkel & Soyoung Kim, *Activist Investors Find Allies in Mutual, Pension Funds*, REUTERS (Apr. 9, 2013, 11:25 AM), http://www.reuters.com/article/2013/04/09/us-funds-activist-idUSBRE9380DU20130409.

5. *See* Chris Burritt & Katherine Burton, *Bill Ackman Sells McDonald's Stake After Stock Surges*, BLOOMBERG (Dec. 5, 2007, 16:08), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aZ6kcnn5qqUo (reporting activist investor Bill Ackman's successful pressure on McDonald's to sell assets and increase distributions to shareholders); Michael J. de la Merced, *How Elliott and Hess Settled a Bitter Proxy Battle*, N.Y. TIMES DEALBOOK (May 16, 2013, 9:11 AM), http://dealbook.nytimes.com/2013/05/16/hess-and-elliott-settle-fight-over-companys-board/ (discussing the proxy battle and eventual settlement between Hess's management and hedge fund Elliott Management); David Englander, *Appetizing Change on the Menu*, BARRON'S (Feb. 9, 2013), http://online.barrons.com/article/SB50001424052748704372504578284040427077104.html (discussing the transformation of fast food chain Wendy's under the control of activist investor Nelson Peltz); Ben Fox Rubin, *Einhorn Sues Apple over Preferred Stock Plan*, WALL ST. J. (Feb. 7, 2013, 1:47 PM), http://online.wsj.com/article/SB10001424127887323452204578289811591849522.html (detailing the pressure exerted by activist David Einhorn over Apple to return its huge cash pile to shareholders).

6. Corporate raiders such as Carl Icahn, Nelson Peltz, and T. Boone Pickens gained notoriety during their heyday in the 1980s for acquiring controlling stakes in undervalued companies, aggressively using debt finance and their power to replace boards of directors and force companies to break up. *See generally* KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER (John C. Coffee et al. eds., 1988).

7. *Shareholder Activism Review 2012*, ACTIVIST INSIGHT, 1 (Jan. 2013), http://www.activistinsight.com/research/Activist%20Insight%20-%20Annual%20Activism%20Review%202012.pdf.

8. *See Europe's Revolting Shareholders*, ECONOMIST, May 12, 2001, at 63, *available at* http://www.economist.com/node/620394.

9. *Hedge Fund Calls for Break-Up of ABN Amro*, N.Y. TIMES DEALBOOK (Feb. 21, 2007, 7:43 AM), http://dealbook.nytimes.com/2007/02/21/hedge-fund-calls-for-break-up-of-abn-amro/.

10. Liam Moloney & Benoît Faucon, *Activist Investor Says Eni Breakup Would Add Value*, WALL ST. J. (Sept. 3, 2009, 11:59 PM), http://online.wsj.com/article/SB125192824412581143.html.

Atos,[11] and succeeded in blocking Deutsche Boerse's attempts to take over the London Stock Exchange and oust its CEO.[12]

The recent surge and growing success of hedge fund activism[13] have provoked a backlash against activism from influential corporate lawyers,[14] legal academics,[15] politicians,[16] business journalists,[17] and prominent judges.[18] Activists have been criticized as short-term speculators destroying long-term value and compromising market transparency by exploiting archaic disclosure rules allowing them to secretly accumulate influential stakes in target companies,[19] decoupling economic ownership from voting rights through the use of derivatives.[20] In response to a petition filed by

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11. Dana Cimilluca, *Chaos Surrounds Atos*, WALL ST. J. (May 23, 2008, 12:01 AM), http://online.wsj.com/article/SB121149152806915431.html.

12. For an excellent overview of this landmark shareholder revolution and its implications for German corporate governance, see Sudi Sudarsanam & Tim Broadhurst, *Corporate Governance Convergence in Germany Through Shareholder Activism: Impact of the Deutsche Boerse Bid for London Stock Exchange*, 16 J. MGMT. & GOV. 235 (2012).

13. *See* Toonkel & Kim, *supra* note 4.

14. *See* Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 26, 2013, 9:22 AM), http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/.

15. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

16. Franz Müntefering, an influential German politician, famously described hedge funds as "swarms of locusts that fall on companies, stripping them bare before moving on." *See Locust, Pocus—German Capitalism*, ECONOMIST, May 7, 2005, at 75, *available at* http://www.economist.com/node/3935994.

17. Ira M. Millstein, *Re-Examining Board Priorities in an Era of Activism*, N.Y. TIMES DEALBOOK (Mar. 8, 2013, 3:52 PM), http://dealbook.nytimes.com/2013/03/08/re-examining-board-priorities-in-an-era-of-activism/; Andrew Ross Sorkin, *Shareholder Democracy Can Mask Abuses*, N.Y. TIMES DEALBOOK (Feb. 25, 2013, 9:30 PM), http://dealbook.nytimes.com/2013/02/25/shareholder-democracy-can-mask-abuses/.

18. *See* Jack Jacobs, *Patient Capital: Can Delaware Corporate Law Help Revive It?*, 68 WASH. & LEE L. REV. 1645 (2011); Leo E. Strine, *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1 (2010).

19. Martin Lipton, *Important Questions About Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 9, 2013, 10:10 AM), http://blogs.law.harvard.edu/corpgov/2013/03/09/important-questions-about-activist-hedge-funds/.

20. *See Beneficial Ownership of Equity Derivatives and Short Positions—A Modest Proposal to Bring the 13D Reporting System into the 21st Century*, WACHTELL, LIPTON, ROSEN & KATZ (Mar. 3, 2008), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.15395.08.pdf [hereinafter *Beneficial Ownership*]. Henry Hu and Bernard Black were the first to explore and conceptualize the phenomenon of equity and risk decoupling. Pursuant to Hu and Black, risk and equity decoupling can be broken down into "empty voting" and "hidden (morphable) ownership." Empty voting refers to a situation where a person has greater voting than economic ownership. In contrast, any person who has greater economic than voting ownership is referred to as a "hidden owner" and his or her ownership as "hidden ownership." *See* Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 812 (2006); Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008); Henry T. C. Hu & Bernard Black, *Hedge Funds, Insiders and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007).

prominent U.S. law firm Wachtell, Lipton, Rosen & Katz voicing the abovementioned concerns,[21] the U.S. Securities and Exchange Commission (the SEC) is currently considering the amendment and modernization of disclosure requirements for outside blockholders.[22] Opponents of the petition point to the beneficial role of outside blockholders and especially activist hedge funds, warn about the chilling effect of the amendments on activism, and call on the SEC to carefully balance their costs and benefits.[23] Across the Atlantic, individual European countries have already tightened their disclosure rules for major shareholders, with the European Commission having recently adopted amendments to Directive 2004/109/EC (the Directive or Transparency Directive) governing disclosure of major shareholdings.[24] Alarmed by the activities of activists, European regulators hastily tightened disclosure rules for outside blockholders without considering the beneficial effects of activist investors and the crucial role that disclosure requirements play in incentivizing outside blockholders. As Gilson and Gordon have argued, current European and U.S. legislative developments alike should be understood as efforts to impose a novel defensive mechanism at a time when activists are gaining increased support by institutional investors.[25]

The aim of this Article is to offer a critique against the current European disclosure rules for major shareholdings for failing to adequately balance on the one hand the beneficial effects of activism and the adverse

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21. Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Sec'y, SEC (Mar. 7, 2011) [hereinafter Letter from Wachtell, Lipton], *available at* http://www.sec.gov/rules/petitions/2011/petn4-624.pdf.

22. *See Beneficial Ownership Reporting*, OFF. INFO. & REG. AFF. (Oct. 2013), http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201210&RIN=3235-AK42. Blockholders who amass a stake of above five percent of voting rights and intend to actively influence the governance of the target are required to file a Schedule 13D with the SEC. The information contained in a Schedule 13D filing includes a declaration of intentions by the shareholder crossing the threshold. The blockholder must describe the purpose of the acquisition of shares of the issuer and any plans that would result in certain extraordinary transactions such as a merger, reorganization, liquidation of the issuer, a sale of a material amount of assets of the issuer, a change in the dividend policy of the issuer, and any plans to change the composition of its board of directors. *See* 17 C.F.R. § 240.13d-1 (2014); *Schedule 13D*, SEC, https://www.sec.gov/answers/sched13.htm (last visited Apr. 11, 2014).

23. Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39, 59–60 (2012).

24. Council Directive 2013/50/EU, 2013 O.J. (L 294) [hereinafter Transparency Directive Amendments]; Council Directive 2004/109/EC, of the European Parliament and of the Council of 15 December 2004 on the Harmonization of Transparency Requirements in Relation to Information about Issuers Whose Securities Are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, 2004 O.J. (L 390) [hereinafter Harmonization of Transparency Directive].

25. Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights*, 113 COLUM. L. REV. 863, 904–05, 907, 911–12 (2013); *see also* Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: An Empirical Analysis of Hedge Fund Activism in Italy and Germany, and Its Evolution*, 10 EUR. CO. & FIN. L. REV. 328, 339–40 (2013).

impact of tighter disclosure rules on it and on the other hand the need for safeguarding market transparency. Part I examines the key role that hedge funds play in modern capital markets and corporate governance and describes the demands and tactics used by activists to achieve their goals. Part II explores the promises and perils of hedge fund activism. Empirical studies have documented the beneficial effects of hedge fund activism on corporate governance and performance, casting doubt on the popular image of activists as short-term agitators. Nonetheless, the tactics used by activists to accumulate their stakes often compromise market transparency and fairness. Part III explains the crucial role that disclosure rules play in incentivizing hedge funds to engage in activism and critiques the current European disclosure regimes as failing to adequately balance the beneficial effects of activism against the need to enhance market transparency. In line with calls by U.S. academics stressing the necessity of empirical analysis before proceeding with the tightening of disclosure obligation for major blockholders in the United States, Part III also urges European regulators to reconsider the current disclosure obligations imposed on activist shareholders and conduct a careful empirical analysis of the benefits and costs of tighter disclosure obligations.[26]

I. HEDGE FUND ACTIVISTS AND CORPORATE GOVERNANCE

A. HEDGE FUNDS AS GOVERNANCE ARBITRAGEURS[27]

Modern shareholder activism began in the United States during the 1970s and 1980s, with individual investors such as Carl Icahn and Nelson Peltz amassing controlling positions and aggressively agitating for actions that would grant them short-term gains.[28] Faced with collective action problems, however, individual shareholders largely abstained from becoming involved in corporate governance.[29] With the U.S. hostile takeover wave fading away in the late 1980s,[30] attention turned to the other

26. Bebchuk & Jackson, *supra* note 23, at 59–60.

27. The term "governance arbitrageurs" was coined by Gilson & Gordon, *supra* note 25, at 896.

28. *See generally* KNIGHTS, RAIDERS, AND TARGETS, *supra* note 6.

29. Two related problems make shareholders passive and rationally apathetic in widely held firms. First, while a shareholder who wishes to become involved in corporate governance must bear the costs of its efforts, including monitoring costs and the costs of launching a proxy campaign, it receives only a pro rata share of the gains if its actions are successful, allowing other shareholders to free-ride on its efforts. Second, knowing that its vote will not affect the outcome, an individual shareholder does not have an incentive to carefully consider a proposal submitted to a vote. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 63–89 (1991); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 526–30 (1990).

30. The U.S. takeover boom lasted from 1984 until 1989 and was characterized by a surge in hostile takeovers and leveraged buyouts. *See* PATRICK GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 57–63 (5th ed. 2011). Hostile takeovers were viewed as the

powerful players in capital markets: institutional investors, and most prominently, mutual funds and pension funds.[31] It was argued that institutional investors as outside blockholders had the incentives to engage in monitoring and intervene in the companies in which they invested.[32] Nonetheless, the promise remained unfulfilled. Nearly two decades afterwards, researchers concluded that the impact of institutional investors on corporate governance and performance was negligible.[33]

Legal barriers, conflicts of interest, and a business model fundamentally incompatible with activism make institutional investor intervention "incidental" and "ex post."[34] Regulatory constraints include diversification

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ultimate disciplinary mechanism against managerial incompetence and self-interest. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965). Multiple factors contributed to the end of the takeover boom, including the economic slowdown starting in 1989; the collapse of Drexel Burnham Lambert, an investment bank specialized in financing takeovers; the enactment of anti-takeover statutes by state legislatures; and the endorsement of takeover defenses by the courts of the state of Delaware, where the majority of public corporations have been incorporated following a series of landmark court decisions. *See* Steven M. Davidoff, *Takeover Theory and the Law and Economics Movement*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATION LAW 216 (Claire Hill & Brett McDonnell eds., 2012).

31. Bernard S. Black, *Agent Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1990). Institutional investors and especially mutual funds and pension funds have come to dominate modern capital markets. In 2009, over 50% of U.S. public equities were held by institutional investors. *See* Matteo Tonello & Stephan Rabimov, *The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition* 22 tbl.10 (Conference Bd., Research Report No. R-1468-10-RR, 2010), *available at* http://ssrn.com/abstract=1707512. Institutional ownership is also prevalent in the United Kingdom, reaching 80% of listed equities and rapidly spreading in continental Europe, reaching for instance 25% in Italy and 29% in Germany. *See* Paolo Santella et al., A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in the EU and in the US 12 (July 2, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1137491.

32. A large shareholder is able to spread the costs associated with monitoring and intervention over a larger share and capture higher gains from its intervention. Furthermore, its substantial voting rights allow it to pressure and potentially remove management through a proxy fight or takeover. *See* Andrei Shleifer & Robert Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 461 (1986); Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 754 (1997).

33. As a legal academic concluded in 1998, "[t]he evidence to date suggests that activism, American style, has had little effect on firm performance." *See* Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459 (Peter Newman ed., 1998). Similarly, in their survey of empirical studies regarding institutional shareholder activism, Gillan and Starks conclude that activism has little impact on improving long-term stock performance or the operating performance of targeted companies. *See* Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, J. APPLIED CORP. FIN., Winter 2007, at 55. In their examination of shareholder proposals submitted in Europe, Cziraki, Renneboog, and Szilagyi find that proposal submissions are rare in Europe and are associated with negative market reactions. *See* Peter Cziraki et al., *Shareholder Activism Through the Proxy Proposals: The European Perspective*, 16 EUR. FIN. MGMT. 738 (2010).

34. Traditional institutional investor activism seeks to safeguard the value of pre-existing investments. Thus, institutional investors will engage in activism only in case a company already

requirements for mutual and pension funds[35] and requirements for daily liquidity for open-ended mutual fund investors,[36] inhibiting their ability to invest in large illiquid positions. Conflicts of interest are particularly severe for pension funds, with public pension funds subject to political pressure and private pension fund managers seeking to obtain and maintain business from their corporate clients.[37] The fundamental explanation for the reluctance of mutual and pension funds to invest in activism is their business model, which prioritizes the quest for relative returns.[38] Mutual fund and pension fund managers are judged against their performance relative to their peers.[39] A manager engaging in activism must bear all of the costs of the effort while sharing the gains with its competitors who hold shares in the target company.[40] As a result, the manager's performance relative to its competitors will decline. Thus, even though activism would increase the value of the company and benefit beneficiaries, managers are hesitant to engage in it.

It is this governance shortfall that hedge funds as *governance arbitrageurs* seek to exploit. With institutional investors paralyzed and unable to invest in profitable activism, activists specialize in searching for

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part of the institution's portfolio is either underperforming or in need of a shake-up in its corporate governance. *See* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 52, 56 (2011); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1069 (2007).

35. For instance, the Investment Company Act of 1940 prohibits mutual funds that wish to advertise themselves as diversified from putting more than 5% of their regulated assets in the securities of any one issuer and including in the regulated part of their portfolios more than 10% of the stock of any company. *See* 15 U.S.C. § 80a-5(b) (2012). Similarly, by virtue of the Employee Retirement Income Security Act of 1974 (ERISA), private pension funds are required to be diversified. *See* 29 U.S.C. § 1104; *see also* Mark Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 19–21, 24–25 (1991) (summarizing the various diversification limits imposed on U.S. mutual funds and private pension funds). Similar requirements are imposed for EU mutual funds by the Undertakings for Collective Investments in Transferable Securities Directive (UCITS Directive). *See, e.g.*, Directive 2009/65/EC, of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), art. 52 § 1(a), 2009 O.J. (L 302), 32, 63 [hereinafter UCITS Directive] (prohibiting mutual funds from investing more than 5% of their assets in shares of the same issuer). For individual European countries' regulations regarding diversification requirements for pension funds, see ORG. FOR ECON. DEV. & COOPERATION, ANNUAL SURVEY OF INVESTMENT REGULATION OF PENSION FUNDS (2013), *available at* http://www.oecd.org/daf/fin/private-pensions/InvRegPensionFunds2013.pdf.

36. For European regulations, see UCITS Directive, *supra* note 35, art. 1 § 2(b); for U.S. regulations, see 15 U.S.C. § 80a-5(a)(1).

37. For an excellent investigation of the conflicts of interests plaguing institutional investors, see Black, *supra* note 29, at 595–608.

38. JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING: FINAL REPORT 39–42 (2012), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf.

39. *See id.* at 42.

40. Gilson & Gordon, *supra* note 25, at 890–93.

undervalued[41] and poorly governed firms and agitating for operational or governance improvements as outside blockholders. Unconstrained by restrictive regulation,[42] with high-powered performance incentives[43] and free of conflicts of interest, hedge funds are able to amass large illiquid positions falling short of control blocks and typically below ten percent of target stock,[44] engaging in costly and time-consuming efforts to propose and aid in the implementation of changes in target companies.[45] In contrast to traditional institutional investor activism, hedge funds invest in order to engage in activism.[46] Their activism, therefore, is "strategic" and "ex ante."[47] Belonging to the group of value investors,[48] hedge fund activists

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41. *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, 63 J. FIN. 1729, 1741 (2008); Alon Brav et al., *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS FIN. 185 (2009) (finding that activists target firms with low market values relative to their book values).

42. Hedge funds are not subject to any diversification requirements, allowing them to concentrate their investments in a limited number of influential positions in target companies. The recent surge in assets under management has allowed activists to amass influential stakes in ever-bigger companies. *See* Anupreeta Das & Sharon Terlep, *Activist Fights Draw More Attention*, WALL ST. J. (Mar. 18, 2013, 11:23 PM), http://online.wsj.com/article/SB10001424127887324392804578360370704215446.html. Furthermore, in contrast to open-ended mutual funds, hedge fund managers grant investors limited withdrawal rights. Activist funds lock up investor capital for an initial period of eighteen months to two years, with several funds adopting longer lock-ups. *See* Azam Ahmed, *For Activist Funds, a Long-Term Approach to Investing*, N.Y. TIMES DEALBOOK (Dec. 20, 2010, 7:45 AM), http://dealbook.nytimes.com/2010/12/20/for-activist-funds-a-long-term-approach-to-investing/; David Nissenbaum & Maria Gabriela Bianchini, *Activist Fund Structuring*, SCHULTE ROTH & ZABEL LLP, 2 (2005), http://www.srz.com/files/News/dc23f4b9-405a-429e-be30-793a1098068a/Presentation/NewsAttachment/71f8978a-ad95-4fef-b535-8629c46fe223/filesfilesai-spring-05-nissenbaum.pdf. Furthermore, hedge funds allow investor withdrawals only during a quarterly or semiannual redemption period and after prior notice. Other mechanisms that hedge funds utilize to ensure liquidity are gates on withdrawals, which limit the amount that can be withdrawn during any redemption period to a specified percentage of the fund's capital. Additionally, activists often place illiquid investments in companies in a *side pocket* account. Investors are not allowed to withdraw their capital from the side pocket until the investment is liquidated. *See* DAVID P. STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS AND PRIVATE EQUITY: THE NEW PARADIGM 213–14 (2010).

43. While mutual funds are compensated on the basis of the assets under management, hedge fund compensation consists of both a management fee, ranging from one to two percent of the assets under management, and an incentive fee, usually set at twenty percent of the fund's profits and widely known as "carried interest." Carried interest creates a powerful incentive for hedge funds to seek absolute performance. *See* Ludwig Chincarini, *Hedge Funds—An Introduction*, *in* RESEARCH HANDBOOK ON HEDGE FUNDS, PRIVATE EQUITY AND ALTERNATIVE INVESTMENTS 13, 24 (Claire Hill & Brett McDonnell eds., 2012).

44. *See* Lucian Bebchuk et al., *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1, 12 (2013) (examining all 13D filings by activist hedge funds in the United States from 1994 until 2007 and finding that activists acquire an average stake of 8.8% and median of 6.3%).

45. *See infra* note 158.

46. Cheffins & Armour, *supra* note 34.

47. Kahan & Rock, *supra* note 34.

48. Activists hold relatively few concentrated positions in target companies and rarely hedge their positions. Their managers and employees are usually former investment bankers and research analysts accustomed to fundamental analysis. The crucial difference between hedge fund activists

conduct diligent research with the aim of spotting targets that will benefit from intervention and identify the changes that will unlock shareholder value.[49] The most common propositions of activists are a sale of the target, return of excess cash,[50] sale or spin-offs of unrelated assets and refocusing corporate strategy,[51] improvements in firm governance,[52] and changes in the target's long-term business plan.[53]

B. GOVERNANCE MECHANISMS: VOICE OR EXIT?

1. Voice

In his landmark treatise, Hirschman emphasized that members of an organization, be it a firm, a nation, or any other collective, have two options when faced with a deterioration in the quality of the organization: either *exit*, namely through withdrawal from the organization, or *voice* their dissatisfaction and attempt to remedy the flaws in the organization by communicating their own proposals.[54] It is for their ability to exercise *voice* instead of selling their shares and voting with their feet by following the practice known as the "Wall Street Walk" that hedge funds have been praised.

Gantchev models hedge fund activism as a sequential process with three different stages: demand negotiations, board representation, and proxy

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and value investors, such as Warren Buffett, is their willingness to adopt an aggressive stance against target management who refuse to implement their propositions. *See* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1383 (2007).

49. Gilson & Gordon, *supra* note 25, at 902.

50. Michael Jensen famously pointed to the agency costs generated by free cash flow, namely cash flow in excess of that required for financing all positive net present value projects. Managers will waste free cash flow in suboptimal projects or hold it on the firm's balance sheet, insulating themselves from the discipline of capital markets. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986). Indeed, empirical studies confirm that firms targeted by activists tend to be profitable but low-growth firms with healthy operating cash flow and low payouts to shareholders. *See* Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, *supra* note 41, at 1753.

51. Deconglomerization gained traction during the 1970s and 1980s after the abysmal performance of conglomerates created during the 1960s. A variety of studies have shown that conglomerates are associated with a "diversification discount" reaching fifteen percent. *See* Philip G. Berger & Eli Ofek, *Diversification's Effect on Firm Value*, 37 J. FIN. ECON. 39, 59–60 (1995); Henri Servaes, *The Value of Diversification During the Conglomerate Merger Wave*, 51 J. FIN. 1201 (1996). Apart from demanding the break-up of conglomerates, activists also advocate the sale or spin-off of unessential and underperforming divisions of a multidivisional firm operating in a single industry. *See* Bratton, *supra* note 48, at 1392–93.

52. Increasingly, activists are demanding the dismantling of takeover defenses with the ardent support of mainstream institutional investors. *See* Matteo Tonello, *Poison Pills in 2011*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (April 3, 2011, 9:49 AM), http://blogs.law.harvard.edu/corpgov/2011/04/03/poison-pills-in-2011/.

53. *See* Bratton, *supra* note 48, at 1390–97; Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, *supra* note 41, at 1741–44.

54. *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).

fight.[55] An activism campaign begins with the filing of a regulatory form announcing the crossing of a specified ownership threshold and the intentions of the activist.[56] Then follows the demand negotiations stage, where the activist communicates its demands and negotiates directly with management.[57] If its demands are rejected, the activist requests board representation and threatens to launch a proxy fight.[58] If management still resists, then the activist moves to the final and most aggressive stage: the commencement of a proxy fight.[59] Crucially, the activist lacking a controlling position in the target has to gather the support of other shareholders—mainly institutional investors.[60] As Gilson and Gordon note, after publicly announcing its presence, the activist will start a nonpublic campaign seeking to convince institutional investors to support its demands.[61] Thus, the activist will move from a less to a more confrontational stage only after it makes a positive assessment about the likelihood of support from traditional institutional investors, with the last stage—a proxy fight—being in essence an official referendum on the activist's proposals.[62]

2. Exit

While exit has been treated as an alternative to activism exercised through voice and therefore inconsistent with it,[63] a recent strand of academic research has recognized exit as another powerful governance

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55. Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 613–14 (2013).

56. *Id.*

57. *Id.* Activists targeting continental European companies, which are often controlled by majority shareholders, tend to cooperate with controlling shareholders. Furthermore, the engagement is usually private, with the proxy fight stage being infrequent. *See* Marco Becht et al., *The Returns to Hedge Fund Activism: An International Study* 3 (Eur. Corporate Governance Inst., Working Paper No. 098/2008, 2013), *available at* http://www.bc.edu/content/dam/files/schools/csom_sites/finance/Franks-031313b.pdf.

58. Gantchev, *supra* note 55.

59. *Id.* at 614.

60. *See* Ruth Sullivan, *Traditional Investors Adopt Activism*, FIN. TIMES (May 5, 2013, 6:14 AM), http://www.ft.com/intl/cms/s/0/62d5ea16-b253-11e2-a388-00144feabdc0.html. Institutional ownership in the top 1000 U.S. corporations has reached an average of seventy-three percent. *See* Tonello & Rabimov, *supra* note 31.

61. Gilson & Gordon, *supra* note 25, at 899–901. Indeed, Brav, Jiang, Partnoy, and Thomas find that activists tend to target companies with high institutional ownership. *See* Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, *supra* note 41, at 1753.

62. Management will also make the same assessment in deciding whether to accept or reject the activist's demands. *See* Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, *supra* note 41, at 1764.

63. *See, e.g.*, John Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (arguing that liquidity impairs activism and voice by making it easier for institutional investors to immediately sell their shares and follow the "Wall Street Walk"); *see also* IRIS H-Y CHIU, THE FOUNDATIONS AND ANATOMY OF SHAREHOLDER ACTIVISM 7 (2010); *see generally* Amar Bhide, *The Hidden Costs of Stock Market Liquidity*, 34 J. FIN. ECON. 31 (1993).

mechanism.[64] Sales of stock by dissatisfied blockholders hurt the manager that has a substantial amount of its compensation tied to stock price performance[65] ex post by lowering stock prices and consequently its wealth. Ex ante, the threat of exit plays a disciplinary role by inducing the manager to enhance firm value.[66] In contrast with previous literature that treats liquidity as harmful for impairing activism by making exit easier,[67] viewing exit as a governance mechanism implies that liquidity is in fact beneficial. First, liquidity encourages initial block formation by allowing a blockholder to buy additional shares without causing any price impact.[68] Second, it facilitates more trading by blockholders and consequently strengthens governance through exit.[69] Indeed, Edmans, Fang, and Zur, using a sample of activist hedge fund block acquisitions from 1995 to 2010, find that liquidity increases the likelihood of block acquisition.[70] Although it reduces the likelihood that the activist files a Schedule 13D rather than a 13G, thus inhibiting voice, liquidity encourages governance through exit.[71] Confirming the governance role of exit, they find that the filing of a 13G is

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64. *See, e.g.*, Anat. R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2445 (2009); Alex Edmans, *Blockholder Trading, Market Efficiency and Managerial Myopia*, 64 J. FIN. 2481 (2009); Alex Edmans & Gustavo Manso, *Governance Through Trading and Intervention: A Theory of Multiple Blockholders*, 24 REV. FIN. STUD. 2395 (2011).

65. The rise of pay-for performance can be traced back to the 1980s and recognition of the powerful role that equity-based compensation plays in incentivizing managers to act in the shareholders' interests. *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990). It is now an indisputable fact that a substantial amount of executive compensation is either granted in stock and stock options or is equity-linked. *See* Martin J. Conyon et al., *The Executive Compensation Controversy—A Transatlantic Analysis* 47 (Inst. for Compensation Studies, Working Paper No. 002, 2011), *available at* http://digitalcommons.ilr.cornell.edu/ics/5/ (finding that at the end of 2006, the median U.S. CEO held stock and options worth 9.7 times his or her cash compensation, with the ratio for European CEOs being 4.4).

66. Alex Edmans, *Blockholders and Corporate Governance* 2–3 (Nat'l Bureau of Econ. Research, Working Paper No. 19573, 2013), *available at* http://www.nber.org/papers/w19573.pdf.

67. *See* LESTER THUROW, HEAD TO HEAD: THE COMING ECONOMICS BATTLE AMONG JAPAN, EUROPE AND AMERICA (1993); Coffee, *supra* note 63; Michael Porter, *Capital Disadvantage: America's Failing Capital Investment System*, 70 HARV. BUS. REV. 65 (1992).

68. Ernst Maug, *Large Shareholders as Monitors: Is There a Tradeoff Between Liquidity and Control?*, 53 J. FIN. 65 (1998).

69. Alex Edmans et al., *The Effect of Liquidity on Governance*, 26 REV. FIN. STUD. 1443, 1444 (2013).

70. *Id.* at 1457–60.

71. The effect is especially strong for firms with high managerial incentives. *See id.* at 1460–61. A Schedule 13D is filed by a blockholder who intends to become active in the governance of the company, while a Schedule 13G is filed by a blockholder who holds the securities as passive investment and does not intend to change or influence control over the issuer. *See* 17 C.F.R. § 240.13d-1 (2014).

associated with positive abnormal returns around the filing date and improved operating performance after the filing.[72]

II. THE PROMISE AND PERILS OF HEDGE FUND ACTIVISM

A. THE PROMISE OF HEDGE FUND ACTIVISM

Law and finance literature has univocally recognized the benefits of large outside blockholders, and especially activist hedge funds, in improving corporate governance and operational performance of target companies.[73] By amassing a large stake, blockholders are able to spread the costs of their activism and reap higher gains from their efforts.[74] Consequently, blockholders are sufficiently incentivized to gather costly information, engage in monitoring, and invest in activism. Ex post, a blockholder will discipline management for suboptimal performance. Ex ante, the threat of a blockholder acquiring a stake motivates management to exert greater efforts and improve performance.[75] Crucially, the gains from monitoring or successful intervention will be reaped by all shareholders of the target company.[76] It is here where modern activists diverge from the "raiders" of the 1980s, who sought to take control of the company, then strip it of its assets or convince the company to buy back their stock at a large market premium, keeping the gains solely for themselves.[77] What is more, in cases of corporations dominated by controlling shareholders where the agency cost shifts from being one between managers and shareholders to one between controlling and minority shareholders,[78] activist initiatives

72. Edmans et al., *supra* note 69, at 1461–66. The stock price spike represents the market's anticipation of governance benefits from the presence of a blockholder who can exert governance through exit. This anticipation is confirmed by subsequent improved operating performance.

73. *See generally* Brav et al., *Hedge Fund Activism: A Review*, *supra* note 41.

74. Shleifer & Vishny, *Large Shareholders and Corporate Control*, *supra* note 32; Shleifer & Vishny, *A Survey of Corporate Governance*, *supra* note 32, at 753–54.

75. Bebchuk et al., *supra* note 44, at 12.

76. Bebchuk & Jackson, *supra* note 23, at 50.

77. *See* John Coffee, *supra* note 63. The practice of greenmail by "raiders" was prevalent during the takeover wars of the 1980s. Raiders would buy a large stake in the target company and under the threat of a hostile takeover coerce the target into buying back the raiders' stake at a substantial premium to the market price without extending the offer to all target shareholders. *See* David Manry & David Stangeland, *Greenmail: A Brief History*, 6 STAN. J.L. BUS. & FIN. 217, 222 (2001).

78. In a concentrated ownership structure, the controlling shareholder will have both the incentives and the power to discipline management and minimize the agency costs between shareholders and management. However, the controlling shareholder will have its own interests and may use its control rights in order to expropriate other shareholders. *See* REINIER R. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 22 (2004); Shleifer & Vishny, *A Survey of Corporate Governance*, *supra* note 32, at 758. The standard narrative views the dispersed ownership model prevailing in the United States and United Kingdom as the exception, with concentrated ownership being the rule around the world and especially in Continental Europe. *See* Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999) (the seminal paper on this topic). Nonetheless, this view

are aimed at curbing private benefit extraction by controlling shareholders.[79] Hedge fund activists seek to discipline controlling shareholders by cooperating with fellow minority shareholders and utilizing the protective tools granted by the legal regime to minority shareholders.[80]

Consistent with the theory that highlights the beneficial role of activists for shareholders, various studies have univocally documented significant positive abnormal returns upon the announcement of the presence of an activist hedge fund.[81] The price increase reflects the market's expectation of

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of the world is rather outdated. The spread of globalization, the liberalization of capital flows, the rise of institutional investors, and regulatory changes have fundamentally transformed corporate structures in Continental Europe. For instance, Germany, once considered a hallmark of concentrated ownership, is increasingly moving towards a dispersed ownership structure. According to the Federal Agency for Public Education, German companies included in the DAX-30 index and representing Germany's thirty largest companies by market capitalization exhibit an average free-floating share capital of 82.6%. *See Aktionärsstruktur von DAX-Unternehmen*, BUNDESZENTRALE FÜR POLITISCHE BILDUNG (Sept. 25, 2010), http://www.bpb.de/nachschlagen/zahlen-und-fakten/globalisierung/52596/aktionaersstruktur-dax. For similar changes in the French corporate governance model, see Michel Goyer & Dong Kwan Jung, *Diversity of Institutional Investors and Foreign Blockholdings in France: The Evolution of an Institutionally Hybrid Economy*, 19 CORP. GOVERNANCE: INT'L REV. 562 (2011); Michel Goyer, *The Transformation of Corporate Governance in France*, BROOKINGS INSTITUTION (Jan. 2003), http://www.brookings.edu/~/media/research/files/articles/2003/1/01france%20goyer/goyer.pdf.

79. The term "private benefits of control" refers to some value that is enjoyed exclusively by the controlling shareholders and is not shared with other shareholders. Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 537–41 (2004). One can distinguish between pecuniary and non-pecuniary private benefits of control. Pecuniary private benefits involve the extraction or shifting of real resources from the company to the controlling shareholder. Apart from outright theft consumption, pecuniary benefits can take the form of related-party transactions, consumption of perquisites, or dilution of minority shareholder interests. Non-pecuniary benefits, such as the social status achieved by the control of a large corporation, are a form of psychic benefits that involve no real transfer of company resources. *See* Pierre-Henri Conac et al., *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy*, 4 EUR. COMPANY & FIN. L. REV. 491, 495–96 (2007); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1663–64 (2006).

80. See Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy* 22–31 (Eur. Corporate Governance Inst., Working Paper No. 225/2013, 2014), *available at* http://ssrn.com/abstract=2325421 (documenting instances where hedge fund activists have sought to curb the extraction of private benefits in Italian companies typically controlled by a major shareholder). Activists have cooperated with other minority shareholders and utilized the legal tools available in the Italian legal regime for the protection of minority shareholders. The demands of hedge funds have ranged from changes in the company strategy, to suggesting or opposing specific transactions and pushing for alteration of the financial structure or dividend policy of firms. *Id.*

81. A large body of empirical work has firmly documented the initial price spike. In their study of over 2000 activist interventions in the United States from 1994–2007, Bebchuk, Brav, and Jiang find large average abnormal returns approximately 6% in a forty-day window around the filing of a Schedule 13D announcing the presence of an activist hedge funds. *See* Lucian A. Bebchuk et al., *The Long-Term Effects of Activism* 16 (Columbia Bus. Sch., Research Paper No. 13-66, 2013), *available at* http://www.columbia.edu/~wj2006/HF_LTEffects.pdf. Similar results are reached by other studies; *see* Brav et al., *supra* note 41, at 1729 (finding average abnormal returns between 7–8% for activist interventions in the United States); Robin Greenwood &

improved firm value resulting from the activist's involvement, adjusted for the probability of success of its campaign.[82] Opponents of activism view the initial price spike as a result of inefficient market pricing that fails to incorporate the long-term costs of activism.[83] Therefore, one should expect the positive disclosure abnormal returns to be followed by negative long-term stock returns, making shareholders worse off. Nonetheless, in their comprehensive study of activist interventions in the United States from 1994–2007, Bebchuk, Brav, and Jiang examine stock returns in the five years after the initial stock price increase and during the three-year period following the activist's exit, documenting no such pattern of negative returns reversing the initial positive abnormal returns.[84]

The market's expectation of increased firm value resulting from the activist's intervention is largely confirmed by subsequent improvements in operational performance.[85] The study by Bebchuk, Brav, and Jiang, using as performance metrics the Return on Assets (ROA) and Tobin's *q*, documents that activists target companies whose operating performance at the time of intervention trails that of their industry peers or their own historical levels.[86]

Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362 (2009) (examining activism in the United States and documenting average abnormal returns around 3.5% over a fifteen-day window); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (examining confrontational activist interventions in the United States and documenting returns reaching 10.2% around a 13D filing). Large abnormal returns have been documented for activist interventions in Europe as well. *See* Marco Becht et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, 22 REV. FIN. STUD. 3094 (2009) (examining activist interventions from the Hermes UK Focus Fund and finding positive abnormal returns around the announcement of changes following the engagement); Marco Becht et al., *Hedge Fund Activism in Europe* (Eur. Corporate Governance Inst., Working Paper No. 283/2010, 2010), *available at* http://www.ecgi.org/tcgd/2011/documents/Becht-Franks-Grant%20Hedge%20Fund%20Activism %20in%20Europe%202010.pdf (analyzing a database of European activist interventions and finding mean abnormal returns of 4.4% around the disclosure date); *see also* Bebchuk et al., *supra*, at 19–20 (examining a large database of shareholder activist interventions in North America, Europe, and Japan and finding disclosure abnormal returns around 7.5%).

82. Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, *supra* note 41, at 1757.

83. *See* Lipton, *supra* note 19.

84. *See* Bebchuk et al., *The Long-Term Effects of Activism*, *supra* note 81. Indeed, studies have found that the market not only correctly anticipates initial gains from intervention, but that it actually undervalues the benefits conferred by activism and the probability of its success as well. *See* Bebchuk et al., *supra* note 81, at 20–23; Greenwood & Schor, *supra* note 81, at 366–68.

85. Although many doubt the expertise and skill of hedge fund activist managers in improving operations, one should note that directors nominated on a target's board by activists are predominantly successful executives having expertise in the relevant industry. *See, e.g.*, Michael J. de la Merced, *Yahoo Shakes Up Its Board and Adds PayPal Co-Founder*, N.Y. TIMES DEALBOOK (Dec. 13, 2012, 10:38 AM), http://dealbook.nytimes.com/2012/12/13/yahoo-said-to-plan-board-shake-up-adding-levchin/ (discussing activist Daniel Loeb's push for including experienced executives on Yahoo's board and executive positions); de la Merced, *supra* note 5 (reporting Elliott's proxy fight with Hess's management and the profile of Elliott's slate consisting of experienced, former high-level executives).

86. Bebchuk et al., *The Long-Term Effects of Activism*, *supra* note 81, at 7–13.

Indeed, targets experience a constant decline in operating performance during the three years prior to the engagement.[87] However, they markedly outperform their peers during the five years following the intervention, with operating performance exceeding the intervention-year level in each year.[88] The beneficial effects of activism are corroborated by Brav, Jiang, and Kim, who use data about the performance of U.S. manufacturing plants owned by firms targeted by hedge fund activists and find that the productivity of target firms' plants declines substantially during the two years prior to the intervention and then rebounds sharply during the two years afterward.[89] Furthermore, underperforming plants sold after the activist intervention experience a substantial increase in productivity and profitability in the hands of the new owners.[90] These results indicate that activists are skilled at efficiently reallocating corporate assets.

Contrary to the proposition that the value created by activism derives from increased operating performance, Greenwood and Schor find in their sample of activist interventions in the United States from 1993–2006 that announcement returns to activism are significant, mainly in instances where the target is acquired within eighteen months of the initial intervention.[91] As a result, they argue that the positive average abnormal returns reflect the market's expectation that the activist will put the firm in play and succeed in getting the target acquired at a premium to the current stock price.[92] Thus, the real skill of activists lies in brokering deals. The evidence should not be viewed negatively and should take into account the gains reaped by target shareholders from selling at a premium to the market price and the tendency of target management to resist a takeover.[93]

Activists are also increasingly successful in pushing for governance changes in target companies. With the support of institutional investors, hedge funds in the United States are increasingly agitating for the

87. *Id.*
88. *Id.*
89. Alon Brav et al., *The Real Effects of Hedge Fund Activism: Productivity, Risk and Product Market Competition* 2–3 (Nat'l Bureau of Econ. Research, Working Paper No. 17517, 2011), *available at* http://www.nber.org/papers/w17517.pdf.
90. *Id.*
91. Greenwood & Schor, *supra* note 81, at 368–70.
92. *Id.* at 363.
93. A prominent example was Yahoo's rejection of Microsoft's hostile bid at a substantial premium in 2008 under the leadership of Yahoo's co-founder and then-imperial CEO, Jerry Yang. Activist Carl Icahn pressured Yahoo to accept the offer under the threat of a proxy fight. Although the deal collapsed, Icahn and another hedge fund investor, Daniel Loeb, agitated for governance changes in Yahoo, including the resignation of Jerry Yang from the board of Yahoo and any executive position with the company. *See* STEVEN DAVIDOFF, GODS AT WAR: SHOTGUN TAKEOVERS, GOVERNMENT BY DEAL, AND THE PRIVATE EQUITY IMPLOSION 187–95 (2009); Amir Efrati et al., *Founder Severs Ties to Yahoo*, WALL ST. J. (Jan. 18, 2012), http://online.wsj.com/article/SB10001424052970204555904577167251792053494.html.

dismantling of takeover defenses or their subjection to a shareholder vote.[94] Furthermore, in their studies of activist engagements, Klein and Zur, as well as Brav, Jiang, Partnoy, and Thomas, find increases in leverage and the payout ratio in target firms following the activist intervention, indicating that hedge funds ameliorate the agency problem of free cash flow.[95] Additionally, hedge fund activism is associated with an increase in CEO turnover rate and pay-for-performance sensitivity of CEO compensation.[96]

B. THE DARK SIDE OF HEDGE FUND ACTIVISM

Critics of hedge fund activism view hedge funds as short-term speculators who agitate for changes that will earn them a quick profit at the expense of long-term value.[97] Holding their shares for a short time period, so the argument goes, hedge funds are able to exit their investments at a profit long before the negative consequences of their actions have materialized, leaving employees and long-term shareholders worse off.[98] As Leo Strine has observed, activists "can easily depart and not eat their own cooking."[99] Thus, activists exacerbate short-termism in financial markets, which are increasingly dominated by short-term investors in search of quick returns.[100]

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94. Various studies have associated takeover defenses with lower firm value. *See* Lucian Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005); Lucian A. Bebchuk et al., *Staggered Boards and the Wealth of Shareholders: Evidence from Two Natural Experiments* (Nat'l Bureau of Econ. Research, Working Paper No. 17127, 2011), *available at* http://www.nber.org/papers/w17127.pdf (finding that staggered boards lead to lower firm value). *See also* Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009) (constructing an entrenchment index consisting of six provisions, including the adoption of a staggered board and poison pill, and concluding that the entrenching provisions are correlated with lower firm value). However, one should note that these studies do not prove a direct causation between takeover defenses and lower firm value. Indeed, takeover defenses are beneficial in cases where management can negotiate a better deal for shareholders as a result of its increased negotiating power and has strong reasons to believe that the long-term value of the company is higher than the current value placed by the bidder. A recent example was Airgas's strong resistance against Airproduct's hostile bid. After Airproduct withdrew its offer, Airgas saw a substantial increase in its stock price, indicating that management's belief that Airproduct's offer was undervaluing the company was correct. *See* Steven Davidoff, *Winners & Losers in the Airgas Poison Pill Case*, N.Y. TIMES DEALBOOK (Feb. 26, 2011, 12:44 PM), http://dealbook.nytimes.com/2011/02/16/who-won-in-the-airgas-poison-pill-case/.

95. *See* Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, *supra* note 41, at 1770–73; Klein & Zur, *supra* note 81, at 222–25.

96. *See* Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, *supra* note 41, at 1776.

97. *See* Lipton, *supra* note 14.

98. Millstein, *supra* note 17; Sorkin, *supra* note 17.

99. *See* Strine, *supra* note 18, at 8.

100. *See* Rebecca Darr & Judith Samuelson, *Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management*, ASPEN INST., 2–3 (Sept. 9, 2009), http://www.aspeninstitute.org/sites/default/files/content/docs/bsp/overcome_short_state0909.pdf.

However, as noted above, in their empirical study of hedge fund interventions, Bebchuk, Brav, and Jiang find that contrary to claims that activism is harmful for long-term firm value, activists are able to create sustainable, long-term improvements in the company's share price and operational performance.[101] What is crucial to understand is that activist hedge funds are not controlling shareholders able to impose their desired changes in the company's strategy or governance, but rather large influential shareholders who invest in monitoring and proposing value-enhancing changes to other shareholders.[102] The shareholders on whose support hedge funds count to implement their agenda are traditional institutional investors—predominantly mutual funds and pension funds with long-term investment horizons that hold shares for a long period of time.[103] Although mutual funds and pensions are reluctant to engage in activism, they are increasingly adopting transparent voting policies and scrutinizing proposals submitted for a vote.[104] What is more, the popular belief that hedge fund activists are short-term investors holding stocks for a short period of time does not correspond to reality. Indeed, Brav, Jiang, Partnoy, and Thomas find an average holding period of twenty-two months for activists targeting U.S. companies,[105] while Becht, Franks, and Grant report

101. *See* Bebchuk et al., *The Long-Term Effects of Activism*, *supra* note 81.

102. Indeed, Bebchuk, Brav, Jackson, and Jiang document that the average activist stake reaches 8.8%, with a median of 6.3%. *See* Bebcuk et al., *supra* note 44. Although the stake is large enough to incentivize the activist to engage in activism, it is too small to guarantee the activist's prevalence in a proxy fight or the adoption of shareholder proposals submitted by him or her. This is also true in cases where the activists seek to discipline a controlling shareholder. In order to counteract the power of the controlling shareholder, the activists will often cooperate with other shareholders. *See, e.g.*, Belcredi & Enriques, *supra* note 80, at 22–31.

103. Despite the popular perception of ever-increasing turnover rates and diminishing holding durations of equities, empirical evidence suggest that these changes are driven by a small subset of hyperactive traders such as high-frequency traders. *See* Mark Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977 (2013). Indeed, Cremers, Pareek, and Sautner find that institutional investor holding durations from 1985 until 2010 have in fact increased over time from 1.2 years in 1985 to 1.5 years in 2010, with pension funds having the longest duration, reaching approximately 1.7 years. *See* Martin Cremers et al., Stock Duration and Misvaluation (Sept. 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=2190437.

104. *See* Toonkel & Kim, *supra* note 4. The shift in the way that institutional investors cast their votes became evident when Lawrence Fink, the co-founder and CEO of Blackrock, the world's largest asset manager and one of the biggest shareholders of U.S. companies, wrote a letter to all U.S. companies in which Blackrock was a shareholder. He warned the companies that they should not assume that Blackrock was following the recommendations of proxy advisory firms blindly, but rather was reaching its voting decisions on the basis of clear guidelines and its fiduciary responsibilities to its investors. Susanne Craig, *The Giant of Shareholders, Quietly Stirring*, N.Y. TIMES (May 18, 2013), http://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html.

105. *See* Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, *supra* note 41, at 1749.

an average holding period of 645 days (approximately twenty-one months) for their sample of activist interventions in Europe.[106]

Activist investors have also been creative in exploiting the gaps of disclosure regimes, accumulating stakes secretly in target companies and decoupling risk and equity. Current reporting rules in the United States and Europe provide a shareholder who has crossed a certain threshold triggering a disclosure obligation a certain time period before it is required to announce its presence to the issuer and the market.[107] During this time period and before any public disclosure is made, a shareholder can continue accumulating shares—amazingly often an influential stake.[108] A prominent example was Pershing Square Capital Management's and Vornado Realty Trust's activist intervention in J.C. Penney Company, the U.S. retailer. Following Pershing Square's acquisition of an initial stake of 4.9%, Pershing Square and Vornado Realty Trust amassed a stake reaching 26.7% through a series of rapid purchases during the ten-day window after crossing the 5% threshold and before disclosing their presence to the market by filing a Schedule 13D.[109] Taking into account that the disclosure of an activist's presence leads to an immediate price spike, an activist has a strong incentive to exploit the reporting lag and acquire additional shares at depressed prices, which do not yet reflect information about the activist's presence and intentions. For instance, from September 28, 2010, when it first crossed the 5% threshold until October 7, 2010, when it filed a Schedule 13D, Pershing Square was able to acquire J.C. Penney shares at an average price of $29.27, well below the post-disclosure closing price of $33.30, earning a profit of $193 million.[110]

Furthermore, innovations in the derivatives market have revolutionized activist investing, allowing hedge funds to sever the link between share ownership and economic interest. Hedge fund activists utilize a variety of cash-settled derivatives instruments to increase their economic ownership, decoupling it from voting power, with one of the most popular being the use of cash-settled total return equity swaps.[111] A cash-settled total return equity swap is a derivative contract that replicates the cash flows of an

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106. *See* Bebchuk et al. *supra* note 44, at 10 tbl.2.

107. *See infra* notes 142–144 and accompanying text.

108. Letter from Wachtell, Lipton, *supra* note 21.

109. *See* Maxwell Murphy, *How Bill Ackman Stalked J.C. Penney*, WALL ST. J. (Oct. 8, 2010), http://blogs.wsj.com/deals/2010/10/08/how-bill-ackman-stalked-jc-penney/.

110. *See* Joshua Mitts, *A Private Ordering Solution to Blockholder Disclosure*, 35 N.C. CENT. L. REV. 203, 213 (2013).

111. Other strategies include the use of cash-settled call and put options and single-stock futures. For an overview of the various strategies, see Hu & Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, *supra* note 20, at 814–48; Wolf-Georg Ringe, *Hedge Funds and Risk Decoupling: The Empty Voting Problem in the European Union,* 38 SEATTLE U. L. REV. 1027, 1034–38 (2013).

investment in shares of a company.[112] In a typical swap, the long party receives the economic returns on a notional amount of shares by the short party without actually holding them.[113] More specifically, when the transaction is wound up, the long party is entitled to receive any cash distributions such as dividends on the referenced shares, plus a cash amount equal to the market appreciation of the shares.[114] The short party on its side is entitled to receive an amount equal to any depreciation in the market value of the shares and a negotiated interest rate, as if it had loaned the notional amount.[115]

As a result, the long party obtains economic exposure to the reference shares without formal ownership.[116] Importantly, the long party may also have informal voting rights.[117] The short party, usually an investment bank that seeks to obtain a return from the interest charged on the notional amount of shares, will typically hedge its exposure by buying the referenced shares.[118] Holding voting rights, but with no economic exposure, the short party interested in maintaining a profitable business relationship has an incentive to cast its vote in support of its client. Furthermore, the parties may decide to physically settle the swap with the long party, immediately acquiring the underlying shares from its short counterparties

112. For an excellent and accurate description of total-return equity swaps, see *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511, 516 (S.D.N.Y. 2008). TCI and 3G are two hedge funds that secretly accumulated positions in CSX through the use of total equity return swaps and direct investments, launching a proxy fight against the incumbent directors of CSX. *Id.* at 518. CSX filed suit, seeking to prevent the funds from voting the shares acquired and arguing that TCI and 3G were obliged to disclose their positions and therefore violated the requirements of section 13(d) of the Securities Exchange Act. *Id.* at 538. The U.S. District Court for the Southern District of New York deemed TCI to be a beneficial owner of the shares held by its counterparties according to section 13(d)(3) and on the basis that it had used the swaps in order to evade the reporting requirements. Furthermore, the court held that TCI and 3G had formed a group and had failed to disclose their positions ordering them to amend their Schedule 13D filing. *Id.* at 573–74. On appeal, the U.S. Court of Appeals for the Second Circuit declined to issue a ruling on the issue of whether equity swaps are included in the definition of beneficial ownership of section 13d(1) and focused on the issue of whether the funds had formed a group under section 13d-3. The court held that more evidence than meetings between the funds alone was required and remanded the case to the lower court for more evidence-taking. CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 654 F.3d 276, 309–10 (2d Cir. 2011); *see also* Ian Cuillerier & Claire Hall, CSX Corp. v. Children's Investment Fund Management (UK) LLP*: Disclosure Requirements in the Context of Total Return Swaps*, 31 FUTURES & DERIVATIVES L. REP. (2011), *available at* http://www.whitecase.com/files/Publication/8643ad76-fdff-4403-85e1-3f08a3c6e9f8/Presentation/PublicationAttachment/91edabe3-e0ad-4edb-aca1-4639138f7ca1/alerts-TRS-Disclosure-Requirements-CSX-Corp.pdf.

113. *See CSX Corp.*, 562 F. Supp. 2d at 519–20.

114. *Id.* at 520.

115. *Id.* at 521.

116. *See* Hu & Black, *Hedge Funds, Insiders and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, *supra* note 20, at 344.

117. *See CSX Corp.*, 562 F. Supp. 2d at 522.

118. *See id.* at 521–22.

and therefore emerging as a major blockholder.[119] Until recently, major jurisdictions did not require the long party to disclose its economic interest. Although European regulators have amended their disclosure rules in response to market innovations,[120] cash-settled derivatives still escape disclosure requirements in the United States.[121]

While the empirical evidence strongly indicates that hedge fund activists are not short-term speculators seeking quick gains at the expense of long-term value, the ability of activists to accumulate large stakes either through exploiting pre-disclosure windows or entering into derivatives transactions clearly undermine market transparency and fairness.[122] Indeed, the purpose of disclosure rules for major shareholders "is to alert the marketplace to every large, rapid aggregation or accumulation of securities."[123]

Mandatory disclosure rules seek to promote market efficiency and improve the corporate governance of companies.[124] The improvements in market efficiency flow from the increased transparency of the voting structure and capital movements.[125] Pre-disclosure accumulations and hidden ownership reduce transparency of the voting structure and changes in it. The accumulation of shares by short counterparties results in the shares being held by a party with no economic exposure to the issuer but the incentive to cast the votes in accordance with the preferences of the long party.[126] Furthermore, the exploitation of pre-disclosure windows and the use of cash-settled equity derivatives to build control-threatening stakes leave the market uninformed of changes in the voting structure.[127] In addition, these tactics compromise the transparency of trading interest and the amount of shares that are in the free float. The heightened interest in the shares remains undisclosed to market participants, while the market may

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119. *See* Hu & Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, *supra* note 20, at 661–81 (reporting instances of decoupling of economic and voting ownership where derivatives have been used in order to secretly build a stake in a target company); Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 460 (2013) (reporting thirteen instances of "hidden ownership" in a sample of 432 activist campaigns outside the United States between January 1, 2010, and December 31, 2010).

120. *See infra* notes 137–145 and accompanying text.

121. *See infra* note 167.

122. Adam O. Emmerich et al., *Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power*, 3 HARV. BUS. L. REV. 136, 136 (2013).

123. GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971).

124. Michael C. Schouten, *The Case for Mandatory Ownership Disclosure*, 15 STAN. J.L. BUS. & FIN. 127, 133 (2009); *see also* EILIS FERRAN, BUILDING AN EU SECURITIES MARKET 127–30 (2004).

125. Schouten, *supra* note 124, at 166.

126. *Id.*

127. Maiju Kettunen & Wolf-George Ringe, *Disclosure Regulation of Cash-Settled Equity Derivatives—An Intensions-Based Approach*, 2012 LLOYD'S MAR. & COM. L.Q. 227, *available at* http://ssrn.com/abstract=1844886.

also hold a distorted view of the size of the free float.[128] Furthermore, in the case of hidden ownership, the marketplace is unable to assess the implications of the long party's increased economic interest relative to its voting rights.[129]

Apart from undermining market efficiency, pre-disclosure accumulations during the window left open by disclosure rules and hidden ownership also have adverse effects on the corporate governance of companies.[130] Ownership disclosure improves corporate governance by facilitating market control. Transparency of major holdings allows a potential acquirer to analyze the size of the free float and persons in control of the company, as well as identify shareholders with whom the bidder could cooperate.[131] Furthermore, disclosure of blockholders alerts other potential bidders that a third party is building a control-threatening stake and therefore promotes competitive auctions.[132] In addition, the ability of activists to amass controlling blocks through derivatives and pre-disclosure accumulations allows them to capture the premium associated with corporate control without sharing it with their fellow shareholders.[133] If an

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128. A prominent example was Porsche's surprise announcement that it had acquired 42.6% of the stock of Volkswagen and had access to another 31% through cash-settled options. Taking into account the stake of the German state of Lower Saxony, which amounted to another 20%, the size of the free float had been reduced to approximately 6%. Hedge funds that were borrowing shares and selling them short (around 12.8% of Volkswagen's shares were on loan) immediately rushed to buy Volkswagen stock in order to close their positions, sending the shares soaring and making Volkswagen the most valuable company in the world. *See* Sarah Marsh, *Short Sellers Make VW the World's Priciest Firm*, REUTERS (Oct. 28, 2008), http://www.reuters.com/article/2008/10/28/us-volkswagen-idUSTRE49R3I920081028.

129. As Gilson and Gordon note, the long party's increased economic exposure relative to its voting leverage reduces the possibility of opportunistic behavior and private benefit extraction by the activist. *See* Gilson & Gordon, *supra* note 25, at 913. However, the increased economic interest of the long party may still distort optimal decision-making since the party may be more risk-averse compared to a shareholder whose economic and voting interests are perfectly aligned. As a result, the disproportionality between economic and voting interests may influence the firm's future cash flows and would therefore be considered as fundamental information by the market. *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983); Schouten, *supra* note 124, at 168.

130. *See* Schouten, *supra* note 124, at 168.

131. *Id.* at 154.

132. Kettunen & Ringe, *supra* note 127, at 15.

133. For an overview of specific instances where activists have used these tactics to acquire controlling blocks and launch stealth takeovers, see Pierre Henry Conac, *Cash-Settled Derivatives as a Takeover Instrument and the Reform of the EU Transparency Directive*, *in* THE EUROPEAN FINANCIAL MARKET IN TRANSITION 49–68 (Hanne S. Birkmose et al. eds., 2012); Hu & Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, *supra* note 20, at 655–81. However, one should note that activists rarely seek to take control of the target companies, with their average stake reaching 8.8%, their median only 6.3%, and the ninety-fifth percentile being 21.2%. *See* Bebchuk et al., *supra* note 44, at 12. The claims that shareholders in such instances who sell to the activist before disclosure of the stake and without any information about its existence or its plans are deprived of a control premium are inaccurate. It is evident that the activist is not seeking to obtain control, which will permit it to obtain private benefits of control not shared by the other shareholders. *See* Bebchuk & Jackson, *supra* note 23, at 51–52.

activist who has acquired a controlling stake decides to launch a takeover offer, minority shareholders may be pressured to tender their shares out of fear that they will be left as minority shareholders in a company under the control of a new shareholder.[134]

III. THE CURRENT REGULATION OF DISCLOSURE OF MAJOR SHAREHOLDINGS IN THE EU: REFRAMING THE DEBATE

A. THE CURRENT REGULATION OF DISCLOSURE OF MAJOR SHAREHOLDINGS IN THE EUROPEAN UNION

Disclosure of major shareholdings in EU companies whose shares are admitted to trading in a regulated market is governed by the Transparency Directive.[135] The Directive significantly upgraded the earlier Substantial Shareholdings Directive, which required a shareholder whose voting rights reached 10%, 20%, one-third, 50%, and two-thirds of total voting rights to disclose its interest to the company and the competent authority within seven calendar days following the acquisition.[136]

Following calls for more effective and timely disclosure of the structure of influence in a company,[137] the Transparency Directive substantially lowered the notification thresholds, shortened the timeframe within which the disclosure must be made, and included certain derivatives in the notification requirements. Article 9(1) imposes on shareholders whose voting rights reach or exceed 5% the obligation to notify the company of the acquisition within four trading days.[138] The disclosure requirements are extended to financial instruments that grant the holder under a formal agreement and on its own initiative the right to acquire shares to which voting rights are attached to an issuer admitted to trade on a regulated market.[139] As a result, cash-settled derivatives, including total return swaps that do not grant the long party the right to purchase shares, did not fall within the ambit of the Transparency Directive until the recent amendments.

The minimum harmonization model adopted by the Directive allows EU Member States to introduce more stringent requirements.[140] In

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134. Kettunen & Ringe, *supra* note 127, at 15.

135. Transparency Directive, *supra* note 24.

136. Council Directive 88/627/EEC, of the Council of 12 December 1988 on the Information to be Published when a Major Holding in a Listed Company Is Acquired or Disposed Of, art. 4(1), 1988 O.J. (L 348) 62, 63.

137. NIAHM MOLONEY, EC SECURITIES REGULATION 195 (2008).

138. Transparency Directive, *supra* note 24, art. 9(1), at 38, 47. The issuer must subsequently disclose this information to the public within three trading days. *Id.* art. 12(6).

139. *Id.* art. 13(1).

140. Member States are free to determine the content of the notification, with some Member States mandating a declaration of intentions by the shareholder crossing the threshold. For instance, France requires any shareholder whose ownership interest exceeds 10%, 15%, 20%, or 25% of the shares or voting rights of an issuer to file a declaration of intent with the French

implementing the Transparency Directive, several Member States opted for lower disclosure thresholds and shorter notification deadlines.[141] The United Kingdom requires disclosure of acquisitions above 3% of shares carrying voting rights in issuers incorporated in the United Kingdom and admitted to trading on a European Economic Area (EEA)-regulated market within two trading days.[142] Similarly, Germany and France mandate the disclosure of shareholdings exceeding 3% and 5% of voting rights respectively within four trading days.[143] Disclosure of acquisitions above 3% in Spain must be made within four trading days.[144] Following the outrage provoked by the use of cash-settled derivatives to secretly acquire controlling stakes in European companies,[145] the majority of European jurisdictions extended their disclosure requirements to cash-settled derivatives, including total return swaps not captured by the Transparency Directive until its recent amendment.

The United Kingdom's modified disclosure rules include financial instruments referenced to the issuer's shares and granting the holder a long

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regulator, describing its intentions with respect to the issuer in the six-month period following notification. It must describe whether the shareholder intends to purchase additional securities, gain corporate control, or request the appointment of directors. It must also disclose any strategic plans with respect to the issuer such as a merger, reorganization, or liquidation or a transfer of material assets. *See* CODE DE COMMERCE [C. COM.] art. L.233-7(VII) (Fr.), *available at* http://www.legifrance.gouv.fr/affichCodeArticle.do?idArticle=LEGIARTI000022963037&cidTexte=LEGITEXT000005634379; Autorité Marchés Financiers, Règlement general art. 223-17(I)(2) (2012). Rules imposing extensive reporting requirements regarding the intentions of a blockholder are criticized for exposing the shareholder to considerable liability risk and carrying substantial enforcement risk since misrepresentations regarding one's intentions are difficult to detect and prosecute. *See* Luca Enriques et al., *Mandatory and Contract-Based Shareholding Disclosure*, 15 REVUE DE DROIT UNIFORME 713, 717 (2010).

141. For an extensive overview of disclosure thresholds and notification deadlines in the European Union, see FABRICE DEMARIGNY & CHRISTOPHE CLERC, TRANSPARENCY DIRECTIVE ASSESSMENT REPORT 112 (2009), *available at* http://ec.europa.eu/internal_market/securities/docs/transparency/report-application_en.pdf; Andrew Hougie et al., *Implementation of the Transparency Directive Changes Shareholder Notification Requirements Across Europe*, 8 J. INVESTMENT COMPLIANCE 63 (2007).

142. FIN. CONDUCT AUTH., DISCLOSURE RULES AND TRANSPARENCY RULES paras. 5.1.1, 5.1.2 (2014), *available at* http://media.fshandbook.info/content/full/DTR.pdf.

143. C. COM. art. L.233-7; Wertpapierhandelsgesetz [WpHG] [Securities Trading Act], BGBL. I at 2708, last amended by Gesetz zur Umsetzung der Richtlinie 2010/73/EU und zur Änderung des Börsengesetzes, Aug. 28, 2013, BGBL. I at 3395, § 21 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/wphg/gesamt.pdf.

144. Transparency Requirements art. XXXV (B.O.E. 2007, 18305) (Spain), *available at* http://www.boe.es/boe/dias/2007/10/20/pdfs/A42692-42708.pdf.

145. Ed Crooks, *Enel Wants Regulator to Speed Up Bid for Endesa*, FIN. TIMES, Mar. 29, 2007, at 27, *available at* http://www.ft.com/intl/cms/s/0/17d74434-dd6f-11db-8d42-000b5df10621.html#axzz2ieQI8dix; Haig Simonia, *Victory Jitters Strike Swiss Industrialists*, FIN. TIMES, Mar. 19, 2007, at 24, *available at* http://www.ft.com/intl/cms/s/0/38f9fb00-d5bf-11db-a5c6-000b5df10621.html#axzz2ieQI8dix; Sarah Spikes, *Funds' Battle with Stork Heats Up*, FIN. TIMES, Nov. 24, 2006, at 24, *available at* http://www.ft.com/intl/cms/s/0/de36673e-7b60-11db-bf9b-0000779e2340.html#axzz2ieQI8dix; Oscar Bodini & Giovanni Legorano, *Italian Court Finds Agnelli's Advisers Guilty of Market Rigging*, WALL ST. J. (Feb. 21, 2013, 9:51 AM), http://online.wsj.com/article/BT-CO-20130221-709691.html.

position on the economic performance of the shares, whether the instrument is settled physically in shares or in cash.[146] Holdings of these instruments are aggregated with any holdings of voting shares in calculating whether the 3% disclosure threshold has been reached.[147] Similarly, Germany extended its disclosure requirements to financial instruments or other instruments that merely enable the holder to acquire voting rights.[148] The notification threshold is set at 5%, and holdings of financial instruments that enable the holder to acquire voting rights must be aggregated with voting shares and instruments giving rights to acquire shares.[149] Finally, France also amended its disclosure rules, mandating the inclusion of any holdings of financial instruments settled in cash and having for the holder an economic effect similar to the possession of shares for the purpose of calculating whether the 5% threshold has been reached.[150]

Furthermore, on October 22, 2013, European regulators adopted amendments to the Transparency Directive.[151] The amendments specifically target the widespread use of financial instruments, giving investors economic exposure to companies and allowing them to acquire secret stakes in companies resulting in market abuse.[152] Pursuant to the amendments to the Directive, EU Member States must extend their notification requirements to financial instruments with economic effects similar to

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146. FIN. CONDUCT AUTH., *supra* note 142, paras. 5.3.3–.4, 5.8.3.

147. *Id.* para. 5.8.2(4). Disclosure is made by reference to the delta of the financial instrument and not the full notional of shares underlying the financial instrument. "Delta" refers to the number of shares that the writer of an option must hold in order to perfectly hedge its position and changes over time as the option moves closer to expiration and the price of the referenced shares varies. *The New FSA Rules on Disclosure of Interests in UK Companies*, LINKLATERS, 3 (May 2009), http://www.linklaters.com/pdfs/publications/capitalmarkets/CFD_disclosurerulesnote.pdf.

148. Securities Trading Act, *supra* note 143, § 25a. An instrument enables an investor to acquire voting rights if the counterparty can exclude or lower risk emanating from these instruments by buying the referenced shares, irrespective of whether the instrument provides for a cash or physical settlement.

149. *Id.* The number of voting rights is determined by the amount of shares that the counterparty would need to hold for a full hedge of its position, assuming a delta of one.

150. CODE DE COMMERCE [C. COM.] arts. L.233-7, -9 (Fr.); *France Adopts New Aggregation Rules*, BAKER & MCKENZIE (Oct. 2012), http://www.bakermckenzie.com/files/Publication/a07004fa-ab21-4cd4-ac43-147cdebc9cb7/Presentation/PublicationAttachment/53fc8fc6-99e7-452f-929e-871c68df248d/al_bf_fanceaggregationrules_oct12.pdf. The number of voting rights to be disclosed is calculated on a delta-adjusted basis. *See* C. COM. art. L.233-11. Furthermore, following amendments to the French Commercial Code in 2012, a shareholder whose ownership interest exceeds 10%, 15%, 20%, or 25% of the shares or voting rights of an issuer as a result of the use of total return swaps or other cash-settled derivatives must report whether it intends to acquire the shares bought by its counterparties in order to hedge their short positions or to alter its agreement with its counterparties and settle the initially cash-settled derivatives in-kind. *See id.* art. 233-7(VII)(e).

151. Transparency Directive Amendments, *supra* note 24. The Directive imposes an obligation on all Member States to aggregate holdings of voting rights with holdings of financial instruments in calculating notifiable interests. Although the Directive still allows Member States to set lower notification thresholds than the minimum thresholds it introduced, they will not be able to impose different requirements regarding the calculation of aggregation of interests. *Id.* at 15.

152. *Id.* at 21.

instruments that give the holder the right to acquire voting shares, whether they are physically settled or not.[153] Holdings of financial instruments must be aggregated with holdings of voting shares in order to determine whether the disclosure threshold has been reached or exceeded.[154] Furthermore, the amendments to the Directive provide that long positions cannot be netted with short positions in the same issuer.[155]

B. REFRAMING THE DEBATE

The rules governing disclosure of major shareholdings—both at the level of individual European countries and at the EU level, including the recent amendments to the Transparency Directive—respond to the innovative and opaque tactics of hedge fund activists and serve the legitimate purpose of safeguarding market transparency and fairness. Nonetheless, they fail to balance the costs imposed by hedge fund activists in terms of compromising market transparency with the benefits of activism for shareholders and companies. Current disclosure rules unfavorably tilt the balance of power between management and activists against the latter and have a chilling effect on hedge fund activism in Europe that substantially lags behind the United States.[156]

The emergence of an activist, the size of its block, and its investments in monitoring depend on its ability to recover its costs and earn an attractive, risk-adjusted return on its investment.[157] For the activist, an intervention entails high expenditures on research, increased idiosyncratic risk arising from its concentrated and illiquid position, and costs associated with an activist campaign, including costs incurred in connection with a proxy fight.[158] Furthermore, increased competition between hedge funds employing different strategies and asset classes for attracting funds requires activists to offer an attractive return to their investors.

The ability of an activist to recoup its costs and earn a profit on its investment depends on securing a sizeable stake at prices that do not reflect

153. *Id.* at 22. The number of voting rights is calculated by reference to the notional amount of shares underlying the financial instrument unless the financial instrument is cash-settled, in which case the calculation of the voting rights shall be made on a delta-adjusted basis. The notional amount of the underlying shares shall be multiplied by the delta of the instrument.

154. *Id.* at 23.

155. *Id.* at 22.

156. *See* Georgina Prodhan & Angelika Gruber, *Lonely Activist Investor Pushes Limits in Austria*, REUTERS (Sept. 6, 2013), http://uk.reuters.com/article/2013/09/06/austria-investment-activist-idUKL6N0GZ2AA20130906 (reporting that while the number of activist campaigns in the United States has reached 357, only twenty-six have been recorded at European companies).

157. *See* Bebchuk & Jackson, *supra* note 23, at 49.

158. Gantchev estimates that the costs of an average activist campaign composed of three separate stages—demand negotiations, board representation, and proxy contest—equal $10.71 million. The proxy contest—involving legal fees, fees of proxy solicitors, and public relations and advertising expenditures—has the highest cost, reaching $5.94 million. *See* Gantchev, *supra* note 55, at 624.

the expected benefits of the activist's intervention.[159] Upon disclosure of an activist's presence, share prices rise, reflecting the expected value of increased monitoring and engagement with the target company.[160] Acquiring a sizeable stake allows an activist to capture an increased fraction of the gains resulting from the stock price appreciation. One should stress that the activist captures only a fraction of the gains, with the rest of the gains accruing to other shareholders.

Disclosure rules are crucial for the activist's ability to recoup its costs and earn a return on its investments. A low disclosure threshold and a short period of time for disclosure after the ownership threshold has been reached reduce the size of the stake that an activist can accumulate before disclosure drives up the share price and eliminates the activist's gains.[161] As the returns of an activist depend on its ability to capture a sizeable proportion of the share price gains by acquiring a sufficiently large equity stake, reducing the size of the pre-disclosure block leads to a decrease in the activist's returns.[162] Similarly, aggregating holdings of equity derivatives granting their holder economic exposure to the target company with voting rights for the purpose of determining the disclosure trigger further reduces the economic stake that an activist can amass.[163] In some cases the activist will not be able to recoup its costs and earn a competitive return, therefore shunning activism altogether, while in other cases, even though the activist will be able to profit from its investment, its small block will make the threat of a successful intervention in the target company less credible.

The abovementioned analysis has shown that the current disclosure regimes at the level of individual European countries—but also at the EU level—significantly impede activism, depriving shareholders of the superior returns documented upon the disclosure of an activist's presence, and companies and the economy in general of the improvements in operating performance that activists are able to implement. Furthermore, by making activism more costly and less frequent, investors will lose the gains arising from the disciplinary effects of activism. The threat of the emergence of an

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159. *See* Bebchuk & Jackson, *supra* note 23, at 50; Gilson & Gordon, *supra* note 25, at 902; Andrei Shleifer & Robert. W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

160. *See* Gilson & Gordon, *supra* note 25, at 903–04.

161. *See* Bebchuk et al., *supra* note 44, at 17–19; Gilson & Gordon, *supra* note 25, at 904–06.

162. Gilson & Gordon, *supra* note 25, at 904.

163. Equity derivatives such as total return swaps allow an activist to increase its economic exposure to the target and gain additional profits from a share price appreciation without increasing its voting rights. The gains of an activist derive from its ability to build an economic stake prior to disclosure of its position. Once disclosure of the activist's economic stake is made, the share price will spike, reflecting the expected value of the intervention. Counting equity derivatives towards the disclosure threshold reduces the returns of the activist by reducing its economic stake. *See id.* at 914–15.

activist reduces agency costs by inducing management to improve share price and operational performance.[164]

Gilson and Gordon argue that the genius of the recent campaign urging the SEC to shorten the time period for disclosure after the threshold has been reached and include derivatives in the calculation of the relevant disclosure threshold is the covert imposition of a low threshold poison pill at a time when shareholders are demanding the dismantling of poison pills.[165] The regulatory cap on the activist's ownership stake functions as a defensive mechanism against activists shielded from shareholder opposition and imposed on all corporations. Analyzed from this perspective, European disclosure requirements go even further and directly contravene the spirit and rationale of the Directive on Takeover Bids.[166] In contrast to the United States, where the board is allowed to adopt defensive mechanisms without shareholder approval,[167] defensive measures are banned in Europe unless the board obtains shareholder approval.[168] In essence, European regulators have created a defensive mechanism targeting solely hedge fund activists.

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164. *See* Bebchuk et al., *supra* note 44, at 20; *see also* Fos, *supra* note 1 (documenting that an increase in the likelihood of a proxy contest is associated with an increase in leverage, dividends, and CEO turnover at target companies and a decline in research and development, as well as capital expenditures and executive compensation. Taking into account that proxy contests are frequently launched by hedge fund activists, the evidence could be interpreted as confirming the disciplinary effects of hedge fund activism).

165. *See* Gilson & Gordon, *supra* note 25, at 910–12. The poison pill is a popular defensive mechanism invented by Martin Lipton, a prominent U.S. corporate lawyer. Under the standard "flip in" pill, the board of directors, by board resolution and without shareholder approval, distributes rights to existing shareholders, which grant each rightsholder the right to buy additional shares in the target at a steep discount. The rights are exercisable once an acquirer has accumulated shares exceeding a specified ownership threshold (usually between ten and twenty percent). As a result, the triggering of a poison pill severely dilutes the acquirer's stock ownership percentage in the target. *See* John Armour et al., *The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytic Framework*, 52 HARV. INT'L L.J. 221, 245–47 (2011). Poison pills are under attack by shareholders, with their number constantly falling during the last decade. In 2001, 2200 public corporations had poison pills in place. By 2011, fewer than 900 public companies had adopted a poison pill. *See* Tonello, *supra* note 52.

166. Council Directive 2004/25/EC, of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2004 O.J. (L 142) 12. The Directive establishes a common framework for takeover bids in Europe, setting minimum requirements with which EU Member States must comply.

167. Defensive mechanisms in the United States are regulated by U.S. states and particularly state courts. Under Delaware law, in the preferred state of incorporation for the majority of large U.S. public companies, defensive mechanisms are reviewed under the *Unocal* standard. Under *Unocal*, the defensive actions must respond to a reasonable threat to corporate value and policy, and the defensive mechanisms must be reasonable in relation to the threat posed. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955–57 (Del. 1985); *see* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373–89 (Del. 1995).

168. Council Directive 2004/25/EC, art. 9, 2004 O.J. (L 142), 12, 19. The ban against defensive mechanisms and the endorsement of the principle of shareholder choice in respect to takeovers demonstrate the recognition by European legislations of the beneficial effects of contests for corporate control. *See* JAAP WINTER ET AL., REPORT OF THE HIGH-LEVEL GROUP OF COMPANY LAW EXPERTS ON ISSUES RELATED TO TAKEOVER BIDS (2002), *available at* http://ec.europa.eu/internal_market/company/docs/takeoverbids/2002-01-hlg-report_en.pdf.

This defensive mechanism against activists significantly impedes shareholder activism in Europe and deprives shareholders and European companies of the gains stemming from activism.

While the goal of safeguarding market transparency and fairness is a legitimate one for European regulators to pursue, a stringent disclosure regime comes at the cost of a reduction in the incidence of activism and its beneficial effects. The lowering of disclosure thresholds, tightening of the time period for disclosure, and the requirement to disclose economic interests acquired through derivatives were relatively straightforward exercises for European regulators. The compelling argument in favor of stringent disclosure rules for major shareholdings was that innovations in the marketplace had allowed activists to compromise market transparency by employing sophisticated techniques to quickly accumulate stakes in target companies.[169] Nonetheless, regulators in Europe have failed to recognize the beneficial effects of activism, the crucial role that disclosure rules play in incentivizing activists to engage with target companies, and the costs that tighter disclosure rules impose upon investors and companies who are deprived of the documented gains associated with activism.[170]

The approach of European regulators can be contrasted with the recent debate between academics, practitioners, judges, and journalists sparked by a petition filed by a prominent U.S. law firm, urging the SEC to shorten the ten-day reporting lag after crossing section 13(d)'s five-percent disclosure threshold for major shareholdings to one business day following the

169. *See, e.g.*, FIN. SERVS. AUTH., NO. 07/20, DISCLOSURE OF CONTRACTS FOR DIFFERENCE: CONSULTATION AND DRAFT HANDBOOK TEXT ¶ 3.6–.7, at 21–22 (2007) (echoing these concerns, and specifically the ability of activists to accumulate secret stakes through derivatives).

170. *See, e.g.*, Transparency Directive, *supra* note 24; *see also* Commission Directive 2007/14/EC, 2007 O.J. (L 69/27); Proposal for a Directive of the European Parliament and of the Council Amending 2004/109/EC on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities Are Admitted to Trading on a Regulated Market and Commission Directive 2007/14/EC, No. COM (2011) 683, at 12 (Oct. 25, 2011); Transparency Directive Amendments, *supra* note 24, at 14. Even though the initial proposal for amendments and the adopted amendments to the Transparency Directive explicitly mention that they have been adopted in response to activists' innovative techniques enabling them to secretly accumulate stakes in companies, there is no mention of either the beneficial effects of activism or the costs of the tightened disclosure rules in terms of a reduction in the incidence of activism. Similarly, the impact assessment of the Transparency Directive quickly rejects the assertion that tightened disclosure requirements will chill hedge fund activism and the benefits associated with it, without engaging in any meaningful empirical analysis. *See* EUR. COMM'N, REPORT FROM THE COMMISSION STAFF WORKING PAPER: IMPACT ASSESSMENT 66–68 (2011), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2011:1279:FIN:EN:PDF; *see also* FIN. SERVS. AUTH., *supra* note 169, at 9 (showing where the British securities regulator engages in a cost-benefit analysis of its proposed rules for including derivatives in the calculation of the disclosure threshold). Nonetheless, it provides a rather superficial analysis of the costs of the tightened disclosure regime in terms of a reduction in the incidence of activism and the gains associated with it.

crossing and include derivatives in the definition of beneficial ownership.[171] Following the filing of the petition, the SEC is currently considering modifying the existing rules for outside blockholders pursuant to the authority granted to it by sections 766(e) and 929R of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[172] While proponents of the petition point to the abusive tactics of hedge fund activists and the destructive effects of activism for market transparency and fairness,[173] opponents stress the beneficial effects of activism and the adverse effects that tighter disclosure rules will have on the incidence and size of activist blocks.[174] Furthermore, opponents of the petition urge the SEC to conduct a careful policy analysis based on empirical evidence of the costs in terms of a reduction in activism and the benefits of modifying the current disclosure regime.[175]

Nonetheless, the overhaul of European disclosure rules was not preceded by any policy analysis with academics and regulators, urging the tightening of disclosure obligations for major blockholders without recognizing their chilling effect on activism and the foregone profits for shareholders and companies. In light of the crucial role of disclosure obligations for activists and the adverse impact of current rules on hedge fund activism in Europe, European regulators should carefully reconsider the existing disclosure regime, both at the European and at an individual country level. The benefits of tighter disclosure rules in terms of improved market transparency and fairness must be weighed against the costs imposed on shareholders and companies as a result of a reduction in the incidences of activist activities.[176]

On the one hand, European regulators with the contribution of European academics should conduct a careful, empirical analysis of the

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171. *See* Letter from Wachtell, Lipton, *supra* note 21. Section 13(d)(1) of the Securities Exchange Act requires any person who acquires beneficial ownership of more than five percent of voting shares to file with the SEC within ten days after the acquisition a Schedule 13D. *See* 17 C.F.R. § 240.13d-l (2014). A beneficial owner is any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has the power to vote or direct the voting of the relevant securities or the power to dispose or direct the disposition of the securities. *See id.* § 240.13d-3. Derivatives are included in the calculation of the 13D disclosure threshold only if the holder has a right to beneficial ownership over the underlying security within sixty days. *See id.* § 240.13d-3(d)(1).

172. *See* Letter from Wachtell, Lipton, *supra* note 21; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 766(e), 929R, 124 Stat. 1376, 1797–99, 1866–67 (2010).

173. *See* Emmerich et al., *supra* note 122; *Beneficial Ownership*, *supra* note 20; Andrew Ross Sorkin, *Shareholder Democracy Can Mask Abuses*, N.Y. TIMES DEALBOOK (Feb. 25, 2013), http://dealbook.nytimes.com/2013/02/25/shareholder-democracy-can-mask-abuses/.

174. Bebchuk & Jackson, *supra* note 23; Bebchuk et al., *supra* note 44; Gilson & Gordon, *supra* note 25. One should note that, in contrast to our analysis, opponents of the petition regard the claims that activist tactics compromise market transparency and fairness as unfounded. *See* Bebchuk & Jackson, *supra* note 23, at 51–55; Gilson & Gordon, *supra* note 25, at 913–15.

175. Bebchuk & Jackson, *supra* note 23, at 59–60.

176. *Id.*

frequency of large-scale accumulations of blocks by activist shareholders in the European Union through exploitation of pre-disclosure windows or use of derivatives, as well as the costs imposed by these activities.[177] One should note that the incidence of empty voting in the European Union may be actually overstated.[178] On the other hand, they should empirically assess the benefits of activism for shareholders and companies in Europe and the costs of tighter disclosure obligations. The empirical analysis will lead to the adoption of more efficient disclosure obligations for major blockholders, which will on the one hand safeguard market transparency and on the other hand allow shareholders and companies to reap the gains associated with hedge fund activism.

CONCLUSION

The shareholder empowerment movement led by hedge fund activists has revolutionized modern capital markets and corporate governance. While activists are criticized as short-term agitators seeking to earn a quick profit, the empirical evidence univocally confirms the beneficial effects of activism for shareholders and companies. In response to the abusive tactics employed by activists seeking to secretly amass blockholdings in target companies and the adverse effects of such activism on market transparency and fairness, European regulators have tightened disclosure obligations for major shareholders. However, regulators in Europe have failed to recognize

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177. One should note that in contrast with the United States, empirical research on the effects of hedge fund activism is still in its early stages. For empirical research concerning activism in Europe, see Bebchuk et al., *supra* note 44; Becht et al., *Hedge Fund Activism in Europe*, *supra* note 81; Becht et al., *Returns to Shareholder Activism*, *supra* note 81; Wolfgang Bessler et al., *The Returns to Hedge Fund Activism in Germany*, 20 EUR. FIN. MGMT. (forthcoming 2014) (finding that hedge fund activists in Germany increase shareholder value both in the short and the long term, and that aggressive activism is initially associated with higher returns that are quickly reversed); Erede, *supra* note 25 (analyzing hedge fund activism in the context of Italy and Germany, two corporate systems characterized by concentrated ownership); Peter Weber & Heinz Zimmermann, *Hedge Fund Activism and Information Disclosure: The Case of Germany*, 19 EUR. FIN. MGMT. 1017 (2013) (examining share price reactions upon disclosure of the presence of activists in Germany); Veronique Bessiere et al., Hedge Fund Activism: A Clinical Study of the French Company Atos Origin (July 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1635283 (examining the battle between hedge fund activists and the management of French company Atos Origin); Tilman H. Drerup, Much Ado About Nothing: The Effects of Hedge Fund Activism in Germany (Dec. 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=1718365 (examining a sample of 278 hedge fund shareholdings in German-listed companies, documenting positive stock market reactions upon disclosure of the presence of an activist that are subsequently reversed and finding no significant changes in central corporate variables such as cash holdings and leverage).

178. The European Securities Markets Authority (ESMA) launched a call for evidence in 2011 seeking to collect information on the incidence of empty voting in the European Union and explore possible regulatory responses to the phenomenon. However, ESMA concluded that there was not sufficient evidence of empty voting in the European Union to warrant regulatory action. *See* EUR. SEC. & MKTS. AUTH., FEED-BACK STATEMENT: CALL FOR EVIDENCE ON EMPTY VOTING 4–5 (2012).

the crucial role of disclosure obligations in incentivizing activists to engage with target companies. Current disclosure regimes in Europe tilt the balance against activists, depriving shareholders and companies of the benefits emanating from activism. In line with calls by U.S. academics stressing the necessity of empirical analysis before proceeding with the tightening of disclosure obligations for major blockholders in the United States, the present Article urges European regulators to reconsider the current disclosure regime by conducting a careful, empirical analysis of their benefits for market transparency and fairness and their costs on shareholders and companies as a result of a reduction in the incidence of activist shareholdings.