

Two academics analyze the challenges of regulating the sort of derivative-driven vote buying used in the Mylan-King situation

## Hedge fund voting: The devil we don't know

HEDGE FUNDS ARE CHALLENGING beasts to regulate. With their use of over-the-counter derivatives, such investment vehicles may legally avoid the reporting requirements imposed on other kinds of investors, including mutual funds and pension funds. The regulatory response to Perry Capital LLC's arbitrage strategy in the failed merger between Mylan Laboratories Inc. and King Pharmaceuticals Inc. illustrates these difficulties.

The Securities and Exchange Commission on Jan. 11 told Perry that it would likely charge the New York hedge fund with violating SEC disclosure rules for its conduct in the Mylan-King deal. With the outcome of the Mylan shareholder vote in doubt, Perry bought 9.9% of its stock while hedging the price risk associated with the Mylan shares. Perry planned to vote its Mylan stake for the deal and make its money from the rise in King stock, which Perry also owned but had not hedged. (See "Mylan, King, and Murphy's Law," April 2005.) The deal collapsed before the stockholder vote, but the easily replicable nature of Perry's investment suggested that every corporate election was vulnerable to such tactics.

Despite the SEC's displeasure with Perry's conduct, federal securities laws don't give the agency a way to bar it beyond suing for violation of disclosure claims—shaky ground, since Perry's investment relied on the use of derivatives, whose disclosure SEC rules do not mandate. Perry literally bought Mylan votes, but the hedge fund didn't

do so in an obviously illegal way by, for example, paying Mylan stockholders to vote their shares for the King merger.

In a recent academic study, Henry T.C. Hu and Bernard Black call Perry's conduct "the new vote buying." The two professors at the University of Texas Law School offer the first thorough academic analysis of the phenomenon in their paper "Hedge Funds, Insiders, and Decoupling of Economic and Voting Ownership in Public Companies," which will run in the May issue of the *Southern California Law Review* and is downloadable at <http://ssrn.com/abstract=874098>.

By allowing the complete separation of economic and voting stakes in a company, "The new vote buying strikes directly at both the economic and legal logic behind shareholder voting rights," Hu and Black write. But the severity of the threat is impossible to evaluate empirically because of the lack of data on the practice.

Instead, the authors evaluate some of the dozen or so examples of "the new vote buying." In addition to Mylan-King, they consider the 2004 acquisition of MONY Group Inc. by Axa Financial Inc., a deal that MONY shareholders narrowly approved, as well as several foreign situations, at least one of which involved Perry. (On Axa-MONY, see "The bitter with the sweet," March 2004, and "Lose the battle, win the war," May 2004.)

Investors such as Perry may employ several strategies. The most obvious is borrowing stock. Hu and Black cite one

study that found most stocks can be borrowed at less than 1% a year—a pittance compared to the possible returns from a successful arbitrage strategy but a profitable one for the stockholders doing the lending. The authors note that CalPERS makes \$110 million a year from stock lending, for example.

Having borrowed stock to gain voting rights, an investor may then hedge his economic risk with derivatives. Alternatively, if the investor owns stock, he may sell it to a counterparty in exchange for a package of derivatives, as Perry did when it invested in New Zealand company Rubicon Ltd. There, Hu and Black write, Perry sold 31 million shares of Rubicon to two banks in exchange for equity swaps on the stock. In litigation over the investment, Perry's head trader testified, "That he had always thought it likely that the shares would be held by the counterparties as a hedge. He also said that if he wanted to terminate the swaps and purchase the shares, it would have been commercially sound for the counterparties to sell him those shares."

Hu and Black hypothesize that Perry's Rubicon investment reflects the emergence of "a de facto practice in which both sides understand that the dealer, if asked, will either unwind the swap and sell the shares to its client or vote the matched shares as its client wants. To refuse to do so would be to risk their business relationship with [the hedge fund]." In a study issued last year, the U.K. Panel on Takeovers and Mergers found this to be the case.

But Hu and Black found a solution as elusive as the SEC has. Given the dearth of information on the new vote buying, the authors suggest that the SEC reform its disclosure regulations to capture more data. They write: "Disclosure rules should treat similarly both voting and economic ownership, long and short positions, and exchange-traded and OTC derivatives. All positions that convey or remove either economic or voting ownership should generally be covered." ■

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