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Coordination and Monitoring in Changes of Control: The Controversial Role of "Wolf Packs" in Capital Markets.

Osgoode Hall Law Journal, Vol. 54(2), 2017, Forthcoming.

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Abstract:
Given recent empirical work suggesting that Canada is one of two countries in which outcomes favourable to shareholder activists are more likely than in the US, one might wonder whether shareholders in Canadian public companies have become too empowered. This concern is perhaps especially acute in light of the light of controversies arising from the emergence of "wolf packs," which are loose networks of parallel-minded shareholders (typically hedge funds) that act together to effect change in a given corporation without disclosing their collective interest. This article analogizes the role of wolf packs in the corporation to that of the blockholder. It isolates certain conditions in which the formation of wolf packs is optimal such that wolf packs are able to overcome the coordination costs that can ordinarily impede shareholders from forming de facto blocks to monitor the corporation's directors and management. At the same time, however, they are able to circumvent the disclosure rules that typically apply to such groups. Because wolf packs are able to wield significant influence in corporate affairs without disclosing their collective interest to other investors, this article argues that the disclosure rules relating to wolf packs in Canada should be tightened and clarified.

Keywords:
Shareholders, wolf, pack, proxy, takeover, corporation

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Coordination and Monitoring in Changes of Control:

The Controversial Role of "Wolf Packs" in Capital Markets

1. Introduction

Corporate law in Canada seeks to mediate the relationship between a corporation's directors and its shareholders by assigning each a distinct set of legal rights.[1] A recent empirical study finds Canada to be one of only two countries in which outcomes favourable to activist shareholders are more likely than in the US.[2] Have shareholders of public companies in the Canadian capital markets become too empowered, and if so, what legal rules should govern their behaviour?[3] The topic's importance is unquestionable in light of controversies arising from the emergence of "wolf packs," which are loose networks of parallel-minded shareholders (typically hedge funds) that act together to effect change in a given corporation without disclosing their collective interest.[4] Wolf packs are able to circumvent disclosure rules typically applied to shareholders that act together by deliberately avoiding being characterized as a "group" for the purposes of US securities laws or as "acting jointly or in concert" for the purposes of Canadian securities laws. As is the case with a group of prowling wolves, the lead wolf (shareholder) might be visible to its prey while the other wolves (shareholders) only appear when necessary.

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1 According to the *Dickerson Report*, balancing the tension between directors and shareholders is the normative underpinning of Canadian corporate law: "We cannot see any practical reason that, at least in the public corporation, shareholders should be involved with corporate administration. This is not to say, however, that directors should not be responsible for their actions and accountable to shareholders and others for what they do": Robert Dickerson et al., *Proposal for a New Business Corporations Law for Canada* (Ottawa: Information Canada, 1971) at 3 [*Dickerson Report*].

2 Marco Becht, Julian Franks, Jeremy Grant and Hannes F. Wagner, "The Returns to Hedge Fund Activism: An International Study" (March 2015), European Corporate Governance Institute Working Paper No. 402 at 37, online: SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2376271>. The Netherlands is the other country in which activist outcomes are significantly more likely than in the US.

3 There is a significant amount of debate on this topic in the US literature. Advocating for greater shareholder empowerment, see, for example, Lucian Bebchuk, "Response to Increasing Shareholder Power: Letting Shareholders Set the Rules" (2006) 119 Harvard L. Rev. 1784 and Lucian Bebchuk, "The Case for Increasing Shareholder Power" (2005) 118 Harvard L. Rev. 833. Advocating for corporate laws that place greater power in the board of directors, see, for example, Iman Anabtawi, "Some Skepticism About Increasing Shareholder Power" (2006) 53 UCLA L. Rev. 561 and Stephen M. Brainbridge, "Director Primacy and Shareholder Disempowerment" (2006) 119 Harvard L. Rev. 1745.

4 John C. Coffee and Darius Palia, "The Impact of Hedge Fund Activism: Evidence and Implications" (2014), European Corporate Governance Institute Working Paper No. 266, online: SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2496518>.

Electronic copy available at: https://ssrn.com/abstract=2906755

Building on the theme of this symposium issue on controversial markets, this article probes the role of wolf packs in Canadian law and particularly in change of control transactions, including proxy contests. Changes of control, especially in the hostile context, are controversial given that the target may have other strategic intentions that the board conceives to be in its long-term best interests. Wolf packs add another element of controversy to changes of control, as they are typically designed to form before the occurrence of the share price appreciation that may occur in a change of control transaction. Further, they are able to overcome the coordination costs and other impediments that smaller shareholders experience in forming *de facto* blocks, thereby making the threat of a proxy contest or a push for a sale of the company more viable.

In particular, there are certain circumstances in which shareholder cooperation generally, and wolf pack behaviour specifically, are able to overcome these costs. First, corporations characterized by large institutional shareholders facilitate wolf pack formation because these shareholders are generally sophisticated rational actors that can coordinate with each other. Second, as sophisticated actors, these shareholders may be motivated by the usual share price increase that tends to follow the filing of mandated disclosures when shareholders pass prescribed thresholds of ownership in a corporation's shares. Third, coordination among wolf pack members is facilitated by corporate and securities laws, which explicitly allow coordination among a small group of shareholders and which can drive the lead activist to focus its recruitment efforts on larger shareholders. This argument is especially pertinent to Canadian capital markets that are characterized by institutional shareholders that hold sizable positions in public corporations.[5]

Currently, two hypotheses explain wolf pack formation.[6] Coffee and Palia contemplate that a lead activist will recruit other investors to join the pack *before* filing disclosure regarding its holdings.[7] By contrast, Brav *et al*, assert that a coordination game drives wolf pack formation, since individual

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[5] Richard Bozec et al find that 58% of Canadian issuers feature at least one controlling shareholder that owns shares representing more than 10% of the voting rights in respect the issuer: Richard Bozec, Mohamed Dia and Yvez Bozec, "Corporate Ownership and Governance Practices in Canada: A Longitudinal Study" (2015) 4:1 J Int'l Corp Gov 51. See also Randall K. Morck, David A. Stangeland and Bernard Yeung, "Inherited Wealth Corporate Control and Economic Growth: The Canadian Disease?" in Randall K. Morck, ed, *Concentrated Corporate Ownership* (Chicago: University of Chicago Press, 2000).

[6] For a more detailed explanation of these hypotheses, see Yu Ting Forrester Wong, "Wolves at the Door: A Closer Look at Hedge Fund Activism" (2016), online: Columbia Business School Research Paper No 16-11 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2721413>.

[7] Coffee, *supra* note 4 at 34.

shareholders are incentivized to join wolf packs without explicit coordination by a lead member.[8] The rational self-interest of the members of the wolf pack is sufficient for the wolf pack to form on the basis of implicit coordination. These two models – which we refer to as the "explicit coordination" and "implicit coordination" models respectively – are informative but insufficient. The explicit coordination model focuses primarily on timing in terms of when the wolf pack is formed relative to the relevant legal rule relating to disclosure of the lead activist's shareholding. The implicit coordination model discounts the importance of a lead activist in coordinating the wolf pack.

Our argument endeavours to push the analysis of wolf pack formation further than these two models by isolating conditions (i.e. in addition to timing) that might engender shareholder coordination. We focus on the concept of investor sophistication, for example, as a contributing element to wolf pack formation. We also highlight the benefits of wolf packs for smaller, less sophisticated shareholders who free-ride on the activism of the lead wolf or shareholder. Finally, we analogize wolf packs to blockholders generally in terms of the monitoring function that both the blockholder and lead wolf play.

A further difference between our argument and the existing models referenced above is that the latter are predicated on US law and in particular the filing of US disclosure triggered at a five percent ownership threshold. By contrast, in Canada, shareholders are generally required only to disclose equity holdings in excess of ten percent.[9] Given that lead activists do not typically acquire a stake greater than ten percent in connection with their campaigns,[10] wolf packs in Canada can form more easily without disclosure of a lead activist's presence. Wolf packs can therefore exert more influence in the corporate governance of Canadian corporations without having to make disclosure in regards to their holdings.

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[8] Alon Brav, Amil Dasgupta and Richmond D. Matthews, "Wolf Pack Activism" (2016) Robert H Smith School Research Paper No RHS 2529230, online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2529230>.

[9] *Securities Act* (Ontario), RSO 1990, c S 5, s 102.1 [*OSA*]. Furthermore, shareholders in US corporations have a ten-day window in which to purchase additional shares after crossing the five percent threshold, while shareholders in Canadian corporations must immediately cease the purchase of additional shares upon hitting the ten percent threshold.

[10] Coffee, *supra* note 4 at 34.

Part 2 examines the role of blockholders in reducing agency costs in the corporation through monitoring. Part 3 analogizes the behaviour of wolf packs to blockholders and analyzes characteristics of Canadian capital markets that facilitate wolf pack formation. Part 4 considers and evaluates the corporate and securities regulatory regime applicable to wolf packs, understanding that at present wolf packs, and the regulation of wolf packs, are harbingers of controversy in capital market regulation. In particular, it argues that, for the purposes of disclosure rules, wolf packs should be treated in the same manner as blockholders (i.e. shareholders that own a large amount of a corporation's shares, usually between 5 and 10 percent, and can generally influence corporate direction by virtue of their share ownership). Because blockholders and wolf packs perform similar roles in the corporation, they should be treated as like entities in the eyes of the law. Part 5 concludes.

2. Monitoring, Coordination and Blockholders

Following Berle and Means, it is widely recognized that the separation of ownership and control in the corporation can lead to a divergence between the interests of shareholders and directors or managers.[11] While shareholders, whom Berle and Means refer to as owners,[12] seek to maximize the value of their residual claim, managers may shirk their duties or divert corporate resources for their own benefit at the expense of shareholders.[13] According to Jensen and Meckling, these divergent interests give rise to agency costs, which are costs that shareholders, as principals, incur to ensure that directors and managers act in the corporation's best interests.[14] Shareholders may therefore be inclined to monitor their actions.

An implication of this conception of the firm is that directors and managers, as rational actors, may seek to entrench themselves. They may make themselves so valuable to the corporation that they are

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[11] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (New York City: MacMillan, 1933) at 6.

[12] Although it is not uncontroversial to refer to shareholders as the "owners" of the corporation, the theoretical concerns raised by Berle & Means remain relevant: see Lynn Stout, *The Shareholder Value Myth* (Berret-Koehler Publishing: San Francisco, 2012).

[13] Michael Jensen & William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3:4 J Fin Econ 305 at 308. See also Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991).

[14] Jensen & Meckling, *supra*. See also Lucian Bebchuk, "The Myth of the Shareholder Franchise" (November 2006) online: Harvard John M. Olin Discussion Paper Series No. 567 <http://lsr.nellco.org/cgi/viewcontent.cgi?article=1353&context=harvard_olin> at 3.

too costly to replace.[15] They may also forego investments in profitable ventures by investing in specialized projects that require their unique expertise, even if these specialized alternatives will not be as profitable.[16] Some argue, contrary to empirical evidence,[17] that managers do not entrench themselves.[18] However, as long as it is *possible* for management to prioritize its own interests above those of the corporation, the concept of management entrenchment remains relevant.[19]

The presence of a shareholder who owns a sizable percentage of the corporation's equity – a blockholder – can mitigate agency costs through two mechanisms that discipline management: "voice" and "exit."[20] On the one hand, voice involves the blockholder's direct intervention in the firm, such as through letters to management, shareholder proposals or the exercise of control or voting rights.[21] Accordingly, managers are compelled to act in the interests of shareholders (or at least those of the blockholder) out of fear of replacement. On the other hand, exit involves the sale of the blockholder's shares. The sale can have the effect of driving down the firm's share price, thereby punishing management ex post.[22] The threat of exit imposes an ex ante discipline on managers.

The role that the blockholder plays in monitoring management and the board is central to its decision to exercise voice or exit. The larger the blockholder, the more readily it can absorb the cost burden of monitoring; its sizeable position in the corporation gives it added "skin in the game" to

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15 Andrei Shleifer and Robert W Vishny, "Management Entrenchment: The Case of Manager-Specific Investments" (1989) 25 J Fin Econ 123 at 125.

16 *Ibid*.

17 Lucian Bebchuk and Ehud Kamar, "Bundling and Entrenchment" (January 2010), online: Harvard John M. Olin Discussion Paper Series No. 659 <http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_659.pdf> and Paul Borochin & John D. Knopf, "Do Managers Seek Control and Entrenchment?" (forthcoming 2016), online: SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2670918>.

18 See Alfred D. Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge: Harvard University Press, 1977). On the role of the board in keeping managers from entrenching themselves, see Stephen M. Bainbridge, "Director Primacy: The Means and Ends of Corporate Governance" (2003) 97:2 Northwestern Univ L Rev 547.

19 Anita Anand, "The Future of Poison Pills in Canada: Are Takeover Bid Reforms Needed?" (2015) 61:1 McGill LJ 1.

20 See Albert O. Hirschman, *Exit, Voice and Loyalty* (Cambridge: Harvard University Press, 1970); Alex Edmans, "Blockholders and Corp Governance" (2014) European Corporate Governance Institute – Finance Working Paper No 385, online: < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2285781>; and Brav, *supra* note 8. For a seminal theoretical paper on the role of blockholders in reducing agency costs, see Andrei Shleifer and Robert W Vishny, "Large Shareholders and Corporate Control" (1986) 94 J Political Econ 461.

21 See Edmans, *supra* note 20 at 24.

22 *Ibid*.

ensure that management is held accountable.[23] The blockholder will intervene only when the costs of intervention are outweighed by the private benefits of doing so. Empirical evidence suggests that there is a positive, or at least a neutral, relationship between blockholders and firm value.[24] The presence of blockholders is associated with improved outcomes for shareholders on matters ranging from executive compensation to the facilitation of takeover bids.[25] The benefits provided by the blockholder's monitoring flow through to the other shareholders, who are able to free-ride on the blockholder's activism.

Of course, the incentives for blockholders to monitor (including their willingness to internalize the costs of free-riding) vary with the size of their block.[26] Small investors can absorb only a negligible share of the firm's risk, leaving them with insufficient incentives to monitor.[27] Put another way, only large blockholders will monitor firms with high monitoring costs.[28] Evidence further suggests that multiple small blockholders are not as effective in influencing corporate decision-making as is a single large blockholder, partly because coordination costs between the small blockholders impede their ability to monitor the firm.[29] As such, a group of small shareholders that collectively owns a block of shares equivalent in size and right to a block owned by a single, large blockholder will likely result in less effective monitoring.[30] It is simply more difficult to organize behaviour amongst a group of dispersed shareholders,[31] especially when shareholders have heterogeneous preferences.[32]

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23 Lucian Bebchuk, "The Law and Economics of Blockholder Disclosure" (2012) 2 Harvard Bus L Rev 39 at 47 [Bebchuk, "Blockholder Disclosure"].

24 See, in particular, Henrik Cronqvist and Rudiger Fahlenbrach, "Large Shareholders and Corporate Policies" (2009) 22:10 Rev Fin Studies 3941. For a general summary of the empirical literature relating to firm performance, see Edmans, *supra* note 20 at 35-43 and Clifford G Holderness, "A Survey of Blockholders and Corporate Control" (2003) 9:1 Econ Policy Rev 51.

25 For a summary of this literature, see Bebchuk, "Blockholder Disclosure," *supra* note 24 at 48.

26 Andrew Winton, "Limitation of Liability and Ownership Structure of the Firm" (1993) 48:2 J Fin 487 at 493.

27 *Ibid*.

28 Amrita Dhillon and Silvia Rossetto, "Corporate Control and Multiple Large Shareholders" (2009), online: University of Warwick Working Paper <https://www2.warwick.ac.uk/fac/soc/economics/staff/academic/dhillon/wp/submission16nov09.pdf> at 31

29 See Winton, *supra* note 26.

30 John Armour, Henry Hansmann and Reinier Kraakman, "Agency Problems, Legal Strategies and Enforcement" (July 2009), online: Harvard John M. Olin Discussion Paper Series No. 644 <http://www.law.harvard.edu/programs/olin_center/papers/pdf/Kraakman_644.pdf> at 3. Although the presence of a single, large blockholder tends to increase shareholder monitoring of management, it is worth bearing in mind the possibility that the blockholder will seek to extract private benefits of control to the detriment of other shareholders (as discussed more fully below).

31 Andrew Kulpa, "The Wolf in Shareholder's Clothing" (2005) 6 UC Davis Bus LJ 4.

In short, the presence of a single, large blockholder can have a beneficial effect on the firm's governance in reducing agency costs through monitoring. At the same time, however, blocks comprised of multiple small blockholders are less effective at fulfilling the role of the blockholder in the corporation. As will be discussed in the following section, under certain conditions, wolf packs are able to overcome the coordination costs that impede blocks comprised of small shareholders. In this way, they operate in a manner analogous to that of a single, large blockholder.

3. Wolf Pack Behaviour

In the previous section, we argued that blockholders perform an important monitoring function when they are incentivized to do so (i.e. when the private benefits of such monitoring outweigh its costs). In this section, we argue that wolf packs are a type of blockholder and they too perform an important monitoring function. We note that reliable empirical data on the incidence of wolf packs is challenging to obtain, since ungrouped shareholders are not obliged to make disclosures in connection with their collective position.[33] We postulate, however, that a wolf pack will only form when it is able to overcome the free-rider problem and coordination costs identified above keeping smaller shareholders from monitoring and that impede the formation of *de facto* blocks by networks of smaller shareholders.

Two hypotheses explaining wolf pack formation dominate the nascent academic literature.[34] Under what we term an "explicit coordination model," Coffee and Palia argue that a lead activist will recruit other investors to join the pack *before* filing the required disclosure called a Schedule 13D in the US (whose equivalent is an early warning report in Canada).[35] Subsequent members of the pack are rewarded with a riskless arbitrage opportunity in return for their support of the lead activist's agenda: the lead activist tips off the pack's other members before filing its Schedule 13D, which is

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[32] Armour, *supra* note 30 at 3. It is worth noting, however, that the coordination issues that hinder shareholder intervention strategies actually make the threat of exit stronger, thereby allowing many small blockholders to have a positive impact on managerial discipline: Alex Edmans and Gustavo Manso, "Governance Through Trading Intervention: A Theory of Multiple Blockholders" (2010) 24:7 Rev Fin Stud 2395 (who argue that the threat of trading activity of multiple blockholders in the face of poor managerial performance disciplines management). Even so, wolf packs ostensibly form to intervene and agitate for change, not to passively invest and then exit.

[33] Becht, *supra* note 1 at 698.

[34] See also Wong, *supra* note 6.

[35] Coffee, *supra* note 4 at 34.

generally associated with a jump in the share price.[36] As such, the wolf pack is formed before disclosure is made through the explicit coordination efforts of the lead activist. As Bratton notes, although the purchase activity of subsequent members of the pack makes it more expensive for the lead activist to make further purchases in the target corporation, that the lead activist is required to share its gains with other members of the pack does not inhibit the activist from assuming a lead position.[37] It is important to note that just as members of the wolf pack are careful to avoid "acting jointly or in concert" for the purposes of disclosure rules, they are also careful not to breach insider trading and tipping laws.[38]

Under an alternative hypothesis, which we term the "implicit coordination model," Brav *et al* assert that a coordination game drives wolf pack formation, since individual shareholders are incentivized to join wolf packs without explicit coordination by a lead member.[39] Wolf packs arise spontaneously because investors monitor the same corporations at generally the same times. Each "small" independent investor on its own does not have sufficient incentive to monitor and intervene because the probability of a successful campaign is low and the expected benefits do not outweigh the costs. However, the entry of a "large" investor, whose position is conveyed to the other "small" investors through the filing of disclosure when it passes the five percent ownership threshold, operates as a catalytic event that increases the expected probability of a successful intervention, and in turn compels small investors to join the intervention and thus form a wolf pack. The rational self-interest of the members of the wolf pack is sufficient for the wolf pack to form on the basis of implicit coordination *after* the lead activist discloses its position to the market.

Neither of these models is entirely applicable to the study of wolf packs in Canada because they are predicated on US law and in particular the filing of a Schedule 13D, which is triggered at a five percent ownership threshold. In Canada, shareholders are generally only required to disclose equity holdings in excess of ten percent.[40] Given that lead activists do not typically acquire a stake greater

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[36] *Ibid*.

[37] William Bratton, "Hedge Funds and Governance Targets: Long-Term Results" (2010), online: University of Pennsylvania Institute for Law and Economics Research Paper No. 10-17 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1677517> at 1384.

[38] In particular, each member of the wolf pack would be careful to avoid being classified as an "insider" or in a "special relationship with the reporting issuer."

[39] Brav, *supra* note 8.

[40] *OSA*, *supra* note 9, s 102.1 [*OSA*].

than ten percent in connection with their campaigns,[41] wolf packs in Canada can form without the disclosure of a lead activist's presence. Furthermore, there are additional reasons for a lead activist to remain below a ten percent ownership threshold in respect of a Canadian issuer.[42]

We believe that a number of unique conditions are necessary to give rise to shareholder coordination in the form of a wolf pack and in some sense these conditions undermine the formation of wolfpacks in Canada because of the nature of capital markets in this country. The first condition, or "non-condition," relates to the nature of the target corporation's shareholder base. If a corporation's shareholder base is widely-held, the formation of a wolf pack is more likely. In Canada, however, many public corporations are dominated by a controlling shareholder[43] who is often the founder or the founder's family.[44] Wolf packs, and activist interventions generally, are unlikely to be effective in controlled corporations, since voting control of the corporation resides with the founder: regardless of the size of the wolf pack's position, it will always be out-voted by the controlling shareholder (unless the controlling shareholder forms part of the wolf pack).[45] As a result, a proxy contest, or the threat of a proxy contest, may be an ineffective means of agitating for change in the corporation.

In addition to a non-controlled (or widely-held) corporation, the presence of an institutional shareholder can facilitate wolf pack formation. The institution may or may not take on the role of lead activist. Regardless, it is sophisticated and will fulfill a monitoring function, a by-product of which is to allow subsequent members of the wolf pack to free-ride on its efforts. This is especially important in the context of the Canadian capital markets, where corporations' share ownership tends

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41 Coffee, *supra* note 4 at 34.

42 For instance, crossing the ten percent ownership threshold requires the shareholder to immediately cease subsequent purchases in the issuer for a full business day and immediately file a disclosure report, and will implicate insider trading and tipping laws based on the shareholder's "special relationship" with the issuer.

43 Bozec, *supra* note 5.

44 Walid Ben-Amar and Paul Andre, "Separation of Ownership from Control and Acquiring Firm Performance: The Case of Family Ownership in Canada" (2006) 33:3 J Bus Fin & Accting 517 at 518.

45 For example, Pershing square's 2006 activist campaign in respect of Canadian Tire Corp. was halted in its tracks by the daughter of a co-founder of the company, who controlled 61 percent of the company's voting shares through a dual-class structure: Lori McLeod, "US Hedge Fund Kicks the Tire" (4 July 2006) *Financial Post*.

to be dominated by larger institutional holders.[46] In some cases, pension funds – which are not typically activist[47] – may join together from time to time.[48]

Wolf packs, by definition, will have a lead who must bear the costs of monitoring up-front before convincing other shareholders to join the wolf pack. It is unlikely that the lead activist will begin a campaign for governance reform where any gains are likely to be modest; rather, the lead activist would likely need to present a plan for the corporation that involves a change of control. The lead activist is willing to bear these monitoring costs up-front because the likelihood of a wolf pack achieving at least one of its intended outcomes is significantly higher than that of an individual activist.[49] As a result, the expected benefits of monitoring rise relative to the costs.

We must remember that the lead activist's position likely sends a signal to other investors. By the time the lead contacts other shareholders, it will have fulfilled at least a portion of its self-imposed monitoring function, thereby allowing subsequent members of the wolf pack to free-ride on its efforts. Because the institutional investors that tend to hold sizable positions in Canadian corporations are not generally activists, they may benefit from a lead activist who has borne the costs of monitoring up-front.

Thus wolf packs might be more likely to feature alliances between a hedge fund, as lead activist, and one or more institutional investor. For example, the Canadian Pension Plan Investment Board publicly supported William Ackman's activist campaign at CP Rail in 2012.[50] These alliances are more readily understandable given empirical work relating to wolf packs which suggests that lead

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[46] For recent statistics on pension fund ownership of Canadian equities, see Vijay Jog and Jack Mintz, "Sovereign Wealth and Pension Funds Controlling Canadian Businesses: Tax-Policy Implications" (2013) 6:5 SPP Research Papers 1, online: The University of Calgary School of Public Policy <http://www.policyschool.ucalgary.ca/sites/default/files/research/jogmintz-pensionwealth.pdf>.

[47] John A Doukas, Chansong (Francis) Kim and Christos Pantzalis, "Security Analysis, Agency Costs and Company Characteristics" (2000) 56:6 Financial Analysts Journal 54.

[48] *Re Magna International Inc.* (2010), 34 OSCB 1290.

[49] Becht, *supra* note 1 at 32 (which finds a 78% success rate for wolf packs compared with a 46% success rate for other activists).

[50] Brent Jang and Jacquie McNish, "CPPIB Backs Pershing Square in CP Proxy Row" *The Globe & Mail* (18 June 2012), online: <http://www.theglobeandmail.com/globe-investor/cppib-backs-pershing-square-in-cp-proxy-row/article4106482/>.

activists may tip off other funds with which they have existing relationships.[51] In other words, wolf packs will typically be comprised of "repeat" groups of shareholders or at least that the presence of a given member of the wolf pack will be associated with a particular group of shareholders that comprises the pack.

The alliances between members of the wolf pack are facilitated by another condition, namely the current legal regime relating to shareholder coordination in respect of Canadian corporations. Shareholders can be incentivized to join a wolf pack because of the opportunity for riskless profit provided by the spike in share price that tends to follow the filing of an early warning report.[52] Even without filing the report, the lead activist can manufacture a comparable share price appreciation by notifying potential members of the wolf pack of its intentions to initiate a proxy contest or agitate for a sale of the target.[53] Indeed, the threat of a proxy contest is perhaps more credible under Canadian securities laws than those in other jurisdiction because these laws allow a dissident shareholder to wage a proxy contest relatively inexpensively without the need to prepare and mail a proxy circular to other shareholders under the public broadcast exemption.[54] In addition, under the 15-shareholder proxy solicitation exemption, a dissident shareholder is permitted to solicit proxies from a limited number of shareholders without having to prepare and mail a proxy circular.[55]

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[51] Wong, *supra* note 6. [Can you also cite my short article in the Canadian investment review on proxy contests as well as my forthcoming piece called "shareholder activism" in a book by P.M. Vasudev]

[52] In the US, empirical studies have indicated that Schedule 13D disclosure results in a positive abnormal share price appreciation (even if only in the short-term). As such, members of wolf packs in respect of US companies that purchase shares before the lead member of the pack files its disclosure obtain a riskless profit: see Coffee, *supra* note 5 at 10 and, on other empirical effects of shareholder activism, Lucian Bebchuk, Alon Brav and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism" (2015) 115 Columbia L Rev 1085 [Bebchuk, "Long-Term Effects of Hedge-Fund Activism"]. To the extent that public knowledge of an activist involvement with an issuer would result in a similar share price appreciation in Canada with the filing of an early warning report, members of the wolf pack have a similar opportunity at riskless profit when the lead member of the pack announces its position.

[53] Empirical work has shown that the announcement of a proxy contest is associated with positive abnormal share price appreciation: Lisa F. Borstadt and Thomas J. Zwirlein, "The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance" (1992) 21 Fin Mgmt 22.

[54] This exemption allows a dissident shareholder to communicate with other shareholders through a website, press release, public broadcast or public speech without having to prepare and mail a proxy circular: *Continuous Disclosure Obligations*, OSC NI 51-102, 36 OSCB 2619 (31 May 2013) [NI 51-102] s 9.2.

[55] *Ibid*, s 9.2. This exemption contrasts with the relatively stricter shareholder communication and proxy rules in the US. For a discussion of these rules, see Stephen Choi, "Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms" (2010), UC Berkeley Public Law and Legal Theory Working Paper Series No 7, online: SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=219933>.

Thus, certain conditions give rise to wolf packs. In the absence of these conditions, it may be too costly or impractical for a wolf pack to form. The first condition is a corporation in which the controlling shareholder or institutional investor is part of the wolf pack. The second condition relates to the lead activist: the lead will assume a monitoring function and will enable other institutions or smaller investors to free ride, thereby potentially broadening the scope of support for the wolf pack's intervention. The final condition relates to the legal regime in place. Rules that lessen disclosure and alleviate the burden of filing proxy materials facilitate wolf pack formation, as will be further discussed in the next section.

4. Legal Regime

There are no formal rules relating to wolf packs *per se*, but their coordinated nature implicates rules relating to proxy solicitation, early warning reporting and possibly insider trading. While wolf packs form loose networks of investors, they generally seek to accumulate a base of support without triggering the shareholder disclosure obligations that would arise if the group's aggregate position exceeded certain ownership thresholds. In this section, we examine competing considerations – including wolf packs' likely preferences – regarding the prevailing legal regime and consider whether changes to this regime are warranted.

(a) Rationale

Generally speaking wolf packs prefer less disclosure to more, likely because of the constraints that disclosure places on their behaviour.[56] A loose disclosure regime allows wolf packs to outflank corporate defences, like poison pills, which are triggered when a shareholder or group of shareholders pass an ownership threshold prescribed by the pill. It becomes impossible to trigger the pill when the size of the wolf pack's position remains unknown. In addition, activists can leverage their superior information regarding the size of the pack when engaging the target board.[57] Furthermore, empirical studies have shown that Schedule 13D disclosure is associated with positive

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[56] See Wong, *supra* note 6 at 31 who states that "…timely and reliable disclosures constrain the ability of blockholders to secure private benefits…".

[57] *Ibid* at 28-39.

abnormal share price appreciation.[58] As such, it becomes more expensive for a shareholder to purchase shares in a corporation after, rather than before, filing this disclosure; efficient markets force large shareholders to buy at prices that reflect their own price impact after the filing, which eats into their returns.[59]

On the one hand, a legal regime that makes it easier for wolf packs to form and requires less disclosure regarding their investments renders it more likely that the monitoring benefits engendered by large blockholders discussed above will materialize. On the other hand, however, many investors may find the mere presence or identity of a wolf pack to be material in making investment decisions. A lenient disclosure regime for wolf packs may allow them to accumulate *de facto* control blocks without paying other shareholders a control premium and facilitate "creeping control" acquisitions. These concerns are revant to (but distinct from) the so-called "short-termism" that hedge funds may exhibit when they are more committed to short-term value maximization rather than managers' long-term strategies for the corporation.

In the face of these competing arguments, is more or less disclosure regarding wolf pack formation appropriate? A rationale for securities disclosure laws generally relates to price efficiency:[60] public issuers are mandated to disclose material information so that investors can determine prices for securities that accurately reflect all such information.[61] There is also a strand of literature that calls for mandatory disclosure on the basis that such disclosure reduces agency costs between managers and shareholders: disclosure makes monitoring easier and decreases the likelihood that managers can use corporate assets for self-interested purposes.[62]

The rationale for blockholder disclosure follows a similar logic. It is well-recognized that blockholders can potentially extract private benefits of control, which can impose costs on other

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[58] Coffee, *supra* note 4 at 33-34 and Bebchuk, "Long-Term Effects of Hedge Fund Activism," *supra* note 52.

[59] Coffee, *supra* note 4 at 33-34.

[60] On the efficient markets hypothesis, see Eugene F Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25:2 J Fin 383.

[61] On the relationship between disclosure and price efficiency generally, see Anita Anand, "Fairness at What Price? An Analysis of the Regulation of Going-Private Transactions in OSC Policy 9.1" (1998) 43 McGill LJ 115.]. On the importance of price efficiency in the public markets, see Fama, *supra* note 61.

[62] Paul G Mahoney, "Mandatory Disclosure as a Solution to Agency Problems" (1995) 62:3 U Chicago L Rev 1047 at 1048.

shareholders.[63] A lack of blockholder disclosure can also facilitate "creeping takeovers," where a blockholder is able to acquire a control block from unknowing shareholders without paying a control premium that is typically associated with a takeover bid or other acquisition.[64] A regime requiring blockholders to disclose their respective positions protects against both these risks. A disclosure regime that governs wolf packs allows investors to take into account the presence of a wolf pack as blockholder in valuing securities. It also reduces the potential costs associated with significant shareholders who exert an undue amount of influence on the corporation for private gain.

(b) Legal Regime

Under Canadian securities law, disclosure rules affecting the formation and disclosure of wolf packs generally fall under the early warning reporting system, which prescribes disclosure rules for blockholders that may influence corporate control or direction.[65] As the Canadian Securities Administrators (CSA) explain:

> Accumulations may be material information to the market even when not made to change or influence control of the issuer…Market participants may also be concerned about who has the ability to vote significant blocks, as these can affect the outcome of control transactions, the constitution of the issuer's board of directors and the approval of significant proposals or transactions. The mere identity and presence of an institutional shareholder may be material to some investors.[66]

Recently, the CSA have confirmed that the objectives of the early warning reporting system apply to proxy-related matters.[67] As such, the rationale for the early warning reporting system is tied to the

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63 Michael J Barclay and Clifford G Holderness, "Private Benefits from Control of Public Corporations" (1989) 25 J Fin Econ 371.

64 Coffee, *supra* note 4 at 82.

65 *Continental Precious Metals Inc v Singh*, 2012 ONSC 7122 [Commercial List] at para 12.

66 Canadian Securities Administrators, "CSA Notice and Request for Comment: Proposed Amendments" (13 July 2013), online: <http://www.osc.gov.on.ca/en/SecuritiesLaw_mi_20130313_62-104_take-over-bids.htm>.

67 Canadian Securities Administrators, "CSA Notice and Request for Comment: Proposed Amendments" (10 October 2014), online: Ontario Securities Commission <https://www.osc.gov.on.ca/en/SecuritiesLaw_mi_20130313_62-104_take-over-bids.htm> [Canadian Securities Administrators, "2014 Notice"].

perceived need to alert the market of impending or potential change of control transactions, including proxy contests.

Under the early warning system, acquirors who hold more than ten percent of an issuer's outstanding securities are required to disclose their position to the market in a promptly-filed news release and early warning report.[68] Acquirors that have crossed this ten percent threshold are required to file additional disclosures upon any additional two-percent purchase of the issuer's securities. Unlike the insider reporting regime, the early warning reporting system deems shares purchased by those who act jointly or in concert with the acquiror to have also been purchased by the acquiror, such that their collective ownership is aggregated for the purposes of determining whether the ten percent threshold has been crossed. For instance, an acquiror with a seven percent stake in a given issuer would be required to file an early warning report if it were acting jointly or in concert with another shareholder holding a four percent stake. Determining whether two parties are acting jointly or in concert with another is a question of fact,[69] and there is limited case law addressing the issue.[70] Of course, how courts – or the regulator in the form of tribunal decisions and policy directives – interpret the breadth of this statutory language will have a significant impact on how wolf packs can form and the nature and timing of their disclosure obligations.

The rules relating to shareholder disclosure set out above expose a tension that is at the heart of wolf packs and related regulation. On the one hand, blockholder formation is valuable in imposing managerial discipline and reducing agency costs, which are benefits that flow to all shareholders. Rules that facilitate the formation of wolf packs – such as a relatively higher ten percent disclosure threshold and a narrow reading of what it means "to act jointly and in concert" with another

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[68] *OSA*, *supra* note 9, s 102.1.

[69] *Ibid*, s 91(1).

[70] See, for instance, *Re Sears Canada* (2006), 35 OSCB 8781 and *Re Sterling Centrecorp Inc* (2007), 30 OSCB 6683 [*Re Sterling Centrecorp*]. These decisions, and the others that interpret this statutory language, do so in the context of take-over bids, insider bids and related party transactions. The OSC's decision in *Re Sterling Centrecorp* is exemplary of the fact-specific nature of these decisions and the difficulty in applying them to wolf packs: the "policy underlying the concept of identifying who is a "joint actor"…is to ensure that all persons or companies who are effectively engaged in a common investment or purchase program are required to abide by the requirements of Ontario securities laws," and further, that a "determination of a joint actor relationship can be made if the facts establish that the parties in question played an integral role in planning, promoting and structuring the transaction to ensure its success beyond their customary role."). An added issue is that many decisions that address the concept of "acting jointly or in concert" do so with reference to the definition of "joint actor" under certain national and multilateral instruments relating to take-over bids. It is an open question whether decisions determining a "joint actor" characterization under take-over bid rules would apply to the determination of whether shareholders are "acting jointly or in concert" for the purposes of early warning reporting.

shareholder – are desirable. On the other hand, rules that permit wolf packs to organize without comprehensive disclosure are arguably unfair to shareholders who are unable to obtain and analyze material information relating to who exercises effective control at the companies in which they have chosen to invest. In light of the foregoing, what is the optimal regulatory regime to balance these competing aims?

The answer at least begins with the mandate of the regulator, which has a legal duty to protect investors on a prospective and preventative basis and can act in the public interest to do so.[71] Although the "public interest" is not defined in either the *OSA*, securities regulation or regulatory policies, the OSC has suggested that it can apply the public interest power "where market conduct engages the animating principles of the [*OSA*],"[72] which include requirements for timely, accurate, and efficient disclosure of information; restrictions on fraudulent and unfair market practices and procedures; and requirements for the maintenance of high standards of fitness and business conduct to ensure honest and responsible conduct by market participants.[73] As the OSC has noted in prior decisions, "[a] sound financial disclosure system is fundamental to the operation of our capital markets."[74] Even if no harm results from misleading disclosure, a finding of abuse can result if the public *could* have "made investment decisions based on [a false] impression."[75]

Wolf packs are effectively blockholders. Shareholders form *de facto* blocks to exert influence at the corporation in much the same manner as a blockholder, but are able to avoid disclosure rules simply by avoiding the characterization of their behaviour as joint action. Thus we believe that wolf packs should be regulated like blockholders. That is, they should be subject to early warning reporting when their collective interest rises above ten percent, just as a blockholder is subject to early warning reporting when its individual interest crosses that threshold. As the CSA noted, "the mere identity and presence of an institutional shareholder may be material to some investors."[76] Investors should not need to make decisions in the absence of material information, such as the existence of a

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71 *Committee for the Equal Treatment of Asbestos Minority Shareholders v Ontario (Securities Commission),* [2001] 2 SCR 132 and *OSA, supra* note 9, s 127.

72 *Re Biovail Corp* (2010), 33 OCSB 8914 at para 382.

73 *OSA*, *supra* note 9, s 2.1(2).

74 *Re Standard Trustco* (1992), 15 OSCB 4322 at 4358-59 [emphasis added].

74 *Ibid* at 4359.

75 *Ibid*.

76 Canadian Securities Administrators, "2014 Notice," *supra* note 67.

wolf pack. Although it is true that blockholders fulfill an important monitoring role in the corporation, the regulator has presumably already weighed this benefit against the need for investors to make investment decisions with access to material information regarding blockholders. If this policy choice has been made in respect of blockholders, then the law's treatment of wolf packs should be no different.

As is clear from the foregoing analysis, central to the analogy between blockholders and wolf packs is the concept of "acting jointly and in concert." Interpretation of this statutory language dictates whether wolf packs will be subject to the same disclosure rules as blockholders: a narrow understanding of what qualifies as joint action allows individual members of the wolf pack to consider only their respective interest for the purposes of passing disclosure thresholds. For instance, in the US context, the Second Circuit held that three shareholders were not acting as a "group," even though one shareholder "was a well-known raider and all three discussed amongst themselves how to improve the value of the target company."[77] Wolf packs would be able to extract the private benefits associated with a block position without the attendant disclosure obligations to which blockholders are subject. For this reason, we believe that the concept of "acting jointly and in concert" should be interpreted and applied broadly to cover a wide range of communication and behaviours associated with wolf pack formation. In particular, tipping by the lead member of the wolf pack to other investors regarding the lead member's plans in relation to the target should qualify as joint conduct. To this end, securities regulators should at a minimum issue a policy statement clarifying the statutory language to specify this point.

Although courts are afforded broad latitude with respect to the remedies they may impose upon a breach of securities regulation, the judicial posture has traditionally been one of restraint. As one court recently stated, "the surgery should be done with a scalpel and not a battle axe."[78] In *Genesis v. Smoothwater*, one of the few cases dealing with the scope of what behaviour qualifies as "acting jointly or in concert" in the context of a proposed proxy contest, the court refused to bar the wolf pack's members from voting their shares despite holding that the wolf pack breached its disclosure obligations; instead, the court ordered the wolf pack make appropriate disclosures regarding its joint

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[77] See *Hallwood Realty Partners LP v Gotham Partners, LP*, 286 F.3d 613 (2d Cir 2002) and Coffee, *supra* note 4 at 39.

[78] *20099 Ontario Inc v Harold E Ballard Ltd* (1992), 3 BLR (2d) 113 (Ont SCJ), cited in *Genesis Land Development Corp v Smoothwater Capital Corp*, 2013 ABQB 509 at para 69 [*Genesis v Smoothwater*].

action and delayed the annual general meeting of the shareholders until the shareholders had adequate time to review such disclosures.[79] Future decisions should consider that wolf packs should not be permitted special status in the "acting jointly or in concert" analysis, especially in light of the potentially weak remedies imposed on them for non-compliance.[80]

Of course, underlying the foregoing discussion of the relationship between disclosure and wolf packs is a potential relationship between wolf pack formation to insider trading and tipping. The chance at riskless profit engendered by wolf packs – based on the relationships between and amongst specific institutional shareholders – seems to run contrary to the policy animating insider trading and tipping laws which is to protect "investor confidence in the marketplace as a level playing field."[81] If it is the case that rules make illegal tipping by persons or companies contemplating take-over bids[82] because of the premium such bids typically command and that the announcement of proxy contests usually result in a similar share price appreciation,[83] then we can legitimately question why one type of behaviour is captured by tipping rules while another is not. Securities regulators should consider whether tipping rules should apply to persons or companies contemplating proxy contests, another form of change of control.

5. Conclusion

It is challenging to ascertain precise figures on the incidence of wolf packs.[84] Nevertheless, this article represents a first step towards understanding the circumstances that engender their formation and the motivations that drive the behaviour of their members. As the law currently stands, wolf packs assume the role of a blockholder in the corporation, but without the same disclosure obligations that blockholders are required to observe. While a legal regime that facilitates wolf pack formation, including a narrow concept of "acting jointly or in concert," may make it easier for shareholders to monitor management and thus reduce agency costs in changes of control, these

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79 *Genesis v Smoothwater*, *supra* note 77 at paras 70-71.

80 Coffee, *supra* note 4 at 42.

81 *Disclosure Standards*, OSC NP 51-201, (2013) 25 OSCB 4492 (31 May 2013).

82 See *OSA*, *supra* note 9, s 76(3).

83 And, in any event, both would be expected to have significant impacts of the value of a given company's securities.

84 Thomas W Briggs, "Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis" (2007) 32 J Corp L 681 at 698.

benefits should not come at the price of deficient disclosure. If a sound disclosure system is the cornerstone of securities regulation, then novel tactics aimed at circumventing that system – especially when analogous shareholders are caught by it – should be more comprehensively regulated.