



Merger Arbitrage, Beneficial Ownership Reporting and Proxy Contests: The SEC's Perry Order

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(Editor's Note: This post is based on a [Latham & Watkins LLP](#) client memorandum.)

Earlier this year, on July 21, 2009, the US Securities and Exchange Commission issued a cease-and-desist order charging investment adviser Perry Corp. (Perry) with securities law violations for its failure to report timely under Section 13(d) of the Securities Exchange Act of 1934 its beneficial ownership of more than 5 percent of the outstanding common stock of Mylan Laboratories Inc. (Mylan).¹ In the *Perry* Order, the Commission determined that Perry was not entitled to avail itself of the annual short-form reporting provisions of Rule 13d-1(b) (the so-called 45-day 13G provision) because it did not satisfy the "ordinary course of business" requirement under that provision.

The *Perry* Order illustrates the Commission's aggressive enforcement of the Section 13(d) beneficial ownership reporting requirements in the context of complex merger arbitrage practices using derivatives products. The *Perry* Order is notable for the breadth of its legal conclusions and their potential implications for requiring a broad array of investors to switch their reporting status from the 45-day 13G regime to either a Schedule 13G filed within 10 days of additional acquisitions or to a full-scale Schedule 13D filing status.

Background on Merger Risk Arbitrage and Beneficial Ownership Reporting

Merger risk arbitrage loosely refers to practices that investors use to profit from arbitrage spread opportunities typically created by cash or stock acquisitions of publicly traded companies. In a stock-for-stock merger, the pre-merger arbitrage spread opportunity exists because the number of shares (and/or fractional shares) of acquirer stock to be received in exchange for one share of target stock often trades at a higher market price than a share of target stock, reflecting market uncertainty about whether the merger will be completed (the "risk" in merger risk arbitrage) and the time it will take to complete the merger (which results in a financing cost to carry the arbitrage position until merger completion). The pre-merger spread decreases if the merger appears likely

¹ In the matter of Perry Corp., Exchange Act Release No. 60351 (July 21, 2009). The *Perry* Order was issued pursuant to a settlement in which Perry, without admitting or denying the Commission's findings, consented to the issuance of the Order and a \$150,000 fine.

to be completed and as the time for completion approaches, and increases if the merger seems less likely to be completed or its completion is delayed.

An investor engaging in risk arbitrage of a stock-for-stock merger captures the arbitrage spread by acquiring target shares, while at the same time selling short the corresponding number of acquirer shares that would be exchanged in the merger for such target shares. If and when the merger is completed, the number of target shares owned by the investor (e.g., that the investor is “long”) turn into the number of shares of the acquirer that the investor is “short,” and the investor can use these newly received acquirer shares to cover its short position. If, however, the merger is not completed, an investor engaging in a risk arbitrage strategy is likely to suffer a loss because, typically, the shares of the target will decrease in price as a result of the loss of the anticipated merger premium and, not infrequently, the acquirer stock price will rise, leading to a loss on the risk arbitrageur’s short position as well.

In general, Section 13(d) requires any person who acquires beneficial ownership of more than 5 percent of a voting class of equity securities registered under Section 12 of the Securities Exchange Act of 1934 (a 5 percent Owner) to report its holdings and related matters on either long form Schedule 13D or short form Schedule 13G. Investors who would normally be required to file a long form Schedule 13D within 10 days of the acquisition that resulted in the investor crossing the 5 percent threshold may instead file a short form Schedule 13G if they meet a passive investor standard—not acquiring the securities “with the purpose, or with the effect of, changing or influencing the control of the issuer or in connection with or as a participant in any transaction having that purpose or effect.”

There are, however, two separate filing dates for Schedule 13G. The first, and far more lenient, filing provision allows certain qualified institutional investors² meeting the passivity standard who acquire the securities “in the ordinary course of his business” to file a Schedule 13G as late as 45 days after the end of the calendar year in which they became a 5 percent Owner (a 45-day 13G).³ On the other hand, qualified institutional investors who meet the passivity standard but do *not* acquire the securities in the “ordinary course of business,” and other investors who beneficially own less than 20 percent of such outstanding equity securities,⁴ must file a 13G within 10 days after an acquisition that makes them a 5 percent Owner (a 10-day 13G).

Perry and the Mylan-King Merger

² Rule 13d-1(b)(1)(ii) enumerates the list of qualified institutional investors. There is no question that Perry was such a qualified institutional investor.

³ However, Rule 13d-1(b)(2) provides that if the person’s beneficial ownership exceeds 10 percent of the class of equity securities prior to the end of the calendar year, the initial Schedule 13G shall be filed within 10 days after the end of the first month in which the person’s beneficial ownership exceeds 10 percent of the class of equity securities, computed as of the last day of the month. 8 Number 941 | October 1, 2009
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⁴ See Rule 13d-1(c).

The *Perry Order*, along with recent cases such as *CSX v. The Children's Investment Fund*, illustrates the Commission's and the courts' evolving interpretations of beneficial ownership reporting requirements in the context of proxy and other control contests in which parties utilize derivative securities as part of their tactics.⁵ Perry is a registered investment advisor that provides investment advice and asset management services.

As of March 30, 2009, Perry had approximately \$8.8 billion under management. According to the findings in the *Perry Order*, by March 2004, Perry had built a significant position in King Pharmaceuticals (King), an established brand-name pharmaceutical company. On July 26, 2004, Mylan, one of the US's largest manufacturers of generic pharmaceutical products, announced an agreement to acquire King in a stock-for-stock merger subject to the approval of both Mylan and King shareholders.

Following the merger announcement, Perry engaged in merger arbitrage, trying to maximize its potential profits by converting its King position into a risk-arbitrage spread position through the short sale of a corresponding number of Mylan shares.

On September 7, 2004, an activist investor group led by Carl Icahn (the Icahn Group) filed a Schedule 13D with the Commission,⁶ disclosing its acquisition of 6.8 percent of Mylan's stock and its opposition to, and intent to solicit proxies against, the Mylan- King merger. This Schedule 13D filing signaled that Mylan shareholder approval of the merger would be a battle, an extremely unusual occurrence in the M&A world where it is assumed, and is almost invariably the case, that the acquirer's shareholders will vote in favor of the transaction.

By September 17, 2004, when the Icahn Group amended its Schedule 13D to disclose that it held 8.9 percent of Mylan's stock, the risk arbitrage spread had widened by 59 percent, from \$3.26 to \$5.19, reflecting significantly increased market uncertainty as to whether the merger would succeed in light of the Icahn Group's opposition. If the Icahn Group had succeeded in blocking the merger, Perry of course would have lost its anticipated profit from its risk arbitrage position.

Following the Icahn Group's Schedule 13D filing, according to the Commission, Perry considered how to obtain Mylan stock in order to vote in favor of the merger, and thereby counter the Icahn Group's votes, without assuming the economic risk of owning Mylan shares. Although Perry's initial risk arbitrage position was vulnerable to a collapse of the deal, the amount of Perry's potential profit was fixed and unaffected by subsequent price movements in the market.

⁵ *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al.*, 2008 U.S. Dist. LEXIS 46039 (S.D.N.Y. June 11, 2008) (addressing how the use of total return swaps in a control contest may lead to the deemed beneficial ownership of the underlying shares). This case was discussed in a Latham & Watkins Client Alert, *Use of Total Return Swaps in Control Contest Leads to Deemed Beneficial Ownership of Underlying Shares* (June 25, 2008), available here.

⁶ Although the Icahn Group was not identified by name in the *Perry Order*, the Schedule 13D identifies the Icahn Group and Carl Icahn's spouse as the persons filing the Schedule 13D. Mylan Laboratories Inc., Schedule 13D, Item 2 (Sept. 7, 2004).

Consequently, there was no obvious reason based on Perry's arbitrage position at that point in time for Perry to care about maintaining secrecy concerning its moves to counter the Icahn Group. However, the Commission charged that because Perry wanted the ability to profit from increasing the size of its arbitrage position by making subsequent additional purchases of King shares and additional short sales of Mylan shares, Perry did not want the market to be aware that it was building a position to vote in favor of the merger. If the market had known that Perry was acquiring Mylan shares to offset the Icahn Group's position, the spread might have narrowed to reflect the increased likelihood that the merger would be completed, reducing Perry's potential profits on its increased arbitrage position.

Perry purchased approximately 5.6 million Mylan shares, or 2.1 percent of Mylan stock, in regular open-market transactions starting on September 8, 2004 (the day after the Icahn Group's initial Schedule 13D filing) and ending on October 13, 2004. During this period, Perry also purchased an aggregate of 21 million Mylan shares from two banks, who had borrowed the 21 million Mylan shares and sold them short to Perry. At the same time, Perry entered into "total return" swaps with the banks on the same number of Mylan shares and at the same prices it paid the banks.

In these total return swaps Perry agreed to pay the banks the amount of any increase in the price of the underlying Mylan shares, and the banks agreed to pay Perry the amount of any decrease in the price of the underlying Mylan shares.⁷ As a result, neither Perry nor the banks had any economic exposure to the price of Mylan stock. By entering into these swap transactions, Perry was able to acquire the voting rights to nearly 10 percent of Mylan's stock, without having any real economic stake in Mylan. Perry also acquired these voting rights without public disclosure.

Perry's acquisition of 21 million shares from the two banks was executed to avoid the trades being reported on the consolidated tape. The Commission ascribed Perry's chosen method to execute transactions in Mylan stock to Perry's conscious planning to avoid public disclosure of its purchases, even though on many days Perry's share purchases eclipsed the total volume of all Mylan shares reported to have been purchased through all reporting exchanges.

Moreover, Perry did not disclose its large voting position in Mylan by filing either a Schedule 13D or 13G within 10 days of its crossing the 5 percent ownership threshold. In so doing, Perry relied on the 45-day 13G filing provisions—that it had acquired the shares "in the ordinary course" of its business and not with the purpose or effect of changing or influencing control of Mylan (presumably meeting the latter test on the basis that there would be no change in control of Mylan, the acquirer in the proposed King transaction).

⁷ Because the banks were borrowing the shares that they sold short to Perry, the banks were at risk if the price of Mylan stock was up at the time the banks needed to cover their short positions. Perry, which was long the 21 million shares it purchased from the banks, was at risk if the price of Mylan stock was down at the time Perry wished to unwind its position. The swaps guaranteed both parties against these potential losses.

On November 19, 2004, the Icahn Group made a tender offer for Mylan shares. On November 23, 2004, Perry consulted with counsel who counseled that, because of the tender offer, Perry now could be said to hold its Mylan shares with the purpose or effect of changing or influencing the control of Mylan. This conclusion made Perry no longer eligible to file a 45-day 13G (or even a 10-day 13G) because Perry no longer met the passive investor requirement. On November 29, 2004, Perry filed a Schedule 13D disclosing its Mylan position, more than two months after Perry had acquired more than 5 percent of Mylan shares.

The Mylan/King merger was not completed for reasons unrelated to Perry's trading activities. On December 8, 2004, King announced that it would have to restate earnings for 2002, 2003 and the first six months of 2004. On February 27, 2005, Mylan and King announced that they had mutually agreed to terminate the proposed merger because they were "not able to agree upon terms for a revised transaction."

The Commission's Conclusions in Perry

The Commission found that Perry had "engaged in a series of transactions in order to acquire voting rights to a large block of Mylan stock for the exclusive purpose of voting the shares in a merger and influencing the outcome of the vote," not in order "to invest in, or profit from, ownership of the Mylan shares."

The Commission next asserted that "irrespective of whether transactions of this type are routine for an institutional investor" filing a 45-day 13G based on the "ordinary course of business" provision is inappropriate "when transactions of the type executed by Perry are undertaken" and that the 45-day 13G exception to the ordinary 10-day disclosure requirements of Section 13(d) for qualified institutional investors "is available only where such investors are acquiring securities for passive investment or ordinary market making purposes as part of their routine business operations."

The Commission stated that when qualified investors acquire ownership of securities "with the purpose of influencing management or direction of issuer or affecting or influencing a transaction—such as acquiring securities, or an interest in securities, for the purposes of voting those securities in favor of a merger, the acquisition of those securities cannot be said to be made in the 'ordinary course of business'" for purposes of the institutional investor's eligibility for a 45-day 13G filing.

Applying this line of reasoning to Perry, the Commission concluded that because Perry did not acquire the Mylan securities in the ordinary course of its business, it had never been eligible for a 45-day 13G filing after year-end and, instead, had been required to disclose its acquisition within

10 days.⁸ The Commission found that Perry had willfully violated Section 13(d) and Rule 13d-1 by not timely filing within 10 days.⁹

Dissecting Perry

The underlying reasoning of the *Perry* Order is unclear.

First, notwithstanding the Commission's repeated references to the purpose and effect of Perry's Mylan position being to influence the outcome of the Mylan merger vote, it does not at any point assert that Perry's purchases of Mylan stock were for the purpose or had the effect of changing or influencing *control* of Mylan and thus caused Perry to fail the passivity standard and be ineligible for all short form reporting on Schedule 13G.

This makes sense because, unlike voting target shares on a merger, which is certainly about control of the target, voting acquirer shares does not, in itself, have anything obvious to do with control of the acquirer. Indeed, not until the Icahn Group announced its tender offer for Mylan did Perry's ownership of Mylan shares become relevant to the control of Mylan and thus ineligible for either type of 13G filing. And, of course, it was at this point that Perry filed a Schedule 13D, an action that the Commission does not criticize in its own right.

There is another reason why the language in the *Perry* Order about Perry intending to affect the outcome of Mylan merger vote cannot be read as a holding that Perry was not eligible to use Schedule 13G because it caused Perry to fail the passivity standard. Otherwise, every qualifying institution reporting or intending to report a greater than 5 percent position on Schedule 13G with respect to an acquirer holding a shareholder vote on a merger would be at risk if it did not switch to a Schedule 13D during the pendency of the vote, a position contrary to both law and practice under Section 13(d). Finally, if the Commission determined that Perry did not meet the passivity standard with respect to Mylan, it could have sanctioned Perry for not filing a Schedule 13D within 10 days of its acquiring in excess of 5 percent of Mylan's stock, which is not the stated basis for the sanction against Perry.

⁸ By the close of business on September 24, 2004, Perry had acquired 16.2 million shares of Mylan, representing more than 5 percent of Mylan shares. Therefore, under the Commission's view, Perry was required to disclose its acquisition by October 3, 2004. In fn 8 of the *Perry* Order, the Commission noted that Perry did not file a Schedule 13G within 10 days of September 24, 2004 and thus was "legally precluded from satisfying its beneficial ownership reporting obligation by claiming that it was a passive investor" as required under Rule 13d-1(c) for such a filing.

⁹ In a somewhat unusual step, the Commission also took some pains to criticize implicitly two (unnamed) lawyers consulted by Perry (neither of whom was a party to the proceeding). The Commission found that in September 2004, Perry consulted two lawyers who agreed that Perry's ownership in Mylan would not amount to "influencing control" under Rule 13d-1(b)(1) (i) and therefore would not automatically trigger a Schedule 13D filing obligation. In opining upon Perry's reporting obligations, however, the Commission found that the lawyers did not specifically consider whether Perry's vote-buying strategy was in the ordinary course of Perry's business. The Commission noted that "Perry's counsel did not ask questions or follow up with Perry concerning whether Perry's strategy was in the ordinary course of Perry's business."

The *Perry* Order thus could be read as being limited to the scope of activities the Commission considers to be part of a qualifying institution's "ordinary course of business." The Commission's position on this point, however, also is unclear.

First, although the Commission asserted that Perry had "never before engaged" in a similar strategy of derivative trading to "acquire voting rights to a security in order to vote those shares in a merger, without having any economic interest in the shares," it did not cite this finding in its discussion of whether Perry met the ordinary course of business test for a 45-day 13G filing. Nor did the Commission examine whether other merger risk arbitrageurs sometimes or regularly engaged in such tactics as the basis for a more general factual measure of what was ordinary course of business for the merger risk arbitrage community.

Similarly, notwithstanding the Commission's findings that Perry had structured its acquisition of Mylan shares and its offsetting derivative hedges to avoid notice to the market, the Commission did not cite these facts in concluding that the acquisition of Mylan shares was not in the ordinary course of business.

The Commission's approach to the factual record in its decision is particularly noteworthy because both the statutory provision authorizing short form Schedule 13G filings (Section 13(d)(5)) and the Commission's 45-day 13G rule are explicitly couched in the particular—that is, both the statutory provision and the rule are applicable if a qualifying person acquires the securities "in the ordinary course of *his* business" (emphasis added) and the person meets the passivity test.

Rather than applying the 45-day filing provision to the factual circumstances of Perry's behavior, the *Perry* Order approached the issue strictly as a matter of law. It did so by asserting that the ordinary course of business provision is available only where investors are acquiring securities for passive investment or ordinary marketmaking purposes as part of their routine business operations.¹⁰

In reaching this legal conclusion, the Commission further elaborated that an acquisition of an acquirer's stock for the purpose of affecting the outcome of a merger vote cannot be ordinary course of business. Paragraph 35 of the *Perry* Order repeats this legal conclusion three times.

Framed as it is, in such broad and general terms, the *Perry* Order has potentially troubling implications for many categories of qualified investors, not just risk arbitrageurs seeking to protect their arbitrage position in the target stock by trying to assure a favorable vote by the acquirer shareholders. The language of the Commission's legal interpretation in the *Perry* Order can easily

¹⁰ The limitations of the exception to the 10-day disclosure requirements of Section 13(d) to investors acquiring securities for "passive investment" or "ordinary market making purposes" do not appear in Section 13(d) or Rule 13d-1, and do not have a clear basis in the legislative history cited in *Perry*.

be read to stand for the more general proposition that buying acquirer shares following the announcement of a merger to influence an acquirer's shareholder vote on a proposed merger cannot be ordinary course for any qualified investor.

Read literally, the *Perry* Order would apply to a mutual fund complex where, following announcement of a proposed acquisition, just one portfolio manager bought¹¹ additional acquirer shares to bolster its voting position, pro or con, on a proposed acquisition. Whether intended or not, the *Perry* Order therefore suggests, if it does not mandate, that any qualified investor taking or intending to take advantage of the 45-day 13G filing provisions, loses eligibility for that relaxed filing status if, following announcement of a proposed acquisition, it acquires additional shares of an acquirer's stock with the nonordinary course of business intent of voting those shares on the merger.

More important, perhaps, is the implicit consequence of the Commission's interpretation of the ordinary course of business test with respect to target stock acquisitions during the pendency of a merger transaction. If acquiring acquirer stock in advance of a merger vote is not ordinary course, then acquiring target stock in advance of a merger vote would seem even less likely to be ordinary course.

This application of the reasoning of the *Perry* Order may not be of great consequence where a Schedule 13G filer acquires target shares after the announcement of a merger specifically to help assure a favorable vote on the merger. The Commission staff during the 1980s established the position in two no-action letters that acquisitions of target stock for the purpose of tendering or exchanging the stock for cash or securities in a merger failed the passivity test and thus was not eligible for Schedule 13G reporting.¹²

We are not aware of any Commission or staff position with regard to acquisitions of target stock for the purpose of helping assure a favorable vote on the merger. Voting for a merger would seem to be an easy case, however, because there does not appear to be any basis for distinguishing the act of voting for a merger (which is intended to result in an acquisition of the target and the receipt of merger consideration) from the act of tendering target stock to the acquirer in a tender offer. If an acquisition of stock for the purpose of tendering it in a merger fails the passivity test, acquisition of stock for the purposes of voting in favor of a merger presumably would also fail the passivity test.

But the implications of the *Perry* Order are more far reaching in that they would extend to a Schedule 13G filer's acquisition of target shares to vote against the merger. Nor is the fact pattern

¹¹ While, read literally, the *Perry* Order would require a 10-day 13G filing for the acquisition of even one acquirer share, presumably there would be some de minimis standard in its practical application.

¹² Blunt, Ellis and Loewi, Inc., SEC No-Action Letter, 1988 WL 234209 (April 15, 1988) and Faith Colish, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) 76,397 (March 24, 1980).

unknown. Over the past several years, particularly during the merger boom of 2005-2007, a number of merger transactions were challenged by target shareholders urging a no vote either to block the merger entirely or to create leverage for a higher price.

It would not be surprising that in those situations, qualified investors (such as registered investment advisers and mutual funds) acquired additional target stock as part of their attempt to vote down a merger or to prompt the acquirer to increase the merger consideration. Whether or not post-announcement acquisitions of target stock to vote against a merger meet the passivity test (a question of some complexity and uncertainty), at a minimum under the *Perry Order's* reasoning, such acquisitions would fail the ordinary course of business test and thus be ineligible for a 45-day 13G filing.

Takeaways

Two key aspects of Perry's acquisition transactions in Mylan stock may have driven the outcome of the *Perry Order*.

First, the Commission clearly disapproved of Perry's acquisition of its large long position in Mylan stock through trades expressly structured to avoid reporting on the consolidated tape.

Second, the Commission noted Perry's hedging of its entire economic exposure in its large Mylan position, for example describing Perry's hedging strategy as "essentially buying votes."

The Commission, however, did not find that either aspect of Perry's tactics, standing alone, gave rise to any violations of the securities laws. Nor, as it constructed its conclusions, did it use these factors explicitly to justify its nonordinary course of business conclusion.

Nevertheless, the legal conclusions in the *Perry Order* are broadly stated. At a minimum, its limitation of the ordinary course of business test for 45-day 13G filings literally applies to any acquisition of either acquirer or target shares where the purpose is to influence the outcome of the vote.

The Commission is in the process of studying how to apply Section 13(d) and the rules thereunder to equity derivatives of all stripes. Perhaps this re-examination will produce additional guidance. In the meantime, institutional investors should be cautious of the *Perry Order* and its broad implications that buying either acquirer or target shares to influence the outcome of a pending merger vote may well affect their 45-day 13G eligibility.