SEC Fines Perry Corp. for Reporting Violations Relating to "Merger Arbitrage"

On July 21, 2009, the Securities and Exchange Commission ("SEC") issued an Administrative Order (the "Order") imposing sanctions and a cease-and-desist order on Perry Corp. ("Perry"), a New York-based hedge fund, for reporting violations relating to "merger arbitrage" activity.[1] The SEC found that Perry acquired 9.89% of the outstanding shares of Mylan Laboratories Inc. ("Mylan")[2] without timely filing a Schedule 13D under Section 13(d) of the Securities Exchange Act of 1934 ("Exchange Act"). Without admitting or denying the SEC's findings set forth in the Order, Perry was censured, consented to the entry of a cease-and-desist order from committing future violations of Section 13(d) of the Exchange Act and Rule 13d-1 thereunder and agreed to pay a civil penalty of $150,000.

In the SEC's press release announcing the settlement, an SEC spokesman stated: "By acquiring significant voting rights to Mylan shares without informing the marketplace, Perry illicitly increased its potential to profit from its merger arbitrage position [and] Perry's failure to follow the disclosure obligations of the securities laws deprived the market of important and relevant facts."[3]

The Order is notable not for the sanctions imposed, but rather for the detailed statement by the SEC of its views regarding the application of the Schedule 13D reporting rules to swap transactions entered into for the purpose of exercising some measure of control over an issuer. This topic was the subject of a notable opinion in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al*.[4] In *CSX*, among other things, The Children's Fund Management (UK) LLP and related entities were deemed beneficial owners of CSX stock based on the fact that they created and used total return swaps with the purpose and effect of preventing beneficial ownership from vesting as part of a plan or scheme to evade the reporting requirement of Exchange Act Section 13(d) and the rules thereunder. The SEC used the Order to expand on the views expressed by the District Court in *CSX,* and so sheds further light on the regulatory parameters of Schedule 13D reporting obligations.

I. Perry's "Merger Arbitrage" Position

The Concept of "Merger Arbitrage"

When two companies contemplate a merger, it is possible for outside investors to profit from the merger's ultimate consummation or failure through a process called merger arbitrage. Depending on the terms of the merger agreement, the share prices of the companies involved just prior to the execution of the merger can be predicted accurately. However, as long as there is uncertainty in the market about the likelihood of the merger, there is a "risk-arbitrage spread" separating the actual share price and the price that would exist if the merger were a certainty. An investor who believes he has better information than the market can bet on this spread.

Where an acquiring company offers to pay the shareholders of the target company more for each share than the current market price, an investor would bet on the consummation of the merger by purchasing shares of

---

1 *In the Matter of Perry Corp.*, Exchange Act Release No. 60351, Investment Advisers Act Release No. 2907 (July 21, 2009), *available at* http://www.sec.gov/litigation/admin/2009/34-60351.pdf. The facts presented here are a summary of the findings of the SEC and have not been otherwise corroborated.

2 Mylan Laboratories Inc. is now Mylan Inc.

3 Press Release, Securities and Exchange Commission, SEC Charges Perry Corp. with Disclosure Violations in Vote Buying Scheme (July 21, 2009), *available at* http://www.sec.gov/news/press/2009/2009-165.htm.

4 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *available at* http://www1.nysd.uscourts.gov/cases/show.php?db=special&id=79.

the target company and short-selling shares of the acquiring company. Then, if the merger is actualized, the investor profits from the rise in the target's share price and the decrease in the acquirer's share price. Likewise, an investor can bet on the failure of the merger by purchasing shares of the acquiring company and short-selling shares of the target. In either case, if the investor makes the wrong bet, he may suffer a loss.

The Perry Position

Beginning in October 2001, Perry amassed a significant position in a company called King Pharmaceuticals, Inc. ("King"). On July 26, 2004, Mylan announced a merger agreement with King, which provided that King shareholders would receive 0.9 shares of Mylan common stock for every share of King. This represented a premium of 61% for King shareholders, and the price of King's shares rose nearly 25% on the day the agreement was announced. Rather than unwinding its position at this time, Perry decided to bet on the consummation of the merger and established a merger arbitrage position. In the five days following the announcement, Perry sold short 3,839,500 shares of Mylan and increased its long position in King to 5,152,600 shares. Had the merger taken place at that time, Perry would have earned a profit of approximately $14.4 million.

Acquiring Voting Rights to Favor the Merger

The merger's prospects became gloomier in the following months when a "prominent activist investor" acquired 8.9% of Mylan's stock and opposed the merger.[5] Because the merger would ultimately require the approval of Mylan's shareholders, the risk-arbitrage spread increased accordingly, representing greater potential profits for Perry as well as greater risk. Threatened by this heightened risk, Perry undertook a plan to get the best of both worlds: Perry would help improve the merger's prospects without sacrificing the favorable spread.

The plan involved a series of transactions, which the SEC found were not promptly disclosed. First, two banks sold short over 20 million shares of Mylan stock to Perry in foreign markets or after hours in the over-the-counter market. This allowed Perry to amass significant voting power without notifying the market of its activities. Since the shares were loaned to the banks and then sold to Perry abroad or after hours, the trading was never reported to the public and the risk-arbitrage spread never narrowed to reflect Perry's increased voting power. Meanwhile, Perry executed "swap" agreements with the banks that made the acquisition of the Mylan shares effectively risk-free.[6] Because the banks were short and Perry was long, any fluctuation in the share price would be a loss to one and a profit to the other. The swaps bound the parties to compensate each other for any such losses, thus mitigating their risk exposure.

The extent of disclosure required under Section 13(d) of the Exchange Act depends on the size of the investor's stake. On September 24, 2004, Perry owned over 5% of Mylan common stock – above the threshold for Schedule 13D reporting, subject to an exception discussed below. At its highest point, Perry's stake reached 9.89%. Perry did not disclose its Mylan position until November 29, 2004, when it filed a Schedule 13D. The merger later collapsed for reasons unrelated to Perry's trading.

[5] The unnamed "activist investor" was Carl Icahn, who held a long position on Mylan and a short position on King, betting that the merger would be scuttled. *See* Andrew Ross Sorkin, *Icahn Accuses Hedge Fund of Stock Manipulation*, N.Y. TIMES, Dec. 13, 2004, at C1.

[6] The banks profited from this arrangement from commissions earned on the sale of Mylan stock, financing fees paid on margin lines drawn on by Perry and the use of the float on funds deposited by Perry as collateral.

II. Violations of Section 13(d) and Rule 13d-1

The SEC found that Perry's failure to promptly report its September 24 acquisition violated Section 13(d) of the Exchange Act and Rule 13d-1. Section 13(d)(1) and Rule 13(d)-1(a) generally require that whenever a person[7] acquires over 5% of "any equity security" registered under Section 12, such acquisition must be reported to the SEC in a Schedule 13D within 10 days. This rule exists to keep the market advised of possible changes in corporate control.[8]

However, there is an exception to this rule for certain types of acquisitions. Recognizing that purchasers like "stock exchange specialists, over-the-counter marketmakers, and investment companies" might acquire large numbers of securities routinely and passively,[9] Congress authorized an exception to the 10-day disclosure requirement where such acquisitions are made "in the ordinary course of business" and not for the purpose or effect of "changing or influencing the control of the issuer."[10] The SEC implemented this exception in Rule 13d-1(b), which only requires short-form disclosure on Schedule 13G, which may be filed by an investor meeting the criteria in the rule within 45 days of the end of the calendar year in which the acquisition was made.[11]

The SEC rejected Perry's argument that delayed disclosure under Rule 13d-1(b) was appropriate for Perry's acquisition of the Mylan shares. Despite Perry's assertion to the contrary, the SEC found that "[w]hen institutional investors acquire, directly or indirectly, the beneficial ownership of securities with the purpose of . . . influencing the outcome of a transaction – such as acquiring securities, or an interest in securities, for the purpose of voting those securities in favor of a merger," they do not act in the ordinary course of their business "for purposes of relying on Rule 13d-1(b)." The decision suggests that the "ordinary course of business" exception is limited to "passive investment" and "ordinary market making purposes." In light of these determinations, the SEC found that Perry willfully violated Section 13(d) and Rule 13d-1 when it failed to disclose its September 24 transaction within 10 days.

III. Conclusion

The SEC's position as set forth in the Perry Order will likely result in the significant curtailment of the use of swaps to obtain some measure of control over a public company. The Order makes clear the SEC's view that such transactions are not in the "ordinary course of business" and thus require relatively prompt disclosure if the 5% reporting threshold for Schedule 13D is exceeded, which would cause the economic benefits sought to be achieved by using such strategy in the context of a merger transaction to be lost. With the Perry Order considered together with the District Court opinion in *CSX,* it is expected that the use of swaps for the purpose of exerting pressure on public companies will become less common.

* * *

---

7 A "person" includes multiple persons acting as a group "for the purpose of acquiring, holding, or disposing of securities of an issuer." Exchange Act Section 13(d)(3).

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

9 *See* H.R. Rep. No. 91-1655, at 4-5 (1970).

10 Exchange Act Section 13(d)(5).

11 Rule 13d-1(c).

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.