

HOSTILE CORPORATE GOVERNANCE AND STOCK LIQUIDITY

Vyacheslav (Slava) Fos
University of Illinois at Urbana-Champaign

EFMA 2014
Panel Session on Hedge Fund Activism

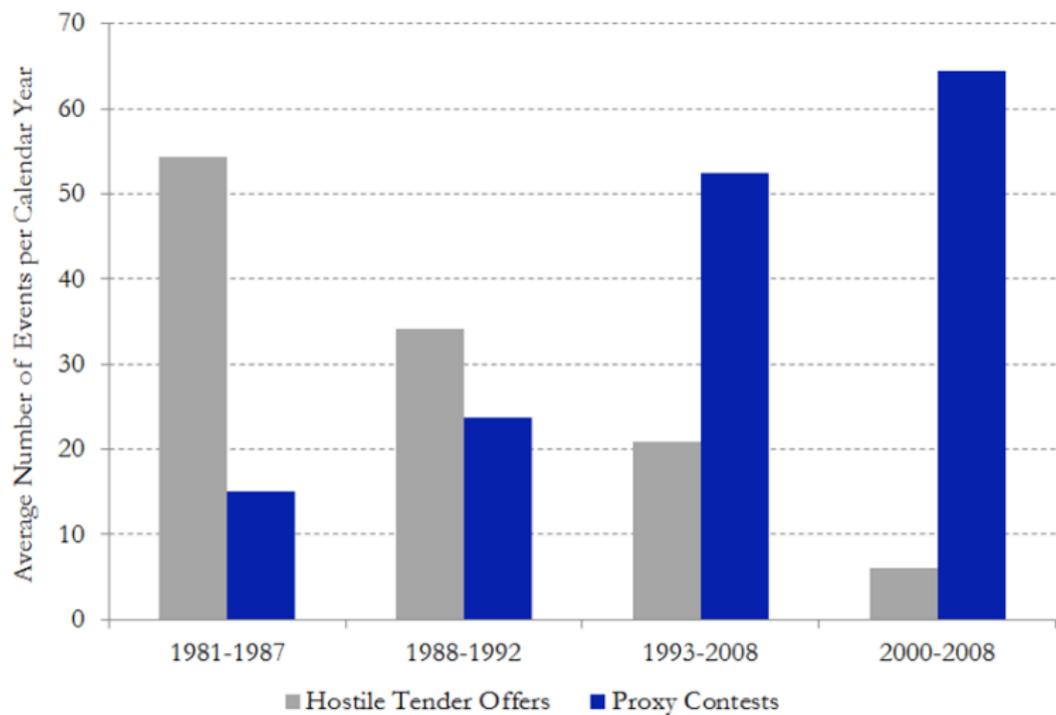
- Activist shareholders play an active role in modern corporate governance and are often successful in increasing the value of targeted companies (Icahn, Buffett, Ackman).
 - Brav, Jiang, Partnoy, and Thomas (2008)

- Activist shareholders play an active role in modern corporate governance and are often successful in increasing the value of targeted companies (Icahn, Buffett, Ackman).
 - Brav, Jiang, Partnoy, and Thomas (2008)
- “Every 30 years in the modern era, corporate America has had to go through a period of slimming down and restructuring. In the 1980s, it was driven by the corporate raider, now it is the activist.”
 - Anthony Scaramucci, founder of SkyBridge Capital quoted in the FT

- Activist shareholders play an active role in modern corporate governance and are often successful in increasing the value of targeted companies (Icahn, Buffett, Ackman).
 - Brav, Jiang, Partnoy, and Thomas (2008)
- “Every 30 years in the modern era, corporate America has had to go through a period of slimming down and restructuring. In the 1980s, it was driven by the corporate raider, now it is the activist.”
 - Anthony Scaramucci, founder of SkyBridge Capital quoted in the FT
- Event-driven funds attracted \$29.6bn in new money in 2013, more than any other hedge fund category, and a further \$4.1bn in the first quarter of 2014, according to data provider Hedge Fund Research. Assets under management more than doubled since 2008.

- Activist shareholders play an active role in modern corporate governance and are often successful in increasing the value of targeted companies (Icahn, Buffett, Ackman).
 - Brav, Jiang, Partnoy, and Thomas (2008)
- “Every 30 years in the modern era, corporate America has had to go through a period of slimming down and restructuring. In the 1980s, it was driven by the corporate raider, now it is the activist.”
— Anthony Scaramucci, founder of SkyBridge Capital quoted in the FT
- Event-driven funds attracted \$29.6bn in new money in 2013, more than any other hedge fund category, and a further \$4.1bn in the first quarter of 2014, according to data provider Hedge Fund Research. Assets under management more than doubled since 2008.
- Famous law firms such as Wachtell, Lipton, Rosen and Katz are lobbying the SEC to review the 13D disclosure rules to make it more difficult for activists to acquire shares “in the interest of transparency and fairness for small shareholders.”

PROXY CONTESTS VS. HOSTILE TAKEOVERS



What is the link between firm value, shareholder activism, and market liquidity?

What is the link between firm value, shareholder activism, and market liquidity?

- Activists' effectiveness depends on stock liquidity: stock liquidity reduces the cost of building a position
 - "Do Prices Reveal the Presence of Informed Trading?" (Collin-Dufresne and Fos, forthcoming JF)
 - "Moral Hazard, Informed Trading, and Stock Prices" (Collin-Dufresne and Fos, 2013)

What is the link between firm value, shareholder activism, and market liquidity?

- Activists' effectiveness depends on stock liquidity: stock liquidity reduces the cost of building a position
 - "Do Prices Reveal the Presence of Informed Trading?" (Collin-Dufresne and Fos, forthcoming JF)
 - "Moral Hazard, Informed Trading, and Stock Prices" (Collin-Dufresne and Fos, 2013)
- Directors bear severe career consequences when their firms are targeted
 - "Shareholder Democracy in Play: Career Consequences of Proxy Contests" (Fos and Tsoutsoura, forthcoming JFE)

What is the link between firm value, shareholder activism, and market liquidity?

- Activists' effectiveness depends on stock liquidity: stock liquidity reduces the cost of building a position
 - "Do Prices Reveal the Presence of Informed Trading?" (Collin-Dufresne and Fos, forthcoming JF)
 - "Moral Hazard, Informed Trading, and Stock Prices" (Collin-Dufresne and Fos, 2013)
- Directors bear severe career consequences when their firms are targeted
 - "Shareholder Democracy in Play: Career Consequences of Proxy Contests" (Fos and Tsoutsoura, forthcoming JFE)
- Incumbents enhance their voting power when targeted
 - "Out-of-the-Money CEOs: How Do Proxy Contests Affect Insider Option Exercises" (Fos and Jiang, 2013)

What is the link between firm value, shareholder activism, and market liquidity?

- Activists' effectiveness depends on stock liquidity: stock liquidity reduces the cost of building a position
 - "Do Prices Reveal the Presence of Informed Trading?" (Collin-Dufresne and Fos, forthcoming JF)
 - "Moral Hazard, Informed Trading, and Stock Prices" (Collin-Dufresne and Fos, 2013)
- Directors bear severe career consequences when their firms are targeted
 - "Shareholder Democracy in Play: Career Consequences of Proxy Contests" (Fos and Tsoutsoura, forthcoming JFE)
- Incumbents enhance their voting power when targeted
 - "Out-of-the-Money CEOs: How Do Proxy Contests Affect Insider Option Exercises" (Fos and Jiang, 2013)
- The impact of hostile corporate governance on firm value is not limited to materialized events
 - "The Disciplinary Effects of Proxy Contests" (Fos, 2013)

Hand-collect data on informed trades come from Schedule 13D filings – Rule 13d-1(a) of the 1934 Securities Exchange Act

- Item 5(c) of Schedule 13D requires the filer to “...describe any transactions in the class of securities reported on”

Hand-collect data on informed trades come from Schedule 13D filings – Rule 13d-1(a) of the 1934 Securities Exchange Act

- Item 5(c) of Schedule 13D requires the filer to “...describe any transactions in the class of securities reported on”

Trades executed by Schedule 13D filers are informed:

- Announcement returns
- Profits of Schedule 13D filers

Hand-collect data on informed trades come from Schedule 13D filings – Rule 13d-1(a) of the 1934 Securities Exchange Act

- Item 5(c) of Schedule 13D requires the filer to “...describe any transactions in the class of securities reported on”

Trades executed by Schedule 13D filers are informed:

- Announcement returns
- Profits of Schedule 13D filers

Trades executed by Schedule 13D filers move prices

Hand-collect data on informed trades come from Schedule 13D filings – Rule 13d-1(a) of the 1934 Securities Exchange Act

- Item 5(c) of Schedule 13D requires the filer to “...describe any transactions in the class of securities reported on”

Trades executed by Schedule 13D filers are informed:

- Announcement returns
- Profits of Schedule 13D filers

Trades executed by Schedule 13D filers move prices

Find that standard liquidity measures **do not** reveal the presence of informed traders:

- For example, Kyle's λ and *PIN* are lower when informed investors trade aggressively
- Both for high frequency and low frequency measures

Do informed trades move stock prices?

	days with informed trading (1)	days with no informed trading (2)	difference (3)	t-stat (4)
<i>excess return</i>	0.0064	-0.0004	0.0068***	9.94

TRADING BY ACTIVIST SHAREHOLDERS - CONT.

"DO PRICES REVEAL THE PRESENCE OF INFORMED TRADING?," FORTHCOMING JF

	days with informed trading (1)	days with no informed trading (2)	difference (3)
Adverse Selection Measures			
$\lambda * 10^6$	14.3311	20.1644	-5.8334*** [-8.38]
<i>pimpact</i>	0.0060	0.0064	-0.0004** [-2.18]
<i>cumir</i>	0.0013	0.0015	-0.0002** [-2.06]
<i>trade - related</i>	0.0654	0.0673	-0.0019 [-0.99]
Other Liquidity Measures			
<i>rspread</i>	0.0081	0.0089	-0.0008*** [-3.43]
<i>espread</i>	0.0145	0.0155	-0.001*** [-3.25]

What Affects Trading Strategies of Schedule 13D Filers?

- Market-wide variables
 - CRSP volume (positive)

- Stock-specific variables

What Affects Trading Strategies of Schedule 13D Filers?

- Market-wide variables
 - CRSP volume (positive)
 - lagged market return (negative)
- Stock-specific variables

What Affects Trading Strategies of Schedule 13D Filers?

- Market-wide variables
 - CRSP volume (positive)
 - lagged market return (negative)
- Stock-specific variables
 - lagged turnover

What Affects Trading Strategies of Schedule 13D Filers?

- Market-wide variables
 - CRSP volume (positive)
 - lagged market return (negative)
- Stock-specific variables
 - lagged turnover
 - contemporaneous turnover

- Generalize Kyle/Back model of informed trading to case of activist who can affect the liquidation value of the firm by expending effort at some cost.

- Generalize Kyle/Back model of informed trading to case of activist who can affect the liquidation value of the firm by expending effort at some cost.
- We solve for the optimal effort level and trading strategy of the activist, as well as for the equilibrium price and market illiquidity

- Generalize Kyle/Back model of informed trading to case of activist who can affect the liquidation value of the firm by expending effort at some cost.
- We solve for the optimal effort level and trading strategy of the activist, as well as for the equilibrium price and market illiquidity
- The key feature of the model is that the activist's optimal effort level is increasing in the size of the stake he has accumulated

- Price impact (\sim Kyle's λ) has two components:
 - the activist may have better information about an exogenous component of the liquidation value (stock picker \sim Kyle).
 - the activist may endogenously add value and more so if he accumulated a large position (activism/'moral hazard')

- Price impact (\sim Kyle's lambda) has two components:
 - the activist may have better information about an exogenous component of the liquidation value (stock picker \sim Kyle).
 - the activist may endogenously add value and more so if he accumulated a large position (activism/'moral hazard')
- Price impact is higher the more severe the moral hazard problem
 - if the activist's productivity is higher, or
 - if the uncertainty about his position is larger.

- Are activists simply better stock-pickers or do they really create value for minority shareholders by expending effort?

MAIN RESULTS - OWNERSHIP DISCLOSURE, PRICE, AND ECONOMIC EFFICIENCY

- Are activists simply better stock-pickers or do they really create value for minority shareholders by expending effort?
- The model suggests that this is very difficult for the market to sort out, if there is uncertainty about the activists holdings.

MAIN RESULTS - OWNERSHIP DISCLOSURE, PRICE, AND ECONOMIC EFFICIENCY

- Are activists simply better stock-pickers or do they really create value for minority shareholders by expending effort?
- The model suggests that this is very difficult for the market to sort out, if there is uncertainty about the activists holdings.
- If we can force the insider to disclose his holdings (i.e., reduce uncertainty about his position), then this makes it easier for the market to sort out his 'stock-picking' from his 'managerial' abilities
 - if it is desirable to remunerate activists only for their efforts, ownership disclosure requirements may be useful
 - however, this might lead to fewer activism events

- Are activists simply better stock-pickers or do they really create value for minority shareholders by expending effort?
- The model suggests that this is very difficult for the market to sort out, if there is uncertainty about the activists holdings.
- If we can force the insider to disclose his holdings (i.e., reduce uncertainty about his position), then this makes it easier for the market to sort out his 'stock-picking' from his 'managerial' abilities
 - if it is desirable to remunerate activists only for their efforts, ownership disclosure requirements may be useful
 - however, this might lead to fewer activism events
- The model also suggests a trade-off between 'economic efficiency' and 'price efficiency':
 - With more noise trading (and therefore less price efficiency) the activist can build up a larger stake, and then expend more effort to increase firm value, thus leading to higher economic efficiency

- The average (median) stock ownership of a Schedule 13D filer on the filing date is 7.51% (6.11%)

- The average (median) stock ownership of a Schedule 13D filer on the filing date is 7.51% (6.11%)
- Schedule 13D filers indeed possess valuable private information

- The average (median) stock ownership of a Schedule 13D filer on the filing date is 7.51% (6.11%)
- Schedule 13D filers indeed possess valuable private information
- An activist's stake size is positively associated with value creation

- The average (median) stock ownership of a Schedule 13D filer on the filing date is 7.51% (6.11%)
- Schedule 13D filers indeed possess valuable private information
- An activist's stake size is positively associated with value creation
- An activist's trading intensity decreases closer to the terminal date

- The average (median) stock ownership of a Schedule 13D filer on the filing date is 7.51% (6.11%)
- Schedule 13D filers indeed possess valuable private information
- An activist's stake size is positively associated with value creation
- An activist's trading intensity decreases closer to the terminal date
- An activist's trading strategy is positively associated with the stake size in 97% of events

The evidence indicates that stock liquidity helps activists as far as hostile corporate governance is concerned

- Micro level trading data
- Event level data

The evidence indicates that stock liquidity helps activists as far as hostile corporate governance is concerned

- Micro level trading data
- Event level data

Theoretical analysis indicates that by increasing profits of activists stock liquidity enhances economic efficiency

- Activists accumulate larger stakes and therefore expend more effort and create more value

The evidence indicates that stock liquidity helps activists as far as hostile corporate governance is concerned

- Micro level trading data
- Event level data

Theoretical analysis indicates that by increasing profits of activists stock liquidity enhances economic efficiency

- Activists accumulate larger stakes and therefore expend more effort and create more value

We still don't know ...

The evidence indicates that stock liquidity helps activists as far as hostile corporate governance is concerned

- Micro level trading data
- Event level data

Theoretical analysis indicates that by increasing profits of activists stock liquidity enhances economic efficiency

- Activists accumulate larger stakes and therefore expend more effort and create more value

We still don't know ...

- Who are dissident directors and how are they compensated?

The evidence indicates that stock liquidity helps activists as far as hostile corporate governance is concerned

- Micro level trading data
- Event level data

Theoretical analysis indicates that by increasing profits of activists stock liquidity enhances economic efficiency

- Activists accumulate larger stakes and therefore expend more effort and create more value

We still don't know ...

- Who are dissident directors and how are they compensated?
- Are monitoring efforts of long term blockholders (e.g., pension funds) and activist hedge funds complements or substitutes?

The evidence indicates that stock liquidity helps activists as far as hostile corporate governance is concerned

- Micro level trading data
- Event level data

Theoretical analysis indicates that by increasing profits of activists stock liquidity enhances economic efficiency

- Activists accumulate larger stakes and therefore expend more effort and create more value

We still don't know ...

- Who are dissident directors and how are they compensated?
- Are monitoring efforts of long term blockholders (e.g., pension funds) and activist hedge funds complements or substitutes?
- Are “passive” positions taken by activist hedge funds indeed passive?

The evidence indicates that stock liquidity helps activists as far as hostile corporate governance is concerned

- Micro level trading data
- Event level data

Theoretical analysis indicates that by increasing profits of activists stock liquidity enhances economic efficiency

- Activists accumulate larger stakes and therefore expend more effort and create more value

We still don't know ...

- Who are dissident directors and how are they compensated?
- Are monitoring efforts of long term blockholders (e.g., pension funds) and activist hedge funds complements or substitutes?
- Are “passive” positions taken by activist hedge funds indeed passive?
- ...