Hostile Corporate Governance and Stock Liquidity

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EFMA 2014
Panel Session on Hedge Fund Activism
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Motivation

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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

![Graph showing average number of events per calendar year for Proxy Contests and Hostile Tender Offers.](image)
What is the link between firm value, shareholder activism, and market liquidity?
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- 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)
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- 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

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- Announcement returns
- Profits of Schedule 13D filers
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Find that standard liquidity measures do not reveal the presence of informed traders:
- For example, Kyle’s $\lambda$ and PIN are lower when informed investors trade aggressively
- Both for high frequency and low frequency measures
Do informed trades move stock prices?

<table>
<thead>
<tr>
<th></th>
<th>days with informed trading</th>
<th>days with no informed trading</th>
<th>difference</th>
<th>t-stat</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>excess return</strong></td>
<td>0.0064</td>
<td>-0.0004</td>
<td>0.0068***</td>
<td>9.94</td>
</tr>
</tbody>
</table>
### Trading by Activist Shareholders - cont.

“Do prices reveal the presence of informed trading?,” forthcoming JF

<table>
<thead>
<tr>
<th></th>
<th>days with informed trading (1)</th>
<th>days with no informed trading (2)</th>
<th>difference (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Adverse Selection Measures</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$\lambda \times 10^6$</td>
<td>14.3311</td>
<td>20.1644</td>
<td>-5.8334***</td>
</tr>
<tr>
<td>$pimpact$</td>
<td>0.0060</td>
<td>0.0064</td>
<td>-0.0004**</td>
</tr>
<tr>
<td>$cumir$</td>
<td>0.0013</td>
<td>0.0015</td>
<td>-0.0002**</td>
</tr>
<tr>
<td>$trade - related$</td>
<td>0.0654</td>
<td>0.0673</td>
<td>-0.0019</td>
</tr>
</tbody>
</table>

| **Other Liquidity Measures** |                               |                                  |                    |
| $rspread$                 | 0.0081                        | 0.0089                           | -0.0008***         |
| $espread$                 | 0.0145                        | 0.0155                           | -0.001***          |

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What Affects Trading Strategies of Schedule 13D Filers?

- Market-wide variables

- Stock-specific variables
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- **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.
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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 (≈ Kyle’s lambda) has two components:

- the activist may have better information about an exogenous component of the liquidation value (stock picker ≈ Kyle).

- the activist may endogenously add value and more so if he accumulated a large position (activism/‘moral hazard’).
Main Results - Price Dynamics

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- 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.
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?
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- 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
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- 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
Summary and Directions for Future Research

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

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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?
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