The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance

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Overview: The Shift from Investment to Payout

1. For better or worse, a revolution may be in progress within the public corporation and in corporate governance generally. Although it may have multiple causes, hedge fund activism represents at least the spearhead of this movement.
2. As a 2015 study of corporate investment by the Roosevelt Institute summarized:

   > "In the 1960s, an additional dollar of earnings or borrowing was associated with about a 40-cent increase in investment. In recent years, the same dollar is associated with less than 10 cents of additional investment." See J.W. Mason, Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment (2015).

3. From the second half of 2009 through 2013, this same study (based on the Federal Reserve's Flow of Funds data) finds that corporations borrowed \$900 billion, but paid out \$740 billion to shareholders (in stock buybacks and dividends), while investing only \$400 billion. In effect, corporate borrowing is primarily funding shareholder payout, not investment.

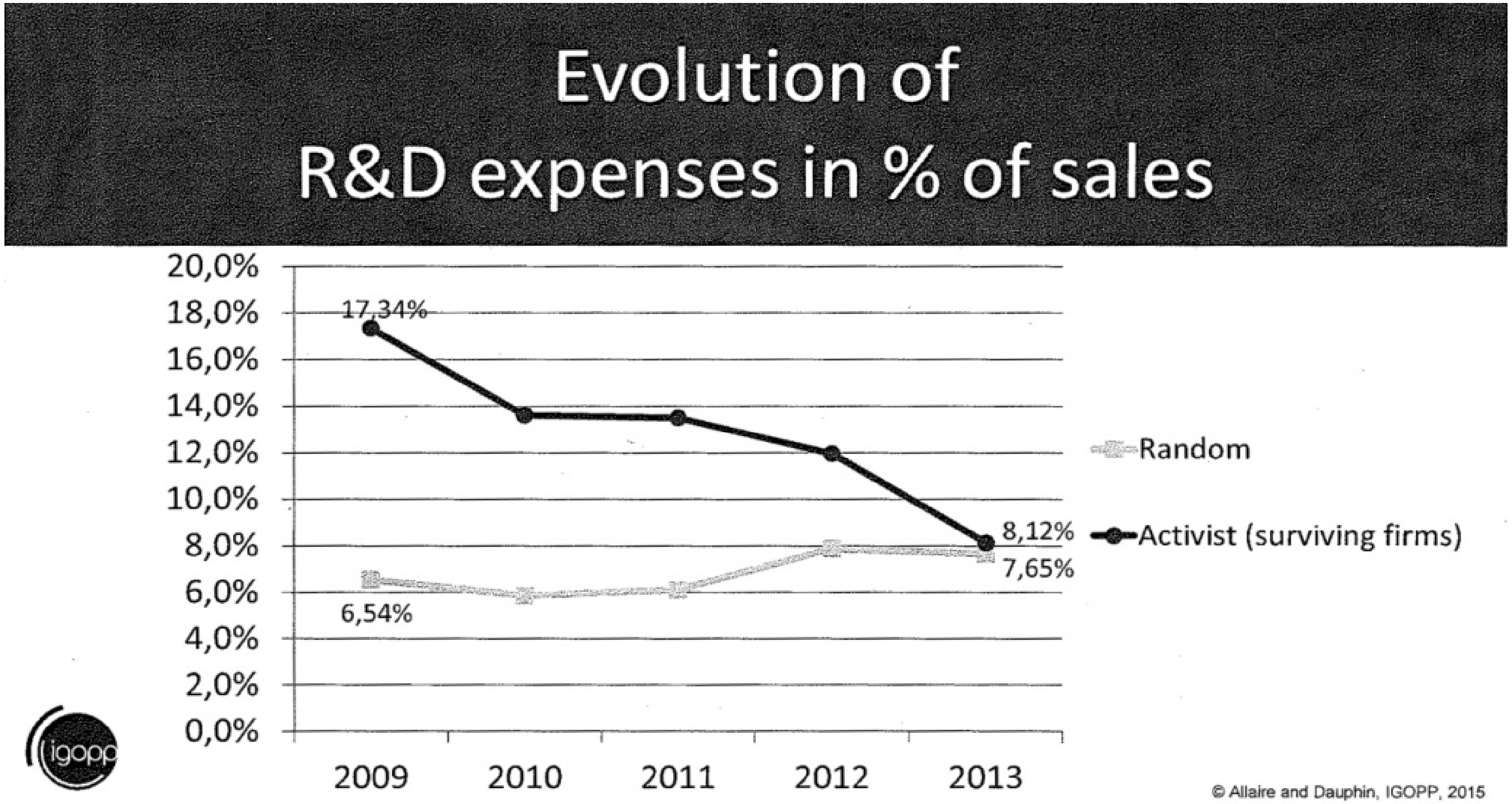
4. Similarly, a study by S&P Capital IQ for the Wall Street Journal finds that companies in the S&P index "increased their spending on dividends and buybacks to a median 38% of operating cash flow in 2013, up from 18% in 2003." (WSJ 5/27/15)—in effect, shareholder payout more than doubled (as a percentage) over the decade. At the same time, these S&P companies are "cutting spending on plants and equipment to 29% of operating cash flow from 33% in 2003." Targets of activism cut even more, reducing capital expenditures in the five years after activists engaged them to 29% of operating cash flow, down from 42% the year before the intervention. These same targets boosted spending on dividends and buybacks to 37% of operating cash flow in the year after the intervention (up from 22% in the year before).

The Implications

1. Ultimately, one question becomes whether the public corporation in the 21st Century can fund R&D or even retain its capital. If hedge fund activism is a principal force driving this transition from investment to payout, it may be producing an externality, even if stock prices are enhanced over some short to medium-term period.
2. Similarly, the balance of power between shareholders and other stakeholders is shifting in favor of the former. Although shareholder primacy tends to be the norm in the U.S. (with the board owing no fiduciary duty to other stakeholders), mature companies avoid shocks to their stakeholders and try to satisfy their expectations. Today, this also may be changing.

The Impact on R&D

1. Traditional financial economists tend to believe that Corporate Managers Overinvest in Capital Expenditures and Research and Development, Seeking to Maximize Corporate Size. In this view, Hedge Fund Activism Corrects and Restores the Corporation to an "Optimal" Investment Policy.
2. But What Is the "Optimal" Policy? Overinvestment may occur, But Activism May Be Creating A Negative Externality by Excessively Curbing R&D.
3. For example, Allaire and Dauphin report, using the FactSet database, that in the four-year period following a hedge fund "engagement," R&D expenses at "surviving" target firms declined by more than 50% (expressed as a percentage of sales), but rose slightly at control sample firms:



4. Moreover, their figure may understate the R&D decline, as it does not include the likely greater R&D decline at firms that are taken over.
5. Although all studies find that activist engagements produce significantly reduced R&D expenditures, proponents of activism retort that targeted firms increase their "innovation output," filing more patent applications thereafter than do firms in a matched sample. See Brav, Jiang, Ma and Tian, "Shareholder Power and Corporation Innovation: Evidence from Hedge Fund Activism" (2015). This "more for less" claim is contestable and depends upon the weight assigned to patent counts and patent citations.
6. <u>Bottom line</u>: Even if activism increases the profitability of R&D expenditures, the reduction in total R&D expenditures should still be of concern because R&D produces positive externalities. That is, other firms and society benefit from greater R&D investment because the firm conducting R&D does not capture all the benefits. Reduced R&D may be socially undesirable, even if it could be privately profitable.
7. Some argue that R&D can be better conducted at smaller, start-up firms. Perhaps sometimes it can, but this ignores that economics of scope and scale may make larger firms better at exploiting innovation and that start-ups may not be able to fund expensive research. Even if small firms can conduct research, larger firms may not be able to acquire them to exploit the innovation in light of "investment-limiting" restrictions.

Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?

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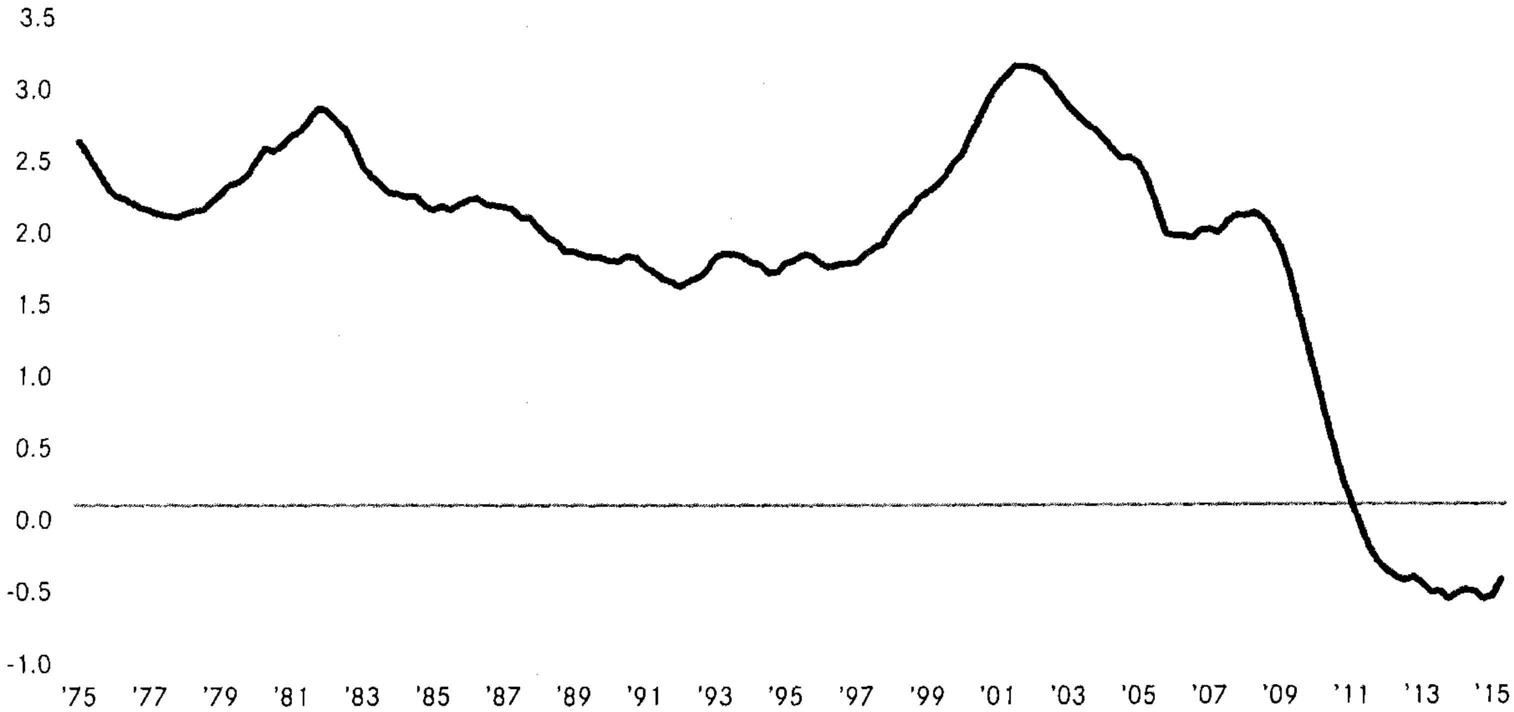
Chart 1

Decline in business investment

(as measured by the 10-year moving average in the financing gap as a share of gross value added in the nonfinancial corporate sector)



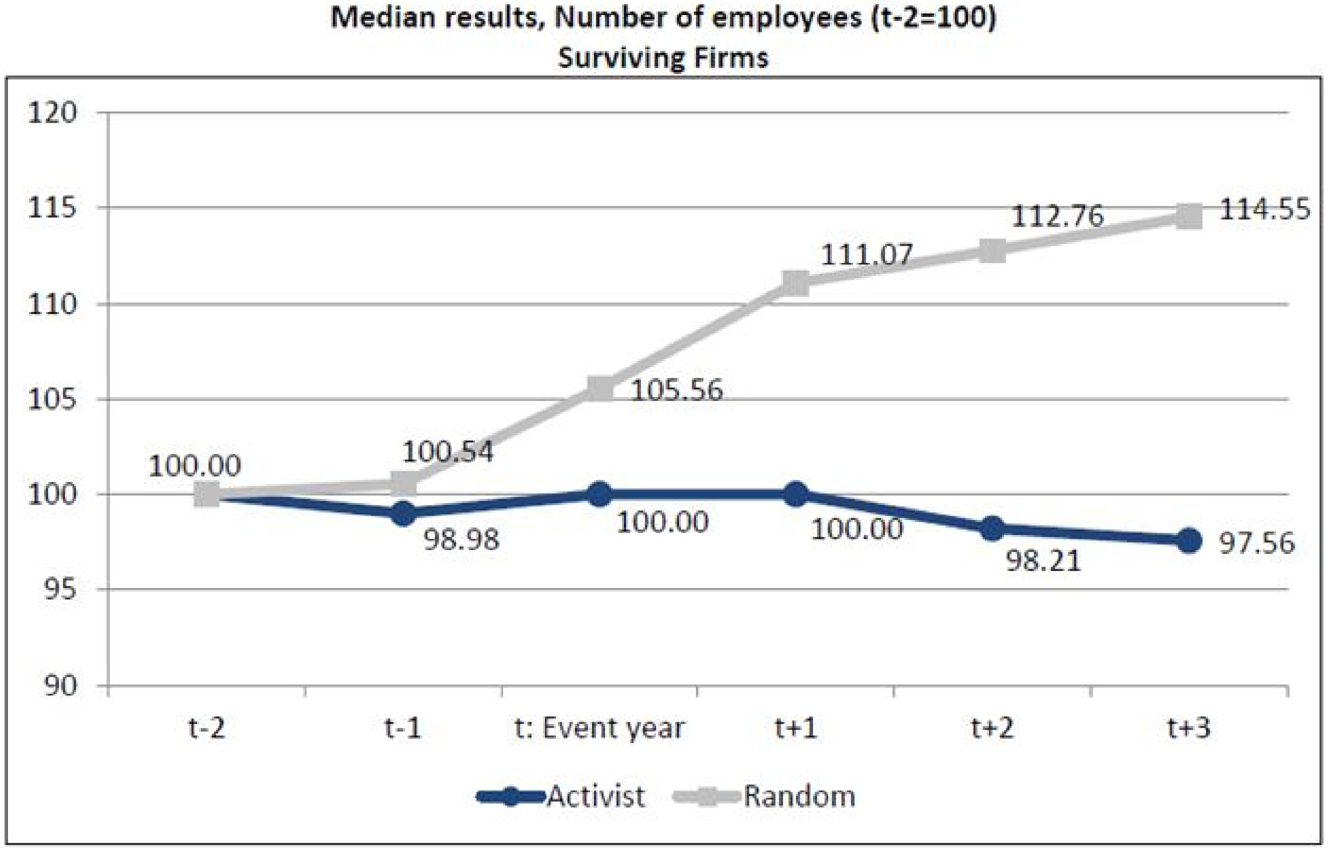
Note: The financing gap is equal to capital expenditures less the sum of the internal funds in the nonfinancial corporate sector.

Sources: Federal Reserve Board: Flow of Funds, Bureau of Economic Analysis

1. Note that the decline is sharpest after 2007, just as hedge fund activism takes hold.

Are There Other Social Costs to this New Activism?

First, there is the problem of wealth transfers, both from creditors and employees. One study of the firms targeted by activist hedge funds in 2010 and 2011 finds a small percentage decline in number of employees but a much larger decline in comparison to a control group, which increased hiring over the same period.[1] Arguably, activism may aggravate social inequality.



Second, a number of studies find that bondholders systematically lose from hedge fund engagements, as increased leverage reduces the value of their bonds.[2]

1. See Yvan Allaire and Francois Dauphin, The Game of "Activist" Hedge Funds: Cui Bono (August, 2015) at Figure 5 (available on SSRN).

2.See April Klein and Emanuel Zur, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors. 69 J. Fin. 187 (2009).

Part II: The Rising Pace of Hedge Fund Activism

1. The phenomena of "activist" hedge funds buying stock in targets specifically to propose changes in business policies appears to date from around 2005 (Briggs 2007). With this transition, shareholder activism moved from the defense (i.e., resisting management proposals and compensation) to the offense (seeking restructurings, buybacks, special dividends, and sales of the company).
2. Earlier forms of shareholder activism were coordinated by diversified investors (pension funds and mutual funds) whose large portfolios dissuaded them from pursuing firm-specific actions; in contrast, undiversified hedge funds are only interested in firm-specific actions.
3. 2014 saw a record 347 "activist" campaigns (FactSet Shark Watch)—up from 209 in 2009. In 2014, "activists gained board seats at a record 107 companies," winning contested contests in 73% of the cases. (WSJ, 8/10/15 at A-1).
4. In 2015, the scale of targets had increased significantly, and Dow and DuPont were pushed into a merger, each under pressure from a different activist firm. This suggests that today no firm is "too big to target."
5. In 2015, many activist hedge funds incurred large losses (in part because of their tendency to herd in the same stocks—such as Valeant). Thus, their activism may be chilled to some degree in 2016.
6. Still, they are not going away, and today few, if any, public companies are immune from activism. There is, however, a special profile to targets: they generally have underperformed the market, have a low Tobin's Q, limited insider ownership, and frequently a conglomerate structure that makes possible "negative synergy" through sales and spinoffs.

What Explains the Rise of Hedge Fund Activism?

1. Since 2000, the costs of proxy contest and other forms of activism are down (deregulation)
2. Structural changes have also helped (decline of staggered boards, increased influence of proxy advisors, proxy access, etc.)
3. Key Business Model Decision: Some Hedge Funds Decided They Could Not Regularly Beat the Efficient Market as Superior Stock Pickers. So, They Shifted to Investing in Underperforming Companies to Transform Them (or Break Them Up).
4. Profits are up ("activist" hedge funds are averaging a 13% return over the last ten years—more than double the 5.8% return for all hedge funds).
5. Correspondingly, the assets managed by "activist" funds have soared, growing from $23 billion in 2002 to $166 billion in 2014. The top ten "activist" funds alone attracted $30 billion in 2013.
6. Best yet, a short-term gain on the filing of the Schedule 13D is relatively certain, with the abnormal gain averaging 6 to 7% across all studies (and more if a "wolf pack" is involved).
7. Bottom line: Costs Down, Profit Up, Gain is Relatively Riskless—But a Bubble could be developing as more and more activists chase fewer and fewer obvious targets. The Consequence: Activist Hedge Funds Are Looking Globally for Targets.

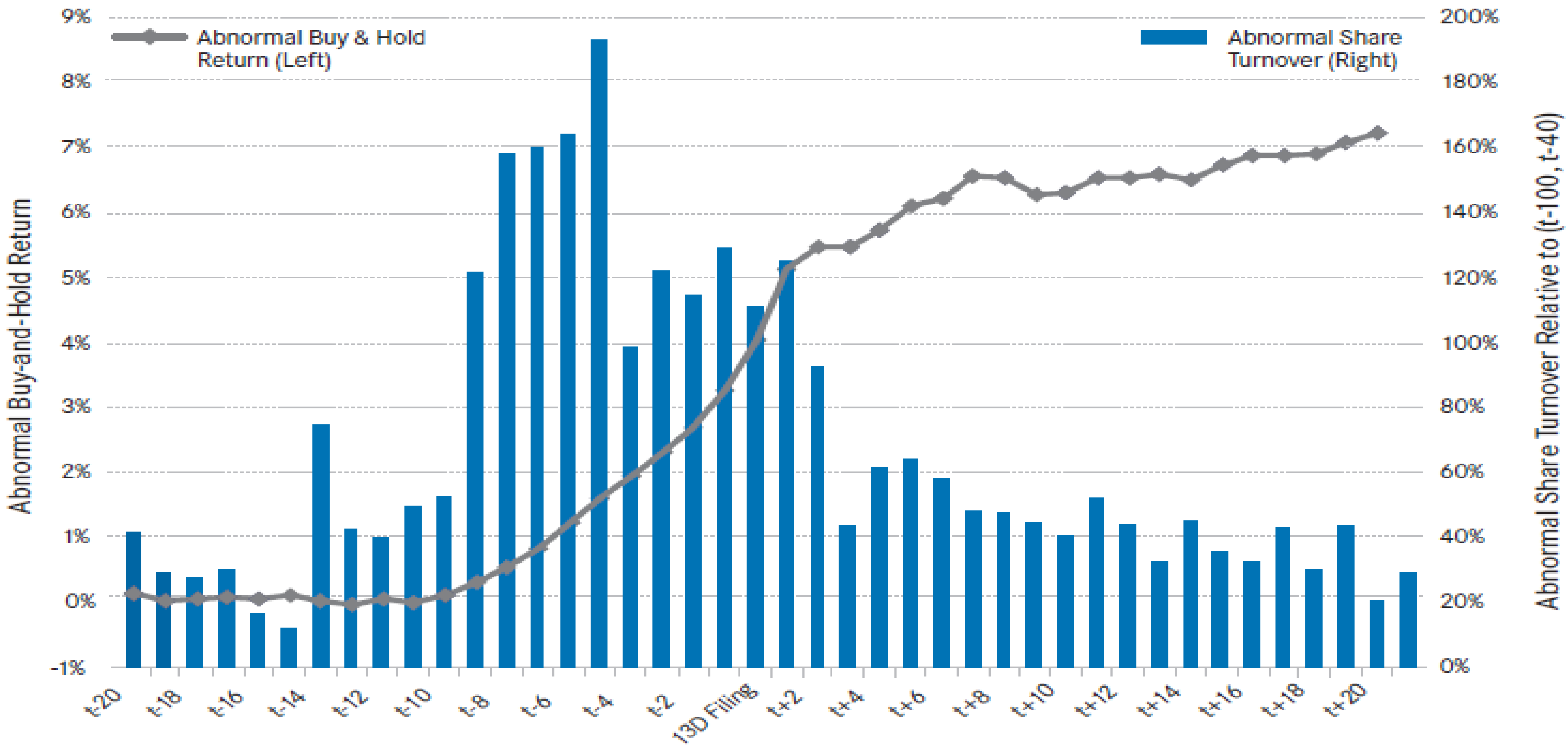
How Successful is Proxy Activism?

1. Several recent studies place the "success" rate in proxy fights for activists at around 75%
2. The actual number of proxy contests has declined—as managements have learned that it is better to settle than to fight.
3. Revealingly, at those companies where activists win even one seat on the board, the CEO leaves within 18 months in 44% of the cases (for example, Sothebys).

One New Tactic Probably Best Explains Activists' Success in Proxy Contest—The Wolf Pack

1. The "Wolf Pack" is a loose association of hedge funds (and some other institutions) that carefully avoid forming a "group" for purposes of §13(d)(3) of the Williams Act, but share a common goal and often have advance knowledge of the impending filing of a Schedule 13D by the wolf pack's leader.
2. Those forming the "wolf pack" can tip prospective allies of their plans because no fiduciary breach is involved (rather, their own institution's interests are furthered); thus, this use of material, non-public information does not amount to insider trading. Norms of reciprocity may develop: "You tip me, and I will tip you."

The following diagram illustrates the characteristic pattern and shows the amount of abnormal trading during the ten day window preceding the Schedule 13D filing:



Source: Alon Brav, Wei Jiang, Frank Partnoy and Randall S. Thomas, "Hedge Fund Activism, Corporate Governance, and Firm Performance," *Journal of Finance*, 63, no. 4, August 2008, p. 1756

1. The Wolf Pack Has Altered Prior Practice, and the Resulting Balance of Advantage in the Following Respects:

A. The Wolf Pack Acquires a Larger Stake: 13.4% as compared to 8.3% by other activists (See Becht, Franks, Grant and Wagner). And This May Understate, Because Silent Allies Need Not Disclose
B. The announcements of a “wolf pack” engagement produces more than twice as high an abnormal market return on the 13D filing date (14% to 6% for other activists—Becht, Franks, Grant and Wagner).
C. The probability of a “wolf pack” achieving at least one of its intended goals is much higher (78% versus 46% for other activists).

A Closer Look at Wolf-Pack Formation

1. Is the "wolf pack" a product of informed trading prior to the filing of the Schedule 13D? That is, does the lead activist gain allies (and reward them) by tipping them in advance that it will soon file a Schedule 13D (which typically creates a price spike)?
2. Such a strategy would make sense as the lead activist would gain increased leverage from a larger block and its allies would profit from advance knowledge of market-moving information—both sides gain from the alliance.
3. But some believe that wolf packs occur spontaneously because investors monitor and target the same firms at the same time (See Brav, Dasgupta and Matthews 2015).
4. Investigating these two hypotheses, Yu Wong finds that on the date that the lead activist crosses the 5%, share turnover in the stock is 325% of the normal trading volume, and trading by persons <u>other than the lead activist</u> accounts for 250% of this 325% (or 75%). Because crossing the 5% level is not publicly announced in the U.S. until 10 days later, this surge prior to the public announcement strongly suggests tipping.
5. Wong also finds a statistically significant association between the presence of a wolf pack and the success of the activists' campaign, and finds the wolf pack most used in the case of better defended companies.
6. Finally, Wong documents that the share accumulations during the 10 day window period are likely to be by those who had a prior trading relationship with the lead activist (in effect they are long-time allies).

Is the U.S. Different?

1. Hedge Fund activism has created a much greater stir (and more controversy) in the U.S. than in the U.K. Why?
2. Possible explanations include:
    1. Hedge fund activism is a partial substitute and replacement for the hostile takeover, which has been chilled in the U.S. (but not the U.K.) by the poison pill and other antitakeover defenses.
    2. The U.S. has a much longer “window period” than the U.K., allowing more time for the wolf pack to be formed (and hence a larger wolf pack).
    3. Tipping prospective allies about an impending Schedule 13D filing might be regarded as unlawful insider trading in the U.K. and Europe (but does not violate the law in the U.S. because there is no fiduciary breach).
    4. Diversified institutional investors (in particular, pension funds) are more likely to support an activist hedge fund in the U.S. than in the U.K.

Longer Term Studies: Basically, 3 Papers:

1. Bebchuk, Brav & Jiang (2015)(BBJ)
2. Becht, Franks, Grant & Wagner (2015)(BFGW)
3. K.J. Martjin Cremers, Erasmo Giambana, Simon M. Sepe and Ye Wang, “Hedge Fund Activism and Long Term Value” (2015)(“CGSW”).

BFGW

1. A uniquely world-wide study, BFGW find that meaningful long term gains depend upon the realization of an outcome: either a takeover or a restructuring. If those outcomes not realized, gains erode.
2. Gains associated with liquidity events (special dividends or stock buybacks) are insignificant to even negative.
3. Gains associated with corporate governance changes are modest and appear to relate to changes in the expected takeover premium.
4. Our Interpretation: Hedge Fund Activism is paralleling bust-up takeovers of the 1980s, seeking to realize negative synergy. But hedge fund activism is not otherwise producing measurable improvements in corporate governance.

Bebchuk, Brav & Jiang

1. BBJ find that targets are like their industry/size/firm age counterparts after intervention but are undervalued before.
2. BBJ follows hedge fund targets for five years after the engagements and find that the original increase in share value on the Schedule 13D filing does not dissipate.
3. But 19% of BBJ's Sample Falls Into a Special Category They Define as "Investment-Limiting" Interventions.
4. They define "investment-limiting" to include the following:
   (i) the increase in leverage from the base year to any of the examined years falls within the top 5% of leverage increases among all public companies in that year; or
   (ii) the increase in payout yield (including dividends and share buybacks) from the base year to any of the examined years falls within the top 5% of payout increases among all public co's in that year; or
   (iii) the increase in capital expenditure and R&D from the base year to any of the examined years falls within the bottom 5% of all firms in that year (hence decrease in investment in large magnitude). By "base year," we refer to the year-end before targeting, that is, year (t–1)
5. This extremely narrow definition of "investment-limiting" suggests that if the criteria were relaxed modestly, an even higher percentage of hedge fund engagements would fall into this category of "investment-limiting" interventions.

Cremers, Giambano, Sepe and Wang (2015)

1. CGSW re-examine the Bebchuk data. Although they do not dispute their findings based on that data set, they point out that most targets have underperformed the market. That, in turn, raises the question of whether their subsequent improvement post-intervention simply reflects a reversion to the mean.
2. To test for this, they construct a matched control group of similar underperforming companies that were not the subject of a hedge fund engagement and examine their subsequent performance over the same period. They find that "the value of the firms in our control group increases more than the value of firms in the target group."
3. They conclude:

   > "[I]n the years following the intervention of activist hedge funds, the firm value of hedge fund targets deteriorates (sizably) compared to control firms."

4. From this perspective, there is a reversion to the mean, which the intervention of hedge funds seem to impede. Thus, one side says targets improve because of hedge fund interventions, and the other side says that targets improve in spite of them. This debate will continue.

Policy Options

1. Shortening the 10-Day Window Under The Williams Act
   A. Under current law, a person (or group) that acquires 5% of a public company must file a Schedule 13D within 10 days thereafter (and Canadian law has a similar window period). In contrast, the U.K. and Australia permit only a much briefer two-day window.
   B. The Dodd-Frank Act in 2010 authorized the SEC to shorten this period, as they determined (In the U.K., the period is two business days).
   C. The business community has pushed hard for shortening the period to two business days; and the institutional investor community (and many academics) have resisted.
   D. The SEC has procrastinated and appears likely to continue to do so.
   E. Still, even if the window period were shortened, most of the trading by the activist's allies occurs on the first day of the window period. Shortening the window from ten to two days may thus not have much impact.
2. Redefining "Group". At present, the ability to avoid being deemed a "group" allows the wolf pack to assemble stakes as large as 20% to 30%. Arguably, the fact that one activist tips another of its intent and invites others to join with it should make the tippees a "group," even if there is no agreement to act in concert. The "gift" of such material information should be the cement that unites and defines the group.
3. Rule 14e-3. A special rule under the Williams Act enables the SEC to deem tipping another of an approaching tender offer to constitute illegal insider trading. Legislation could expand this provision to cover mergers and other acquisitions as well. Functionally, tender offers and mergers are simply substitute transactions. Properly designed, such a rule would chill group formation and Allergan-like bidding structures.
4. The "Window Closing" Poison Pill. Private ordering could also stop the wolf pack. If the pill was triggered by purchases above 5% that were made before the filing of the Schedule 13D, activists could buy to 5%, file their Schedule 13D, and then buy more in unlimited amounts—but the market would know of their arrival and stock prices would rise (ending the "cheap" profits).
5. Insider Trading Revisions. Congress or the SEC could attempt to bar the tipping of 13D filings, but this might disrupt or paralyze attempts by shareholders to take action against weak managements.

<u>CONCLUSIONS</u>

1. Shareholder activism is generally desirable, but not always.
2. When it becomes riskless (because those who trade ahead of the public announcement make virtually certain gains), we may encourage excessive interventions and exacerbate externalities: namely, employees, creditors and the economy may suffer when long-term investment is broadly discouraged.
3. Although targets of activism are underperforming firms, it remains unresolved whether activism improves or impedes their recovery.
4. Still worse, we do not yet have an accurate sense of the impact of hedge fund activism on firms that are not targeted, but that reduce their investment in R&D and other long-term investments in order to avoid being targeted.
5. This deterrent effect on third parties is harder to measure but shows up in the general shift from investment to payout.
6. <u>Bottom Line</u>: Corporate Governance Affects Not Only Shareholders, but Society and the Economy Generally.