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Hedge Fund Activism in Corporate Governance

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Definition

Hedge fund activism is an important disciplinary mechanism in corporate governance. It consists in actions aimed to change the way a company is managed, without trying to gain control. Because hedge funds aim to profit from these actions, this is called entrepreneurial shareholder activism.

A hedge fund campaign can only succeed if a majority of institutional shareholders supports it. The question whether hedge fund activism leads to inefficient short termism in corporate governance can only be answered by looking at which investors are decisive on such campaigns. Although the empirical evidence on this is still unclear, index funds seem to be decisive in most instances.

Because of their incentives, index fund managers cannot be trusted to make an informed decision about whether the company should be managed for the short term or the long term. It turns out that the optimal choice in this respect varies with the individual companies and with time. As a result, companies should be enabled to opt out of hedge fund activism by way of dual-class or at least loyalty shares, if a majority of institutional investors agrees to this solution ex-ante.

Introduction

Some ten years ago, a prominent law and economics commentator defined hedge funds (and private equity funds) "the newest big thing in corporate governance" (Macey 2008: 241). Activist hedge funds are definitely the big thing in corporate governance today. They intervene in corporate governance with the goal to make changes happen. So do private equity funds, but there are two differences. For one, hedge funds are supposed to unlock existing value, whereas private equity purports to create new value. Secondly, hedge funds confront the management of public companies, whereas private equity makes friendly deal with them to take the company private. This entry focuses on hedge fund activism as a disciplinary mechanism in the governance of public companies.

Although hedge fund activism has emerged as an US phenomenon, it has now become international (Becht et al. 2016). Hedge fund activism is increasingly prominent in Europe, for instance, in the UK. Moreover, hedge funds are active in concentrated ownership structures, too. Somewhat surprisingly, activist hedge funds have succeeded in extracting concessions also in the presence of

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dominant shareholders. Importantly, hedge funds do not always achieve outcomes from engaging the management and do not need to engage overtly in order to achieve outcomes.

Activist hedge funds screen the market for underperforming companies and buy a significant stake in them in order to engage their management. The goal of activists is to make a profit from improving the company's performance, which will be reflected by an increase in the value of their stake when it is sold back to the market. In doing so, hedge funds are coping with the fundamental agency problem stemming from separation of ownership and control, namely, the failure by management to maximize shareholder value. However, because hedge funds profit from a short-term change in the stock price of the target company, they may also be responsible for short termism in corporate governance. Feeling the pressure of hedge funds, managers may pursue short-term stock returns at the expenses of long-term value creation. For this reason, hedge fund activism is highly controversial.

From a law and economics standpoint, the question is whether hedge fund activism remedies or exacerbates market failure. On the one hand, the reduction of agency costs stemming from activism improves the efficiency of corporate governance. On the other hand, if the profitability of hedge funds activism depends on short-term pricing, the ability of corporate governance to sustain certain long-term projects may be undermined. To answer these questions, it is crucial to understand what drives hedge fund activism as well as the factors affecting its success.

Hedge Fund Business Model

Shareholder activism is not new. Activists, such as individuals or public pension funds, have always been prompting managers to act on some issue, sometimes for ideological reasons. Before the advent of hedge funds, however, such activism has not been very effective in achieving outcomes of sort, let alone in affecting stock prices (Bratton and Mc Cahery 2015).

Hedge fund activism is different. Like other activists, hedge funds take actions aimed to change the way a public company is managed, without trying to gain control (Gillan and Starks 2007). However, differently from traditional activism, hedge funds strive to profit from the changes they provoke. This is called "entrepreneurial activism" (Klein and Zur 2009). The changes can be quite radical, such as the departure of the CEO or some other executives, if not the restructuring of the company. Likewise, activist hedge funds may seek to stop a change wanted by the management, for instance an acquisition.

The mark of entrepreneurial activism's success is whether the desired change happens or not. Hedge funds have a different business model than other institutional investors. Hedge fund managers charge a performance fee in addition to a percentage of the asset under management. The remuneration usually follows the so-called 2-20 rule: 2% of the asset under management plus 20% of any increase in the value of the portfolio. This remuneration structure aligns the hedge fund incentives with investors having a relatively high appetite for risk. Hedge funds profit from investing in stock that they can buy, hold, and resell at a higher price.

Two factors are key for the success of entrepreneurial activism. First, the hedge fund needs to be able to buy the bulk of its stake in the company, while the stock market does not anticipate the engagement. The moment the engagement is revealed, investors will anticipate gains, and discounting those for the probability that the engagement fails, the stock price will rise disabling further profit from activism. Second, the activist needs to be able to persuade the management to implement the desired changes. To increase its leverage with the management, the activist can use several techniques, ranging from news campaigns to threatening a lawsuit. The last resort, however, is a shareholder vote. Reached that point, the success of the engagement will depend on whether the activist has managed to attract sufficient support from other shareholders to get a favorable vote. This explains the importance of proxy contests for activism in the USA

and of the rules for initiating and executing a shareholder vote in the European jurisdictions.

The support by institutional investors is crucial for successful engagement. The typical hedge fund stake in the target company is slightly above 6%, which is not nearly a controlling one. As a result, activists must persuade other investors to vote for them. Similarly, engagement may succeed based on the sheer threat of winning a contested vote. From the moment the hedge funds formulate their demands to the management, both parties start to speak with the largest institutional investors, while the investing public is in the dark about the engagement. Management will give in to the activists' demands when it is clear they are going to lose the vote, whereas hedge funds will withdraw from engagement when they realize that not enough institutional investors will vote for them. The fight becomes public only when the outcome is ambiguous. Consequently, a substantial portion of hedge fund engagement takes place behind closed door. This is consistent with the theoretical literature on litigation vs. settlement, as noted by Bebchuk et al. (2017a).

As explained by Gilson and Gordon (2013), the tremendous influence activists have gained in corporate governance depends on the reconcentration of ownership occurred in the past few decades. The bulk of equity investment is no longer in the hands of dispersed individual stockholders, but is managed by institutional investors. In 2016, institutional investors collectively held 63% of US public equities. Institutional ownership is also concentrated. The largest five and 20 institutional investors control, respectively, above 20% and 30% (on average) of the voting rights in the 20 largest US public companies (Bebchuk et al. 2017b). This is very important for activists, who need to be able to speak rapidly with the people casting a majority of the votes. The situation is similar in Europe. A recent OECD study reveals that institutional investors own nearly 90% of UK listed equities (Isaksson and Celik 2013). Although the style of engagement differs considerably across countries, hedge funds activism consistently gets traction wherever institutional ownership is concentrated.

Although institutional investors are crucial for the success of hedge fund activism, they do not act as activist themselves. The reason is agency costs. Institutional investors are prohibited from charging performance fees. Instead, they charge fees as a proportion of the assets under management, which is for them the key variable to maximize. Differently from hedge funds, institutional investors care about relative, not absolute performance. Asset managers do not have incentives to monitor individual companies because competitors will free ride on their efforts. Therefore, the activists' teaming up with institutional investors seems to be beneficial for corporate governance. On the one hand, activists lower the agency costs of institutional ownership. On the other hand, institutional investors screen the activists' proposals and should sanction only the value-increasing ones.

Reducing agency costs undoubtedly improves the efficiency of corporate governance. However, this does not imply that hedge fund activism is always value increasing. Several objections have been raised concerning the judgment of institutional investors.

Critique of Hedge Fund Activism

A first point of criticism is that institutional investors may fail to exercise judgment in the presence of hedge fund engagement. Rather, they would blindly follow the recommendations of proxy advisors, notably including global market leaders such as Institutional Shareholders Services (ISS) and Glass-Lewis, to decide whether to vote for or against hedge funds. The incentives of proxy advisors to get corporate governance right are even more questionable than those of institutional investors, if only because advisors do not have stakes in the companies for which they recommend a vote. Nevertheless, US legislation has effectively encouraged institutional investors to purchase proxy advisory services to meet the obligation to disclose their voting and avoid embarrassment (Rock 2015). The European Union is now following suit (Pacces 2017).

Empirical research suggests that the impact of proxy advisors on the voting by institutional investors may be not as decisive as it looks. To begin with, only the smaller institutional investors systematically follow the proxy advisors. Large asset managers, such as Blackrock, Vanguard, or State Street, seem to vote independently. Moreover, every study of proxy advisors' impact faces a fundamental reverse causality problem. In the end, although there are clear synergies in judgment (McCahery et al. 2016), it is impossible to determine how much proxy advisors influence large institutional investors and how much they are influenced by them. Although there are no specific studies on the impact of proxy advisors on hedge funds activism, a US study of uncontested elections reveals that ISS advice against the management shifts at most 10% of votes.

Another fundamental critique levered at hedge funds is that they may succeed without any screening by institutional investors, if they act as a coalition, namely as a so-called "wolf pack." Empirically, wolf packs account for about 22% of the engagements observed internationally and are associated with a higher success rate than individual engagements – 78% as opposed to 46% (Becht et al. 2016). On this basis, Coffee and Palia (2016) have argued that wolf packs are a nearly riskless strategy for hedge funds, suggesting that this may lead to over-engagement. However, the impact of wolf packs seems to be overestimated. Firstly, in more than one-fifth of observed wolf pack engagements, the engagement has been unsuccessful. Because unsuccessful engagements result in losses, even wolf packs face risks. Second, wolf packs are never large enough to control a majority of the votes, which makes institutional investors still decisive. Finally and most importantly, 78% of the overt engagements mapped internationally are not wolf packs. This cannot be random because hedge funds choose their battles. If they decide to join and form a wolf pack only when success is more likely, the success rate of wolf packs is overestimated.

The recurrent objection to hedge funds activism is short-termism. This critique is more difficult to handle because short-termism means different things to different people. In one respect, this critique is not borne out by the empirical evidence. Both in the USA and internationally, the announcement of hedge fund engagement leads, on average, to a significant increase of the stock price. This increase is not reversed for up until 5 years down the road (Bebchuk et al. 2015), provided that the engagement is effective in determining change (Becht et al. 2016). Therefore, hedge funds are not short-termist in the conventional sense of "cutting and running." While useful to defend hedge fund activism from an easy rhetoric against them, this result says nothing about whether the stock markets is myopic relative to some horizon longer than the activists' holding period (1.7 years on average), let alone whether it makes sense to consider such a longer horizon to assess the performance of any particular company.

Theory and Evidence on Hedge Fund Activism

Underlying the short-termism discussion, there is a fundamental question about the desirability of hedge fund activism. Hedge fund activism is an important feedback mechanism in corporate governance, but its efficiency is not obvious. Assuming that other stakeholders either protect themselves by contract or are protected from externalities by efficient regulation (Pacces 2012), efficient corporate governance requires maximization of shareholder value. If financial markets were informationally efficient, there would be no difference between short-term and long-term maximization of shareholder value because any asymmetry would be arbitraged away. If, however, stock markets overweight the short-term profits of a company relative to its long-term profits, albeit temporarily, there is market failure. This is a problem for corporate governance to the extent that short-termism leads managers to make value-destroying choices. Whether this is actually the case is uncertain, though, as the management may more or less intentionally err towards the long term to justify

underperformance (long-termism). Defining short- and long-termism is conceptually difficult in the absence of a consensus on what constitutes the "right term" to maximize profit.

What is "right" term depends on the "right" strategy to maximize profit; both are difficult to identify. Stock markets are an impressive source of information in this respect, but alas, they are imperfect. Because they overreact to news, misprice risks, and are prone to asset bubbles, stock market prices do temporarily fail to incorporate the value of future profit opportunities. When this is the case, the Efficient Capital Market Hypothesis (ECMH) does not hold true. Therefore, there may be a conflict between the pursuit of short-term results, which are immediately impounded in market prices, and long-term projects, whose expected results are underweighted or even overlooked by stock prices. Because the hedge fund business model is based on stock market prices, pressure from activist hedge funds may well turn the short-termism of stock market into short-termism of managerial choice.

The question whether public companies should be managed for a shorter or a longer term cannot be answered empirically. Data reveal that successful activism, on average, is associated with a stock price increase. However, this result is uninformative because hedge fund activism produces unobservable effects, too, and because the companies for which we observe engagements cannot be meaningfully compared to those that are not engaged.

The first part of the problem is that we only observe a portion of the true activism, the overt part, whereas a great deal of activism takes places behind closed doors. Moreover, the distribution between overt and covert activism is not random. Better-managed companies react in anticipation of hedge fund engagement, whenever this is a credible threat. Activists, on the other hand, may have to make their campaign public precisely when the targeted is more mismanaged, which overestimates the observable returns from engagement.

The second part of the problem is that companies that are or can be targeted by activists fundamentally differ from those that are not and cannot be targeted. The fact that companies successfully engaged outperform a market index, on average, does not really show that activism improves performance. It only shows that target companies were undervalued relative to a market benchmark and that activism brings performance back in line with that benchmark. These studies cannot rule out the possibility that a target company would outperform the benchmark by a larger extent, if not engaged, because this counterfactual company does not exist and, if it existed, it would be a different firm. This fallacy affects as well the studies arguing that hedge fund activism is value decreasing on the grounds that comparable companies, which have not been engaged, outperform engaged companies in the long run (Cremers et al. 2016).

In theory, whether hedge fund activism is efficient depends on context. Some companies benefit from the correction of underperformance fostered by activist hedge funds, particularly in the presence of investor expropriation or misuse of free cash. For other companies, though, underperformance is temporary and the change of strategy promoted by hedge funds can indeed destroy value. The disagreement on the proper length of time in which to assess performance reflect a more fundamental conflict between two views of the target firm, one by the activist hedge fund and the other by the incumbent management. These views normally differ on strategic issues, such as whether the company should be leaner, more focused on certain businesses and cost-effective in carrying them out, which hedge funds typically like to see perhaps because they are impatient to cash in the profit from engagement. The opposite view that the company should pursue longer-term goals, typically fostered by the management, is equally legitimate although it may procrastinate the acknowledgment of mistakes or conceal the extraction of private benefits of control. For this reason, hedge fund activism should be framed as a conflict of entrepreneurship (Pacces 2016).

Who Decides on Hedge Fund Activism

Framing hedge fund activism as a conflict of entrepreneurship brings up the question who decides on the conflict and whether this is efficient. As explained before, hedge funds need to garner institutional investors' support in order to succeed. Institutional investors, however, differ considerably from each other in terms of investment strategy and incentives. Their propensity to exercise voice to support or to stop hedge funds likewise differs.

Based on Bushee (1988), institutional investors can be broadly characterized as transient (small stakes, high turnover), dedicated (large stakes, low turnover), and quasi-indexers (small stakes, low turnover). According to Hirschman (1970), a fundamental activator of voice is loyalty, that is, a commitment not to exit. Transient and dedicated investors are not loyal. The former enter or exit whenever there is a tiny profit to make, as is the presence of hedge fund engagements. The latter compete with hedge funds on entering and exiting portfolio companies timely. Only quasi-indexers, exemplified by index funds, are loyal in Hirschman's sense.

Index funds are likely to be the decisive institutional investors in a hedge fund campaign. They cannot exit an investment they are dissatisfied with, so long as this investment is part of the index they track. Thus, they are committed to exercising voice. Empirical evidence seems to confirm this. Ownership by index funds in the USA increases the frequency and the success rate of hedge fund engagements requiring high voting support to succeed (Appel et al. 2016). Apart from this, however, very little is known about how index funds vote or are expected to vote on a hedge fund campaign. Assuming that index funds are indeed pivotal, whether they are the right arbiters between the opposing views of hedge funds and incumbent managers depends on context.

To illustrate the conflict of entrepreneurship with an example, a strategic issue on which the views of activists and incumbent management typically collide is quality and quantity of R&D expenditures. Activist hedge funds want companies to focus on developing specific products, which usually results in cuts of R&D expenditures and larger short-term profits. The managers usually ask for the return on R&D expenditures to be assessed over a longer horizon. Reducing R&D expenditures does not necessarily imply that a company is less innovative. There is evidence that activism increases R&D productivity and output. Hedge fund activism, however, systematically reduces R&D input. This may be not the right choice for a number of companies. In particular, nonlinear innovation with long lifecycles benefits from conglomerate structures in which R&D input is large and can be redirected internally from a project to another. Those are precisely the structures that activists seek to break up.

Drawing on their long-term commitment to index tracking, managers of large index funds, such as Blackrock and State Street, have recently made public statements to distance themselves from the short-termism of activist hedge funds. However, such statements must be taken with a grain of salt. Whereas regulation effectively compels index fund managers to vote, they do not have the right incentives to decide on firm strategy. Index fund managers cannot benefit from firm-specific monitoring because their competitors can free ride (Bebchuk et al. 2017b). In pursuing relative performance, index fund managers will rather choose low-cost voting policies that are generally appreciated by investors. That is to say, index funds may support a hedge fund's request to cut on R&D expenditures not because it is efficient, but because the target has poor corporate governance. Whether it is efficient for the particular company to engage in linear or nonlinear innovation is a more idiosyncratic question than an index fund manager can answer. And yet the choice whether to invest for the long term or focus on short-term should depend on firm-specific variables, such as the competitive environment and the length of the innovation cycle.

Relying on the judgment of index funds is efficient in other situations. Often, what prompts hedge fund activism is waste of resources. Because index funds are expected to vote in a standardized, predictable fashion on a hedge

fund's memo showing waste, hedge fund activism protects investors by way of committing management to being efficient. Facing the threat of hedge funds teaming up with institutional investors, managers have to be more careful about misusing fee cash or being unresponsive to the competitive environment. In this perspective, hedge funds activism is a tremendous tool to stop management from being lazy or building empires.

In conclusion, index funds cannot always be trusted to screen hedge fund activism because they do not have incentives to make an informed decision on individual company's strategy. Nevertheless, the incentives of index funds are aligned with the interest of the investing public regarding the control of agency costs. Therefore, the problem whether a company should be exposed to hedge funds activism does not warrant a one-size-fits-all solution. Different companies may need different degrees of exposure to activism at different points in time. As a result, individual companies should be able to choose the exposure of management to the scrutiny by hedge funds and to alter this choice over time.

Policies Towards Hedge Fund Activism

Similarly to hostile takeovers, hedge fund activism is a disciplinary mechanism in corporate governance. If anything, activism is more effective than hostile takeovers to keep managers on their toes because it is cheaper to operate. Unsurprisingly, hedge fund activism has attracted as much criticism as hostile takeovers used to do, if not more. As a result, a number of one-size-fits-all policies have been proposed to fend off hedge fund activism.

The business model of activist hedge funds is based on the purchase of a "toehold" of undervalued stock to secure a reward for screening the market for potential targets. If target identification were revealed before the engagement, other investors would free ride on hedge funds' investment and reduce, if not eliminate, their reward. Free-riding is a mechanism that fundamentally undermines hedge fund activism, as it undermines hostile takeovers for comparable reasons. By nurturing free riding, the regulation of ownership disclosure and shareholder identification curbs hedge fund activism across the board.

The purpose of ownership disclosure is to reveal the build-up of significant stakes in a company. This is important information for the investing public and the company's management. Regulation mandates transparency of large ownership on both sides of the Atlantic. The specific rules, however, differ between the USA and the EU. In the USA, ownership disclosure is triggered by the crossing of a 5% beneficial ownership threshold, after which the shareholder has 10 days to disclose its stake. These rules are sufficiently lenient to make the USA one of the legal environments most favorable to hedge fund activism. Although EU regulation also mandates a 5% beneficial ownership threshold, the time window to disclose it is shorter (4 days), and more important, these are only minimum requirements. The EU member states can and do set lower thresholds and shorter time windows, for instance in the UK, Italy, and the Netherlands. These stricter rules make hedge fund activism less profitable and thus less likely to happen.

In the USA, attempts have been made to curb hedge fund activism through stricter rules on ownership disclosure. Antiactivist legislation is well illustrated by the so-called Brokaw Act, proposed in 2016 by Senators Bernie Sanders and Elizabeth Warren (Brav et al. 2016). This proposed legislation took on board several previous anti-activist proposals (Coffee and Palia 2016). In the Brokaw Act, the most important curbs to hedge fund activism are: (a) shortening the disclosure period from ten to two days and (b) conferring upon the Securities Exchange Commission (SEC) the authority to determine when a group of hedge fund acted as wolf pack, and to mandate disclosure accordingly. The Brokaw Act has not become law at the time of writing.

In the EU, curbs on hedge fund activism have been adopted not by altering the regulation of ownership disclosure, but by introducing EU-wide shareholder identification obligations (Pacces 2017). Different jurisdictions have different rules on shareholder identification. In the USA, institutional investors can opt out of

identification altogether. The EU rules, instead, seek to harmonize shareholder identification rules by requiring that all shareholders above 0.5% be identified by the company's management and the investing public. Differently from ownership disclosure, the purpose of shareholder identification is to facilitate coordination between noncontrolling shareholders. Whereas this policy seems consistent with encouraging the engagement of institutional investors, which is a goal of the EU, the cost of shareholder identification for corporate governance may be higher than the benefits (Enriques et al. 2010). Particularly the cost for hedge fund activism can be substantial, unless hedge funds manage to circumvent identification and purchase several toeholds without crossing the 0.5% threshold.

Ownership disclosure and shareholder identification are two examples of regulation curbing hedge fund activism across the board. As argued before, such one-size-fits-all curbs are inefficient. Law should enable individual companies to tailor exposure to activism to their circumstances, for instance, depending on whether is optimal for them to profile on short-term or longer-term strategies.

In several jurisdictions, companies can effectively opt out of hedge fund activism through dual-class shares, which are interesting relative to other antiactivist tools (such as low-trigger poison pills) because they commit some of the controller's own wealth to the claim that a project must be evaluated in the long term. The problem is that dual class-shares can only be introduced before the company has gone public, unless they are presented as loyalty shares. Formally, loyalty shares provide super-voting rights to any owner that retains the shares for long enough – say, 2 years. Practically, however, loyalty shares are only interesting for controlling owners, because institutional investors are reluctant to give up the higher liquidity of common stock regardless of the average length of their investment horizon.

Both dual-class and loyalty shares confer upon the controlling management super-voting rights. A founder concerned with the adverse impact of activism on certain styles of innovation can go public with dual-class shares, as for instance, Google did. In already listed companies, however, the management cannot exchange existing shares for two classes of shares, one with higher voting rights for the controlling group and one with lower voting rights for the investors. Such dual-class recapitalizations are prohibited. Loyalty shares are a way out of this prohibition. Companies can issue them after having gone public because, formally, loyalty shares do not discriminate between shareholders. European legislation, for example in France, has sometimes gone as far as to allow the introduction of loyalty shares even despite the opposition of a majority of institutional investors.

Loyalty shares are a good instrument for individual companies to tailor exposure to hedge fund activism. However, managers could abuse their power to introduce them. It would be more efficient to allow dual-class recapitalizations explicitly and subject them to a veto by institutional investors. The ex-ante approval of such transactions by a Majority of Minority shareholders (MOM) is a good regime to support contracting between management and shareholders in the midstream. If a MOM vote is required to introduce dual-class shares, the management will have to persuade institutional investors that insulating the company from hedge fund activism, perhaps for a limited time, is value increasing.

Conclusion and Future Research

This entry discusses the role of hedge fund activism in corporate governance. Activist hedge funds are an important source of feedback in corporate governance. However, their influence is not always efficient. Although other institutional investors are decisive on a hedge fund campaign, their judgment cannot always be trusted. In particular, index funds appear to be most often decisive on a hedge fund campaign. However, they do not have the right incentives to decide on company's strategy. On the contrary, the optimal decision whether a company should be managed for the short or the long term depends on the circumstances faced by the individual company. Therefore, individual companies should be able to

tailor exposure to hedge fund activism to their needs and to alter this choice over time.

We still do not know enough about hedge fund activism, because most part of it happens behind closed doors. In order for companies and legislatures to fine-tune the rules on hedge fund activism, it would be useful to know more about how institutional shareholders actually vote and whether different categories of institutional investors are decisive on different campaigns. Moreover, it would be good to know more about the role of coalitions in determining success of hedge fund activism. These are interesting topics for future research.

Cross-References

- ▶ Concentrated Ownership
- ▶ Governance
- ▶ Governance Structure
- ▶ Hirschman, Albert O.
- ▶ Law and Finance
- ▶ Principal-Agent
- ▶ Takeover Regulation

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