Soft Shareholder Activism

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Motivation

- Activists have strong view on how companies should be managed
- Criticize managers/directors for lack of competence and accountability
- If they could, they would impose their views on these companies
Motivation

But...

- Obtaining control of a public company is not trivial:
  - must accumulate voting shares, win board seats
  - how? takeovers, proxy fights, litigation
- Companies can defend themselves
  - poison pills, staggered board, dual-class structures, etc.
- Securities regulation also puts limits
  - e.g., filing requirement of schedule 13D
- In practice, activists rarely own more than 10% of the equity, and rarely hold the majority of board seats
Motivation

**Bottom line,**

- Activists cannot simply force their ideas on companies ⇒
- Activists must persuade the board or other shareholders to support their proposal
  - otherwise, they either remain passive or exit
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Shareholder activism requires communication

- Communication:
  - sending letters, calling management, meeting directors
- Agenda:
  - payout policy, capital structure, strategy, governance, CSR
Anecdotes

“...boards can also benefit from access to the ideas and the concerns investors may have. Good communications can build credibility with shareholders and potentially enhance corporate strategies.”

Chairman Mary L. Schapiro, US. SEC, 10/19/2010
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“When we offer companies **private advice**, they either take it, or they explain why they are not going to take it... sometimes, we agree to disagree, and then decide whether to hold the stock or **exit** the position.”
David Einhorn from Greenlight Capital, 4/25/2017
In May 2012, the activist hedge fund Elliott Management wrote a letter to board members of BMC Software:

“we initiated a dialogue with senior management about exploring pathways together to create greater value for stockholders. In turn, BMC responded by issuing a press release and adopting a poison pill.”

- Shortly after, Elliott nominated directors and pushed for the sale of BMC which was acquired a year later
Evidence

**Informal communications are common!**

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  “The hedge fund intends to communicate with the board/management on a regular basis with the goal of enhancing shareholder value.”
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  - they conclude that “behind-the-scenes” shareholder activism may be more prevalent than previously thought
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This paper

Under what conditions communication is an effective form of shareholder activism?

- What factors contribute to successful dialogues between investors and firms?
- Under what circumstances will investors resort to more aggressive tactics, and when will they choose to exit?
- Why are most communications held behind-the-scenes
The model in a nutshell

- The challenge of the activist is to convince the board, who is biased and uninformed, to change the status quo
  - Communication: cheap-talk à la Crawford and Sobel (1982)
  - Behind-the-scenes

If the board is unresponsive then the activist can either
- Exit: sell her stake (price is endogenous), or
- Voice: launch a public campaign

The campaign is costly, and it succeeds only if shareholders support it.

The board accommodates the activist's demand because
- he is persuaded by her arguments, or
- out of fear of a successful campaign

Communication is effective if the activist can use her private information to influence the board's decision in equilibrium.
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The model in a nutshell

1. Investor privately observes $\hat{\theta}$.

2. **Behind-the-scenes communications**: Investor sends the board a private message $m$.

3. Board observes message $m$ and decides on $x^* \in \{L, R\}$.

4. Investor observes the board’s decision $x^*$.

5. Investor exits ($s=1$) or remains passive ($e=0$).

6. Investor holds onto her shares ($s=0$) and launches a campaign ($e=1$).

   - **Campaign fails**
     - Firm value is realized based on the board’s initial decision, $x^*$.
   - **Campaign succeeds**
     - The status quo changes: Firm value is realized based on $x=R$. 
The key friction
Communication with voice

Effective Behind-the-Scenes Communications
Communication with voice

Board

keep change

θ + β - k

Activist

keep change

launch campaign

θ + c

θ

θ

θ

θ

θ

θ
Communication with exit

Exit → cut and run → Voice

Effective Behind-the-Scenes Communications

threat
Communication with exit

Exit → cut and run → Voice

- Relaxing tension
- Threat

Effective Behind-the-Scenes Communications
Communication with exit

Board

Activist

$p$

$\theta$

$\tilde{\theta}$

$\theta + \beta$

keep change

keep change
Effective Behind-the-Scenes Communications
Communication with **voice** and **exit**

- **Board**
  - $\theta$ to $\tilde{\theta}$
  - $\theta + \beta - k$

- **Activist**
  - $\theta$ to $\tilde{\theta}$
  - $p$ to $p + c$

- Keep, change
- Launch campaign

- Arrows indicate transitions between states.
Summary of the main results

Effective Behind-the-Scenes Communications
Key takeaways so far

Voice enhances communications. Why?

- The best way to avoid intervention is compliance

Implications

- Communication is more effective when:
  - shareholder base is non-dispersed and homogeneous
  - control is contestable (e.g., declassified board, one class of shares, no supermajority provisions)
  - reputational damage to target board members from a successful campaign
Key takeaways so far

Exit enhances communications. Why?

- Relaxing the tension between the activist and the board
- Enhancing the credibility of voice: “put the money where the mouth is”

Implications

- Communication is more effective when:
  - short-term capital gains taxes are low
  - anonymous trade is feasible (e.g., weak disclosure requirements or fragmented market structure)
  - adverse selection is mild (e.g., due to liquidity shocks)
  - liquid stock
Public communications

Why are most communications held behind-the-scenes?

- Market maker and other shareholders observe the activist’s message.
Public communications

Main result

- Public communications are ineffective
- Justifies the prevalence of behind-the-scenes communications

Why?

- The activist is tempted to manipulate prices in order to secure her exit
- The desire to inflate the stock price diminishes the activist’s credibility and limits her influence on the board

⇒ behind-the-scenes communications are more effective
Informed board and alternative sources of private information

The board may be uninformed (about the benefit from changing the status quo, \( \tilde{\theta} \)) because:

- bias
- coordination problems (e.g., free-riding, conformity, group-think)
- conflict with senior management
- busy directors
Informed board and alternative sources of private information

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- bias
- coordination problems (e.g., free-riding, conformity, group-think)
- conflict with senior management
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Suppose instead the board is informed, and consider two alternative sources of private information for the activist:

1. feasibility or consequences of a successful public campaign
2. activist's preferences or beliefs
Informed board and alternative sources of private information

Main result

1. Investors cannot credibility communicate information related to their future intention/ability to intervene
   - activist has incentives to pretend that:
     - a successful campaign is more likely than it really is
     - the consequences to the board are more severe than they are
Informed board and alternative sources of private information

Main result

1. Investors cannot credibility communicate information related to their future intention/ability to intervene
   ▶ activist has incentives to pretend that:
     ★ a successful campaign is more likely than it really is
     ★ the consequences to the board are more severe than they are

2. Communication must involve value-relevant information
   ▶ board is interested in learning about the determination of the activist to launch a campaign
   ▶ activist can credibility convey this information – preventing the board from mistakenly changing the status quo
Literature


- **Exit as a governance mechanism:** Admati and Pfleiderer (2009), Edmans (2009)

- **Communication in corporate governance**
  - **board structure:** Adams and Ferreira (2007), Chakraborty and Yilmaz (2016), Harris and Raviv (2008), Levit (2017)
  - **managerial compensation:** Almazan, Banerji, and Motta (2008)
  - **takeovers:** Levit (2017)
  - **shareholder activism:** Bhattacharya (1997), Cohn and Rajan (2013), Harris and Raviv (2010), Levit and Malenko (2011)

- **Communication & outside options:** Che et al. (2013), Levit (2017), Matthews (1989), Shimizu (2008)

- **Real effects of financial markets:** e.g., Bond, Edmans, and Goldstein (2012, survey)
Conclusions

Activists cannot simply force their ideas on companies ⇒

- They must persuade the incumbent board or other shareholders
  - ⇒ role for communications as a form of shareholder activism
  - ⇒ communications are prevalent in practice

Main results

- Voice and exit enhance the effectiveness of communications
- Public communications are less effective
- Effective communication must involve value-relevant information
Thank You