A Leximetric Approach to Comparative Corporate Governance: The Case of Hedge Fund Activism

Dr Dionysia Katelouzou
King’s College London, Dickson Poon School of Law

LCCGE Monthly Research Seminar
30 May 2014
Quantitative comparative legal research

- Numerical comparative law (Siems and Deakin 2010)
- ‘Law and finance’ literature (e.g. La Porta et al. 1998)
- Measurement of legal rules protecting the rights of shareholders and other stakeholders
- Leximetric research on shareholder protection (Lele & Siems 2007; Siems 2008; Katelouzou & Siems 2014)
Leximetric Coding Techniques

- Law is expressed in numerical terms
- Index construction:
  - Identify a phenomenon of interest, e.g. shareholder protection
  - Choose indicators or variables
  - Devise a coding algorithm
  - Decide on measurement scale
  - Decide on weights of the individual variables or indicators
- Use the resulting index in statistical analysis
- Relationship between legal rules and other data – hedge fund activism
What is shareholder activism, hedge-fund style?

- Shareholder activism – ‘agency costs’
- Characteristics:
  - Equity stake as the departure point
  - No initial endowment (ex ante)
  - Pro-active accumulation of a nontrivial stake
  - Activism as a profit making strategy
- Activist hedge funds: 2000s
- Decline after the crisis, but substantial recovery since 2010
- Increase of the activist hedge fund sector: from $23 bn in 2002 to $166 bn in 2014
Benefits and costs of hedge fund activism

- Value-creation both in the short- and long-term (e.g. Brav et al. 2008; Clifford 2008; Boyson and Mooradian 2011; Bebchuk et al. 2013; Becht et al. 2014)

- ‘Dark side’ of hedge fund activism (Katelouzou 2013)
  - Short-termism (?)
  - Control seeking (?)
  - Aggressiveness (?)
  - Equity decoupling (?)
Hedge fund activism: a global phenomenon

- US
- UK
- Continental Europe
- Asia (Japan)

- Previous empirical datasets (e.g. Brav et al. 2008; Katelouzou 2013; Becht et al. 2014)
The Incidence and Magnitude of Global Hedge Fund Activism

Source: Katelouzou 2014
Number of activist campaigns by the degree of activist hedge funds’ aggression. Only countries with more than 3 activist events are included.
Success Rate

Success rate of activist campaigns by target country. Only countries with more than 3 activist events are included.
Activist Campaign: Sequence of 4 Stages

- Katelouzou 2014:

- What influences hedge fund activism? macro- and micro-level factors(?); legal variables (?)
The Role of Corporate Law in Hedge Fund Activism

- Katelouzou 2014:

  - Entry Stage
    - Continuous mandatory disclosure

  - Trading Stage
    - Ownership disclosure rules (e.g. initial thresholds), insider trading rules, acting-in-concert legislation, mandatory bid rule

  - Disciplining Stage
    - Shareholder rights (e.g. meetings, election of directors, litigation)

- Additional impact of extra-legal factors
Testable Hypotheses

• Hypothesis 1 (H1): *More rigorous shareholder protection rules are associated with a higher number of hedge fund activism campaigns.*

• Hypothesis 2 (H2): *Stronger shareholder protection is associated with friendlier activist hedge fund campaigns.*

• Hypothesis 3 (H3): *Stronger shareholder protection is associated with more successful hedge fund activism.*
Data on Hedge Fund Activism

- Hand-collected activist dataset
- Sample period: 2000-2010
- 25 countries (for a sample of 17 countries, see Katelouzou 2013)
- Sources: Factiva (online database of business news)
- Constructed sample: 432 activist campaigns, 129 activist funds
Dependent Variables

- **ACTIVISM**: counts how often activist hedge funds target companies incorporated in the sample countries – 25 observations

- **AGGRESSION**: binary variable that equals 0 if the activist hedge fund employs only gentle/soft tactics, and 1 if the activist employs mixed or aggressive tactics – 432 observations

- **SUCCESS**: binary variable that equals 0 if the outcome of the activist campaign is failure and 1 otherwise (success or partial success) – 402 observations
Independent (Legal) Variable

- Existing shareholder protection indices:
  - anti-director rights index (La Porta et al. 1998, Spamann 2006, Djankov et al. 2008)
  - CBR index (Armour et al. 2009 and Anderson et al. 2012 for Australia)

- CBR-SPI: proxy for shareholder protection between 2000 and 2005

- RLAW: proxy for law enforcement between 2000 and 2009 (World Bank Governance Indicator)
CBR-SPI

- Arithmetic average of the following 10 CBR variables between 2000 and 2005 (Armour et al. 2009):
  1) powers of the general meeting for de facto changes;
  2) agenda setting power;
  3) anticipation of shareholder decision facilitated;
  4) prohibition of multiple voting rights;
  5) independent board members;
  6) feasibility of director’s dismissal;
  7) private enforcement of director duties;
  8) shareholder action against resolutions of the general meeting;
  9) mandatory bid; and
  10) disclosure of major share ownership.

- Alternative indices: CBR-SPI-2 (excl. litigation variables), CBR-SPI3 (no mandatory bid)
Control Variables

- **Country Level**
  - Ownership concentration (COWNERSHIP – La Porta et al. 1998)
  - Market development (MARKETDEV – World Bank Indicators)
  - Legal origin (ORIGIN – La Porta et al. 1998)
  - Mandatory disclosure (PROSPECTUSDISCL and ACTUALDISCL – La Porta et al. 2006 and Bushman et al. 2004, respectively)

- **Firm-level**
  - Ownership concentration (TOWNERSHIP)
  - Size – market value (TSIZE)
  - Domicile of activist hedge funds (FOREIGN)
  - Wolf-packs (WOLFPACK)
  - Stated objective (OBJECTIVE)
  - Tactics - Proxy fights (PROXYFIGHT)
  - Financial crisis (CRISIS)
Regressions with **ACTIVISM**

- Count data models (Poisson, negative binomial)
- Significant positive relation with *CBR-SPI* (at 5% level)
- After controlling for country-level control variables, *CBR-SPI* remains positive and statistically significant at 5% level
- Robustness checks: use of alternative indices (*CBR-SPI-2, CBR-SPI-3*) yields similar results
Regressions with AGGRESSION

- Binary dependent variable – logistic regressions
- Weak evidence that shareholder protection laws influence the aggressiveness of activist campaigns
- Salient factors:
  - \textit{TSIZE} and \textit{TOWNERSHIP}: activist hedge funds are more aggressive in small target companies with relevant concentrated ownership structures.
- Robustness checks:
  - clusters: random effects (RE) – similar findings
  - use of alternative versions of the CBR-SPI yields similar results.
Regressions with **SUCCESS**

- Binary dependent variable – logistic regressions
- Weak evidence that shareholder protection laws influence the success rate of activist campaigns
- Salient factor:
  - **CRISIS**: campaigns taking place before 2008 have a greater chance of the firm acceding to the activist hedge funds’ demands
- Robustness checks:
  - clusters: random effects (RE) – similar findings
  - use of alternative versions of the *CBR-SPI* yields similar results.
New Research

- Katelouzou & Dai (2014)
- Is activist targeting conditional on differences in the shareholder right regimes?
  - A total of 2261 matched firms (sic2 and 5 by 5 portfolio based on mv and mb)
  - Probit analysis of targeting
  - 2529 observations
  - Percent targeted: 11.85%
New Research (cont’d)

- Is stronger shareholder protection associated with larger activist hedge funds’ ownership stakes?

- Is value creation is conditional on differences in the shareholder right regimes?

- Take advantage of longitudinal legal data:
  - New CBR shareholder protection index: 30 countries, 1990-2013 (Katelouzou & Siems 2014)

- Controlling for financial characteristics (e.g. MB, GROWTH, ROA, CF)
Limitations, Potentials and Future Directions

- The extent to which law matters depends on the stage which activism has reached.

- Use of econometric techniques to control for the possibility of interactions between the different variables of interest

- Limitations (?) – selection, coding and weighting of variables; shortcomings of linear regression

- Likely impact of other (legal, political, cultural) factors

- Need for multi-method approaches (interview-based fieldwork or case studies)