SEC Wants Activist Hedge Funds To Share With The Rest Of The Class

Dealbreaker
Matt Levine
August 15, 2012

Financial markets are basically about information asymmetries, real and imagined, and financial regulation is largely about limiting those asymmetries to socially acceptable kinds and quantities. A general rule for trading success – perhaps the only useful rule for trading success – is: if you know something that nobody else knows and that will increase the value of a stock, then you should buy that stock! Afterwards, you should tell people. If you know something that will decrease the value of a stock, same thing, but with selling. If you don't know anything that nobody else knows, index.

If you follow that rule too closely, though, you will end up in jail, as one does. So the trick is to know what kinds of secret information it's okay for you to trade on, and what kinds it's not okay for you to trade on. This is actually much harder than most people think it is, which is why Doug Whitman is on trial.

My favorite category of nonpublic information that it's maybe okay to trade on is your own intentions. If you wake up and say to yourself "I'm going to buy J.C. Penney stock today," then right there you have an information advantage: *you know something that no one else does*.

Of course, who cares? In expectation, (1) you're poor, so you're not buying enough JCP stock to push up the price, and (2) you're stupid, so your opinion of JCP won't change anyone else's view on the fair price. But occasionally you – not *you* you, but the "you" in this sentence – are rich and smart, and then your intentions are actually valuable information. One way you know that they're valuable information is that stealing them is illegal: if Warren Buffett is secretly planning to buy Lubrizol, and his deputy knows about it, the deputy probably can't go around buying Lubrizol. Another way to know: when Warren Buffett or Bill Ackman announces a position in a stock, the stock usually goes up.

So: is it okay for Bill Ackman to profit from his knowledge that he wants to buy J.C. Penney stock? Or does he need to tell everyone about his plans before he executes them, so that everyone can adjust their price in light of the knowledge that there's a big buyer? Obviously you can't arrest Ackman for insider trading because he traded on his knowledge that he was going to trade. (There are degenerate cases where you can come close.) But you can argue about whether he owns that information and should therefore be able to profit from it, or whether instead that information should be public so he can't take advantage of it at the expense of unwitting public investors who would have held out for a higher price if they'd known he was the buyer.

Harvard professor Lucian Bebchuk has a column in DealBook today about how the SEC shouldn't prevent activists from secretly buying shares in companies. My main reaction was: wait, were they planning to? The main evidence he points to is this March 2011 letter from Wachtell Lipton to the SEC, and Wachtell Lipton's main raison d'être is to prevent activists from secretly buying shares in companies, so I didn't take that very seriously. But in fact it does seem that the SEC is interested in Wachtell's proposals, specifically (1) requiring investors to disclose acquisitions of 5% or more of a company's shares within 1 day instead of the current 10 days and (2) treating economic interests acquired via swaps just like actual voting shares acquired physically for reporting purposes. The result of this would be that hedge funds would not be able to build big stakes quickly and silently: instead of Pershing Square and Vornado being able to acquire 16.5% of J.C. Penney's shares (plus more on swap) before disclosing anything, they'd be limited to just 5%.

Bebchuk doesn't like that. His basic argument is that Bill Ackman owns his intent to buy J.C. Penney shares and should be able to profit from it:

Much research documents that the presence and involvement of outside shareholders enhances a company's value and performance. Large shareholders have an incentive to monitor the performance of incumbent mangers and to engage with them, or even mount a proxy challenge, in the event of underperformance. …

The proposed 5 percent hard cap, however, would reduce the amount of stock that could be purchased before making a 13D filing. That would lower the potential returns to large outside shareholders produced by identifying an underperforming company and taking a significant stake in it. Consequently, the proposal would probably mean fewer shareholders would move to take large stakes in companies, which in turn could well result in more managerial slack at corporations.

The Wachtell proposal doesn't disagree at all with this – it just doesn't care. Here's what they say:

[T]he purpose of the 13D window period was never to grant a license to hedge funds to make extraordinary profits by trading ahead of the undisclosed, market-moving information contained in their delayed 13D filings, nor to provide additional inducements to spur hedge fund activity. The activists' purported rationale for the window period is directly contrary to the overall purposes of the 13D reporting requirements – namely, to inform investors and the market promptly of potential acquisitions of control and influence so that investors have equal access to this material information before trading their shares.

In other words: you have no right to profit from your plans to buy a lot of shares in undervalued companies and turn those companies around. If your plans to buy shares are material to the markets, then everyone should have equal access to those plans.

The SEC is not totally crazy here: the Williams Act that they are enforcing with their 13D rules really was intended to hinder outside investors in their efforts to gain influence over public companies, though as Bebchuk points out, since the Act passed in 1968, state takeover laws (and the Wachtell-invented poison pill) have hindered those investors far more than the Act's authors could have dreamed of.

Still, as a matter of first principles: this is weird, isn't it? If you believe – and why not? – that the SEC's mission is basically to come in to work each day and try to eradicate a few socially harmful information asymmetries in the financial markets, why focus on this one? Hedge funds need to get their asymmetries somewhere, and the proposed rules essentially limit the advantage that hedge funds can gain by careful research and value-creating operational suggestions. In equilibrium that should push investors more toward other sources of alpha like, I dunno, quote-stuffing and insider trading.

Also, while activists' ability to build stakes in secret really does give them an advantage over public investors, is it the sort of advantage that should be regulated? You can, today, buy stock in the Great Idea Corp. so that its promoter can do literally whatever he wants with your money. Or you can buy stock in J.C. Penney, running the risk that when you sell it might be to an activist hedge fund manager who has big plans for improving the company, big plans that you won't benefit from. Which is more likely to end in tears?