Negative Activism

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ABSTRACT

Shareholder activism has become one of the most important and widely studied topics in law and finance. To date, popular and academic accounts have focused on what we call "positive activism," where activists seek to profit from positive changes in the share prices of targeted firms. In this Article, we undertake the first comprehensive study of positive activism's mirror image, which we term "negative activism." Whereas positive activists focus on increasing share prices, negative activists take short positions to profit from decreasing share prices.

We develop a descriptive typology of three categories of negative activism and use a private database of activist activity and other hand-collected information to provide empirical evidence about the frequency and manner with which each category occurs. First, informational negative activism seeks to uncover and then communicate the truth about companies whose shares the activists believe are overvalued. We show that the announcement of this kind of activism is associated with a statistically significant abnormal decline in share prices. Second, operational negative activism involves dismantling or disabling sources of value at companies. We document a range of actual and potential instances of operational negative activism and associated abnormal share price declines. Third, unintentional negative activists are failed positive activists: their announcements of ownership stakes in companies they target are met with immediate negative abnormal returns,

Using this typology and the related evidence, we explore the policy and regulatory implications for each category of negative activism. We show a range of areas where policy and regulatory goals either conflict with or seemingly ignore the effects from negative activism. We also offer several ways that existing regulatory approaches could be improved to account for negative activism. In general, we advocate less regulation, and even subsidization, of informational negative activism; tighter regulation of operational negative activism; and a more nuanced approach to unintentional negative activism.

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INTRODUCTION

On June 17, 2018, Elon Musk announced that a Tesla employee had sabotaged the car company's operations, changing its computer code and exporting sensitive data to third parties. Musk wrote: "We need to figure out if he was acting alone or with others at Tesla and if he was working with any outside organizations."[1]

On April 11, 2017, three roadside bombs exploded while the German soccer team Borussia Dortmund drove by on its way to a tournament quarterfinal match. The bombs sent metal pins through the bus, injuring one of the players, but miraculously sparing the others. Unlike most sports teams, Borussia Dortmund had publicly traded shares.[2]

On July 15, 2016, the Federal Trade Commission announced a settlement in which Herbalife, the nutritional supplement company, agreed to pay $200 million in consumer relief, hire an external monitor, and substantially change some of its business practices. FTC officials previously had been pressured by various parties, including members of Congress, to find that Herbalife misled investors by failing to disclose that most of its sales were generated from recruiting new distributors, not from selling to customers.[3]

On February 10, 2015, an *inter partes* review was filed with the U.S. Patent Trial and Appeal Board, challenging a patent held by Acorda Therapeutics, Inc., a pharmaceutical company whose shares were traded on NASDAQ.[4] The media reported the news of the filing the same day.[5]

On May 15, 2014, Jim Chanos, the head of Kynikos Associates, appeared on CNBC and criticized Keurig Green Mountain and SodaStream, two manufacturers of single-serve hot beverages. Chanos

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[1] CNBC obtained a copy of Musk's email, which is available at https://www.cnbc.com/2018/06/18/elon-musk-email-employee-conducted-extensive-and-damaging-sabotage.html.

[2] For a long-form writeup of this story, see Thomas Rogers, *The Get-Rich-Quick Scheme That Almost Killed a German Soccer Team*, BLOOMBERG BUSINESSWEEK, Oct. 29, 2018, https://www.bloomberg.com/news/features/2018-10-29/the-get-rich-quick-scheme-that-almost-killed-a-german-soccer-team.

[3] See Matthew Goldstein & Alexandra Stevenson, *Herbalife Settlement With F.T.C. Ends Billionaires' Battle*, N.Y. TIMES, Jul. 15, 2016, at B1; see also Statement of the Federal Trade Commission v. Herbalife International of America, Inc., Jul. 15, 2016, available at https://www.ftc.gov/public-statements/2016/07/statement-federal-trade-commission-ftc-v-herbalife-international-america.

[4] See Petition for Inter Partes Review of U.S. No. 8,663,685, at 1, Coal. for Affordable Drugs (ADROCA) LLC v. Acorda Therapeutics, Inc., IPR No. 2015-00720 (P.T.A.B. Feb. 10, 2015)

[5] For a study of this strategy, J. Gregory Sidak & Jeremy O. Skog, *Attack of the Shorting Bass: Does the* Inter Partes *Review Process Enable Petitioners to Earn Abnormal Returns?*, 63 UCLA L. REV. DISC. 120, 123 n.8 (2015).

expressed skepticism about efforts by both companies to expand into single-serve cold products.[6]

Year after year, shareholder activism dominates both media headlines[7] and legal scholarship.[8] Hundreds of times per year, a hedge fund activist announces that it has acquired a significant stake in a company and then demands reform.[9] The targeted company's stock price typically increases during the time surrounding the announcement, and often a vicious battle

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[6] See Bruno J. Navarro, *Jim Chanos: Best Shorts in a Bull Market*, CNBC HALFTIME REPORT, May 15, 2014, https://www.cnbc.com/2014/05/15/jim-chanos-best-shorts-in-a-bull-market.html.

[7] The year 2017 alone had activist campaigns involving many familiar firms, including Xerox, Proctor & Gamble, Nestlé, Whole Foods, and General Motors. *See* LAZARD, 2017 ACTIVISM YEAR IN REVIEW, https://www.lazard.com/media/450414/lazards-review-of-shareholder-activism-q4-2017pdf.pdf (Jan. 2018). The current year has so far followed a similar route. *See* LAZARD, REVIEW OF SHAREHOLDER ACTIVISM – 1Q 2018, https://www.lazard.com/media/450557/lazard-1q-2018-activism-review.pdf (Apr. 2018) (highlighting campaigns at Lowe's and Barclays Bank, among others). The topic of shareholder activism has even penetrated popular culture, with recent Presidential candidate Hillary Clinton characterizing its practitioners as "hit-and-run activists whose goal is to force an immediate payout." Andrew Ross Sorkin, *Clinton Aim Is to Thwart Quick Buck on Wall Street*, N.Y. TIMES, July 28, 2015, at B-1.

[8] Shareholder activism is a particularly fertile area for recent important and influential legal scholarship, and arguably has been the most important issue in business law scholarship during the previous decade. For examples, see Leo E. Strine, *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870 (2017); Lucian A. Bebchuk, Alon Brav, Wei Jiang, & Thomas Keusch, *Dancing with Activists*, HARV. L. & ECON. DISCUSSION PAPER NO. 906, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2948869 (Nov. 27, 2017); K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67 (2016) (examining whether staggered boards provide value in the face of increased activism and other shareholder interventions); Lucian A. Bebchuk, Alon Brav, & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1100 (2015); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637 (2013); Lucian A. Bebchuk & Robert J. Jackson, *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 40 (2012); Henry T.C. Hu, *Too Complex to Depict? Innovation, Pure Information, and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601 (2012); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 653–59 (2010); Stephen M. Bainbridge, *Investor Activism: Reshaping the Playing Field?*, UCLA L. & ECON. RESEARCH PAPER NO. 08-12 (May 12, 2008), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1130969; Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 86 S. CAL. L. REV. 811, 823–46 (2006).

[9] *See* ACTIVIST INSIGHT, THE ACTIVIST INVESTING ANNUAL REVIEW 2018, 6 https://www.srz.com/images/content/1/5/v2/155375/The-Activist-Investing-Annual-Review-2018-HiRes.pdf (2018) (finding the number of activist campaigns grew from 570 in 2013 to 805 in 2017); Lucian A. Bebchuk et al., *supra* note 8, at 1100 (finding hedge fund activism to have grown from 10 cases in 1994 to 272 in 2007).

ensues.[10] Shareholder activists say they are trying to improve companies and increase share prices by persuading management to improve operations, or sell off underperforming units, or reveal new information to the public. We refer to this well-known kind of shareholder activism as *positive activism*, because its goal is to make money through interventions that positively affect share prices.

Although positive activism has received extensive attention, it is not the only form of activism. The five examples cited above also involve activists who are attempting to influence companies. However, in these examples, the activists are trying to destroy their targets, often in unorthodox or undesirable ways. We label activism that seeks to make money through interventions that negatively affect a company's stock price as *negative activism*.

In this Article, we identify and systematically address, for the first time in the literature, the concept of negative activism, which is in many ways the mirror image of positive activism. In negative activism, the activist typically sells short[11] a company's shares instead of buying them. A negative activist thereby seek to profit from, and has incentives to cause, a decline in share prices – the opposite of a positive activist, who profits when share prices rise.[12]

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[10] *See* C.N.V. Krishnan, Frank Partnoy, & Randall Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296, 297 (2016) (finding abnormal stock price increases of over 7% during the period immediately surrounding an activist intervention public announcement). For a prominent example of the conflicts generated by activist interventions, see Zachery Kouwe, *Target's Shareholders Strongly Reject Dissident Slate, Ending Divisive Proxy Battle*, N.Y. TIMES (May 28, 2009), http://www.nytimes.com/2009/05/29 /business/29target.html. *See generally* Strine, supra note 8, at 1934–1956 (discussing potential negative effects of investor activism on retail investors that may justify defensive measures). Although scholarship on activism typically focuses on activists' efforts to impact share prices, activists also on occasion intervene in debt markets. *See, e.g.,* Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U.L. REV. 281 (2009) (studying this phenomenon).

[11] In a classic short sale, the seller borrows shares of stock that she does not yet own and sells those shares at current market prices; the short seller later "covers" this short position by purchasing the share at a future date and then returns the borrowed shares. The short seller therefore profits when share prices decrease between her sale and subsequent purchase. *Short Sales*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/answers/shortsale.htm (last visited June 29, 2018)

[12] Our concept of negative activists therefore encompasses a larger group than activists who profit from short positions. In addition to, or instead of, shorting, activists might hold derivative instruments that function like shorted shares, which we consider later in the Article. Activists might also hold certain debt instruments that increase in value when share prices decline, such as when those debt instruments are drafted so that share price declines trigger default in those debt instruments. *See, e.g.,* Shaun J. Mathew & Daniel E. Wolf, *Shareholder Activism: Evolving Tactics*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Aug. 23, 2018), https://corpgov.law.harvard.edu/2018/08/23/shareholder-activism-evolving-tactics/ (describing bondholders acquiring shareholder voting rights to trigger company insolvency). For convenience, we focus in the Article on activists who profit from shorting company positions, as that method currently appears to be the most

The above five examples illustrate what we mean by negative activism. Elon Musk asserted that the Tesla employee-saboteur might have been involved with short sellers.[13] The perpetrator of the soccer team bombing was a German citizen who had borrowed money to bet $45,000 against the soccer team's shares on the day of the attack, seeking potential profits of up to $600,000.[14] The campaign against Herbalife was orchestrated by Pershing Square Capital Management, a hedge fund with a $1 billion short position in the company.[15] The Acorda Therapeutics *inter partes* patent challenge was filed by the Coalition for Affordable Drugs, a group of hedge funds managed by Kyle Bass who had taken a short position in the company.[16] Jim Chanos had sold short shares of Keurig Green Mountain and SodaStream before he disclosed those positions.[17]

As we show, negative activism is important and surprisingly common, with hundreds of examples in recent years. Some instances involve large public companies, such as Herbalife, that are embroiled in controversy.[18] Other examples involve claims of corporate mismanagement or misleading disclosures,[19] in many ways providing a quasi-regulatory function traditionally served by shareholder class actions, the SEC, and other bodies.[20] Some negative activism is by firms that long positions in some companies, but short positions in others. Yet the literature on shareholder activism currently focuses on positive activism and ignores negative activism, even though negative activism is a significant portion of activist activity.

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common form of negative activism. However, our implications apply to the broader set of negative activists who hold instruments that pay off upon share price declines.

[13] CNBC obtained a copy of the email, which is available at https://www.cnbc.com/2018/06/18/elon-musk-email-employee-conducted-extensive-and-damaging-sabotage.html.

[14] Although team's stock price, instantly fell by two percent after the bombing was announced, it quickly recovered. The perpetrator later testified that he had set the bombs to traumatize the players, disrupt their performance, and tank the stock. See Rogers, *The Get-Rich-Quick Scheme That Almost Killed a German Soccer Team*.

[15] For discussion of Pershing Square's protracted short position in Herbalife, see Lucinda Shen, *Ackman Calls It Quits on Herbalife as Pershing Square Restructures*, FORTUNE, Feb. 28, 2018, http://fortune.com/2018/02/28/bill-ackman-valeant-herbalife-short/.

[16] Although Acorda Therapeutics stock price fell approximately ten percent on the day of the announcement, subsequent similar patent challenges by the same group were not as profitable. See Sidak & Skog, *supra* note 5 at 123 n.8.

[17] See Bruno J. Navarro, *Jim Chanos: Best Shorts in a Bull Market*, CNBC HALFTIME REPORT, May 15, 2014, https://www.cnbc.com/2014/05/15/jim-chanos-best-shorts-in-a-bull-market.html.

[18] Valeant Pharmaceuticals is another prominent example. See Lucinda Shen, *Bill Ackman Finally Apologizes for his 'Huge Mistake' with Valeant*, FORTUNE, Mar. 29, 2017, http://fortune.com/2017/03/29/valeant-pharmaceuticals-stock-bill-ackman-pershing-square-hedge-fund-letter/.

[19] *See infra* Part II.B.1.

[20] *See, e.g.*, Jessica Erickson, *Overlitigating Corporate Fraud: An Empirical Analysis*, 97 IOWA L. REV. 49 (2011) (exploring the interaction between various private and public actors in enforcing securities fraud prohibitions).

Moreover, negative activism presents crucial policy challenges. As the word "activism" implies, negative activists do not sit back and wait for stock prices to decline so that their short positions will gain value. Instead, many actively attempt to induce a decrease in share prices. In a market economy that typically prioritizes value creation, rather than value destruction, negative activism may strike many as troubling or manipulative.

In this Article, we have two primary goals. First, we set forth an analytic framework for assessing different types of negative activism. Like positive activism, negative activism exhibits a range of characteristics, and it is important not to paint all of negative activism with a single broad brush. A saboteur at Tesla or a roadside bomber are different from an anti-corporate campaigner or a patent challenger or a skeptic about a company's profitability. We present a rubric for distinguishing among these, and other, examples.

Second, and relatedly, we address different potential policy responses to negative activism. We argue that such responses should be tailored to the characteristics of the different types of negative activism. (The five examples of negative activism above do not deserve the same regulatory response.) We show several ways that our analysis of negative activism can be applied to improve business and financial regulation. In the process, we show how scholars and policy makers might adopt and apply our framework to business and financial regulation of various types.

This Article proceeds in three parts. Part I provides background on positive activism. We describe the conditions that have led to activist investing's rapid rise from a small slice of all investments to a significant force today.[21] We also summarize the law and finance literature on activist investing, and demonstrate its focus on positive activism.

In Part II, we develop an analytic framework for studying and assessing negative activism. We split negative activism into three categories. First, *informational negative activism* seeks to uncover and then communicate the truth about companies whose shares the activists believe are overvalued. Jim Chanos's short selling of beverage companies fits this category, as do certain aspects of the campaign against Herbalife. We collect data regarding instances of informational negative activism from 2009 through 2016 and show that the public announcement of this kind of activism is associated with a statistically significant decline in prices surrounding the announcement date. In other words, negative activism appears to accomplish the activist's objectives, at least in the short term.

Second, and in contrast, *operational negative activism* involves dismantling or disabling sources of value at companies. Operational negative activists do more than simply communicate information. They actually undertake to change, and even damage, the corporations they

[21] *See, e.g.*, ACTIVIST INSIGHT, *supra* note 9 (discussing several new large activist positions taken in 2018).

target. The Dortmund soccer team bombing falls into this category, as would the Tesla saboteur (if there were proof of a connection to short selling). Patent challengers and "hacktivists," who disrupt company information technology systems, present more difficult cases, which we discuss in detail. We document a range of actual and potential instances of operational negative activism.

Third, and most unusual, *unintentional negative activism* involves failed attempts at positive activism. Positive activists take long ownership positions in companies they target, not short positions, and they seek to increase share prices, not decrease them. On average, these positions are associated with a 7% cumulative abnormal positive return surrounding announcement.[22] However, not all positive activist interventions are greeted with such enthusiasm. In some cases, the market reaction to the announcement of positive activist interventions is negative, due to apparent deep skepticism about the activist's potential interventions. We view these instances where the positive activist unintentionally brings about a negative response as unintentional negative activism. Unintentional negative activism is a fascinating, yet not previously studied, phenomenon. (We also briefly discuss unintentional positive activism, which is failed attempts at negative activism: in other words, unintentional positive activism involves negative activists, who are seeking stock price declines, whereas unintentional negative activism involves positive activists, who are seeking stock price increases.)

Part III turns to regulation and policy. We summarize the goals of activist regulation and the current regulatory approach, which largely focuses on positive activism. We consider the gaps that this focus has generated for regulating negative activism, and we propose ways that regulatory policy could and should be improved to account for the increasingly prevalent phenomenon of negative activism.

Our proposals vary depending on the category of negative activism. We view informational negative activism, in light of existing anti-fraud laws, as presenting minimal additional policy concerns; in fact, a case can be made for subsidizing this form of negative activism. We see operational negative activism very differently: it is often deleterious or potentially dangerous. We suggest a new regulatory framework aimed directly at operational negative activism, and we explore the line-drawing questions of informational versus operational negative activism that such a system would require. How we think about operational activism depends both on its objectives and the extent to which it generates informational benefits.

Finally, we suggest that policymakers, including courts, view unintentional negative activism more skeptically than they view general positive activism. Although in many ways the market reaction will provide all the deterrent that is needed for unintentional negative activism, a negative market reaction is an important piece of information that could

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[22] Krishnan et al., *supra* note 10, at 297.

justify more a defensive approach by company management. For example, courts might take into account a negative market reaction when reviewing anti-takeover responses by a targeted company.

We then conclude.

I. Positive Activism

We begin by briefly describing the practice of positive shareholder activism as well as the academic research it has generated. This Part sets up our focus on negative activism, which we turn to in Part II.

Positive activism has been driven by hedge funds, which rely on exemptions from the Securities Act and the Investment Company Act to operate as essentially private, pooled investment vehicles for sophisticated investors.[23] As hedge funds have become more powerful and influential – managing some $3 trillion in assets today – so too has their proclivity for activism.[24] Although there are thousands of hedge funds, with a wide range of investment approaches, a significant subset of several hundred hedge funds have developed strategies that target underperforming companies and then seek a variety of operational or financial reforms aimed at increasing shareholder value. Positive activists often seek to change company management,[25] encourage or discourage a potential merger or acquisition,[26] change executive compensation practices,[27] reform corporate governance,[28] and reveal private company-specific

[23] *See, e.g.*, Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, *in* New Financial Instruments and Institutions: Opportunities and Policy Challenges 114 (Yasuyuki Fuchita & Robert E. Litan eds., 2007) (noting that although "[t]here is no generally agreed-upon definition" for hedge funds, they are typically characterized by four factors: investment pooling; professional investment manager administration of those pools; not being generally available to the retail public; and operating mostly outside securities regulation and registration requirements); Linda Chatman Thomsen, Daniel M. Hawke, & Pauline E. Calande, *Hedge Funds: An Enforcement Perspective*, 39 Rutgers L.J. 541, 544 (2008) (noting that a hedge fund is "generally . . . an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings . . . and which is not registered as an investment company . . . .").

[24] Melissa Karsh, *Hedge Fund Assets Pass $3 Trillion in 2016 for First Time*, Bloomberg, Jan. 23, 2017, https://www.bloomberg.com/news/articles/2017-01-23/hedge-fund-assets-pass-3-trillion-in-2016-for-first-time-chart. *See also* Registration Under the Advisors Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056 (Dec. 10, 2004) (reporting that hedge funds accounted for 10% to 20% of all U.S. equity trading by volume).

[25] *See, e.g.*, Activist Insight, *supra* note 9, at 17 (recounting efforts by Trian Partners to appoint directors at General Electric and Proctor & Gamble).

[26] *Id*. at 10, 12 (highlighting activists' attempts to block planned mergers).

[27] *Id*. at 46–47 (summarizing efforts by asset managers to influence executive compensation practices).

[28] *Id*. at 8 (noting that 38% of public activist demands of large firms were related to corporate governance issues).

information to the public.[29] Each of these strategies is designed to add value for shareholders.

Law and finance scholars responded eagerly to the emergence of positive activism. Early studies of hedge funds highlighted the funds' ability to earn significant positive returns, even when adjusted for hedge funds' comparatively high levels of investing risk.[30] These early studies, however, did not focus on positive activism as a strategy unto itself. Then, in 2006, two law professors published a book chapter describing a hand-collected dataset of positive activist interventions,[31] and during the following years several more comprehensive studies were published, consistently showing that the announcement of positive activism was associated with a statistically significant increase in targeted firms' share prices.[32] Scholars also began examining the characteristics of positive activism, including its varied objectives and strategies.[33]

For more than a decade, legal scholars and practitioners also have debated a range of policy issues related to positive activism.[34] Proponents of positive activism argue that it helps reduce the shareholder apathy and agency cost problems that inflict publicly held firms, pointing to the positive shareholder returns associated with positive activism.[35] Critics

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[29] *See, e.g.*, Shen, *supra* note 15 (discussing efforts to affect Herbalife's share price).

[30] *See, e.g.*, Carl Ackerman et al., *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 J. FIN. 833 (1999); Bing Liang, *On the Performance of Hedge Funds*, 55 FIN. ANAL. J. 72 (1999). *See generally* Rene M. Stulz, *Hedge Funds: Past, Present, and Future*, J. ECON. PERSP. 21 (2007) (summarizing hedge fund performance literature).

[31] *See* Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, in NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES (Yasuyuki Fuchita and Robert E. Litan, eds. 2007) .

[32] *See, e.g.*, Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009); Christopher Clifford, *Value Creation or Destruction: Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323 (2008); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *The Returns to Hedge Fund Activism*, 64 FIN. ANAL. J. 45 (2008); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681 (2007); William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1418–21 (2007); Marco Becht, Julian R. Franks, Jeremy Grant & Hannes F. Wagner, *Returns to Activism: An International Study*, 30 REV. FIN. STUD. 2933 (2017).

[33] *See* Matthew Denes, Jonathan M. Karpoff & Victoria McWilliams, *Thirty Years of Shareholder Activism: A Survey of Empirical Research*, 44 J. CORP. FIN. 405 (2017); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PENN. L. REV. 1021 (2007); Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 459 (2013).

[34] *See, e.g.*, Frank Partnoy, *U.S. Hedge Fund Activism*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER 99, 104 (Jennifer Hill and Randall Thomas, eds. 2015) (describing the shareholder activism literature); John C. Coffee & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016) (raising concerns about positive activism); Strine, *supra* note 9 (same).

[35] *See, e.g.*, Gilson & Gordon, *supra* note 8; Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

question whether positive activism generates long-term value or instead sacrifices these gains for fleeting short-term profits.[36] Several leading scholars have written comprehensive assessments and critiques of various aspects of positive activism.[37]

In sum, positive activism has become a central topic in corporate and securities law, perhaps *the* central topic. Given the predominance of debate about positive activism, it is striking how little attention has been paid to its mirror counterpart, negative activism, which we turn to now.

II. NEGATIVE ACTIVISM

Our treatment of negative activism contrasts sharply with scholarship on positive activism, for the straightforward reason mentioned above: negative activism profits when share prices decline. In contrast, positive activism has been focused on activists' efforts to increase the value of target company shares. Although commentators have disagreed about the impact of positive shareholder activists, the widespread assumption has been that positive activists are at least attempting to add value to share prices, hence the adjective "positive."

Instead, the analysis of negative activism necessarily begins with the proposition that successful negative activism is bad for shareholders of the targeted firm. Thus, unlike positive activism, which often carries a powerful and positive normative presumption, negative activism faces an uphill normative battle, the presumption being that it destroys shareholder value.

As we show in this Part, negative activism is an even more complex and varied phenomenon than positive activism. The motivations and techniques of negative activists vary widely. Accordingly, we begin by presenting a taxonomy of three categories of negative activism, based on whether it is primarily informational, operational, or unintentional. Then we demonstrate some of the characteristics associated with each of these three categories of negative activism by considering a range of data, both statistical and anecdotal. Much of this analysis focuses on the behavior of hedge funds, who are the primary players in this space. In other work, we develop the case for how other types of institutional players beyond hedge

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[36] Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (Feb. 26, 2013), http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-companywreck-the-economy/.

[37] Coffee & Palia, *supra* note 34; Strine, *supra* note 8; John C. Coffee & Darius Palia, *The Impact of Hedge Fund Activism: Evidence and Implications*, Colum. L. & Econ. Working Paper No. 489, Oct. 4, 2014, https://ssrn.com/abstract=2496518; John C. Coffee, *The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality*, European Corp. Gov. Institute – Law Working Paper No. 373/2017, Nov. 22, 2017, https://ssrn.com/abstract=3058319.

funds could engage in negative activism as part of a broader strategy of short selling.[38]

A. Three Categories of Negative Activism

To capture negative activism's nuances, we split it into three categories. First, we characterize as *informational negative activism* behavior that seeks to uncover and then communicate the truth about companies whose shares the activists believe are overvalued. Examples include recent short sellers at Herbalife, Valeant, and numerous financial institutions, who have undertaken investigations that they believed established the companies' public share prices overstated their actual value. Enron is another prominent example, where negative activists uncovered and disclosed information about accounting fraud in 2001. Informational negative activism can be focused on past disclosures by companies, which the negative activist argues contain misstatements or omissions, or on future expectations about a company's prospects.[39]

Second, *operational negative activism* seeks to change the operations of a company, by dismantling or disabling sources of earnings or cash flow. For example, operational negative activists have taken short positions in a company and then argued that its patents were invalid, attempting to reduce that company's value. Other operational negative activists have attempted to influence the likelihood of mergers or recapitalizations, again in an attempt to reduce share prices. Unlike informational negative activism, operational negative activism typically is focused on the future, not the past, except to the extent past facts are helpful in assisting the activist campaign to harm the company's future prospects.

Third, *unintentional negative activism* involves attempts at positive activism that instead are associated with a reduction in share value. Although scholars have criticized positive shareholder activism on various grounds, those critiques have struggled to explain away the overwhelming evidence that stock prices usually react positively during the period surrounding the public announcement of activist intervention. The law and finance literatures have established that this stock price reaction is statistically significant, not later reversed, and persists over time.[40] However, recent studies have demonstrated significant variance in the individual stock price reaction associated with activist interventions by different activists.[41] Although the mean announcement returns are positive, the announcement of activist interventions by some shareholder activists is

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[38] Peter Molk & Frank Partnoy, *Institutional Investors as Short Sellers?*, __ B.U. L. REV. __ (forthcoming 2019).
[39] *See, e.g.*, "*Activist" Short Selling*, MUDDY WATERS, Feb. 17, 2016, Slide 16, https://www.hvst.com/attachments/4120?download=true.
[40] *See supra* notes 31–32 and accompanying text.
[41] *See* Krishnan et al., *supra* note 10.

associated with a negative market reaction. It is this subset of attempted positive interventions that we label unintentional negative activism.

Although negative activism has negative connotations and can result in harm to firms and society, certain forms of negative activism also can generate substantial benefits. Informational negative activism can be desirable when it generates valuable information, thereby enhancing the informational efficiency of markets and helping to move stock prices closer to their fundamental value. Even operational negative activism can be desirable, if it eliminates company value that never should have been present, such as by unwinding patents that turn out to have been incorrectly granted.

Social policy arguably should take into account those potential benefits. We leave the detailed analysis of these policy questions to Part III. Our present goal in the remainder of this Part is to contribute to scholarship on shareholder activism by gathering and analyzing data related to each of the three categories of negative activism.

B. Empirical Evidence of Negative Activism

In this section, we report a range of empirical evidence for each category of negative activism. We use a combination of data analysis and anecdotal evidence. The evidence establishes not only that negative activism is widespread and influential, but also illuminates the important distinctions among the three categories of negative activism. These distinctions are helpful when considering optimal regulatory and policy treatments of each form of negative activism.

1. Informational Negative Activism

There is abundant anecdotal evidence of negative informational activism, but comprehensive study has been significantly less. Studying negative activism presents challenges that are absent when studying positive activism. Most importantly, positive activists must publicly disclose their ownership stake through a Schedule 13D filing within ten days of crossing the five percent ownership threshold.[42] There are no analogous disclosure rules in place for short positions, of any size.[43] Also, institutions with more than $100 million under management must publicly disclose their long positions in quarterly Form 13F filings; these requirements do not apply to short positions.[44] Accordingly, the two most important and reliable data sources for studying positive activism do not exist for the study of negative activism.

In the absence of disclosure mandates, empirical analysis of short selling must rely on self-reporting. There are strong incentives for

[42] For additional discussion of disclosure rules for positive activism, see *infra* notes 102–116 and accompanying text.
[43] For additional discussion of disclosure rules for positive activism, see *infra* note 149 and accompanying text.
[44] *See infra* notes 122–123 and accompanying text for additional discussion.

selection bias in self-reported incidents of negative activism, for both obvious and non-obvious reasons. Negative activists have incentives to report their most persuasive positions in the most favorable light, and their unpersuasive positions not at all. Disclosures also can be made at any short selling threshold: someone who is only short a handful of shares and little money at risk can post a report online and then selectively boast about a subsequent stock price decrease.

Less obviously, short sellers are generally reluctant to report their positions publicly. Many fund managers believe that disclosing positions can lead to "copycat investing," making them reluctant to give away their informational advantages.[45] Additionally, Owen Lamont provides evidence that firms take legal and regulatory actions against disclosed short sellers, by alleging criminal conduct, suing them, hiring private investigators, asking public authorities to investigate them, and manipulating securities markets to impede short selling.[46]

Notwithstanding these difficulties, there have been some attempts to analyze informational negative activism. In a 2016 article, Alexander Ljungqvist and Wenlan Qian reported on a study of 358 short-seller reports targeting 124 companies from 2006 to 2011.[47] They find these reports have a significant impact on various forms of market activity. Short-seller reports are associated with more frequent trading and widen the bid-offer spreads for the targeted stocks, creating order imbalances, and increasing volatility, while significantly decreasing share prices.

In another 2016 article, Lei Chen considered 443 similar types of short-selling reports from 2007 to 2014; these reports identified problems at several dozen Chinese firms listed on U.S. exchanges.[48] This study found share prices of the targeted firms declined in reaction to these reports, as did prices at peer firms with the same auditor. Chen's study reinforces the notion that self-reporting by informational negative activists can have a significant impact on markets.

In a more comprehensive 2018 working paper, Wuyang Zhao reported results from a collection of more than 6,000 reports on negative activist

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[45] *See, e.g.*, Annie Massa, *NYSE Pleads for Rules to Make Hedge Funds Reveal Short Positions*, BLOOMBERG, Oct. 21, 2015, https://www.bloomberg.com/news/articles/2015-10-21/nyse-pleads-for-rules-to-make-hedge-funds-reveal-short-positions (quoting hedge fund manager David Tawil).

[46] Owen A. Lamont, *Go Down Fighting: Short Sellers vs. Firms*, 2 REV. ASSET PRICING STUD. 1 (2012). These costs of disclosure generate a separating equilibrium between a group of aggressive, less risk averse negative activists, who are willing to expose themselves to the potential risks associated with a public short position, and more conservative negative activists, who prefer to avoid those costs and instead reap the benefits of their information over time as it gradually disseminates into the market. This distinction between aggressive and conservative negative informational activists introduces additional bias into any study based on voluntary public announcements.

[47] Alexander Ljungqvist & Wenlan Qian, *How Constraining Are Limits to Arbitrage? Evidence from a Recent Financial Innovation*, 29 REV. FIN. STUD. 1975 (2016).

[48] *See* Lei Chen, *The Informational Role of Short Sellers: The Evidence from Short Sellers' Reports on US-Listed Chinese Firms*, 43 J. BUS. FIN. & ACCT'G 1444 (2016).

events in Seeking Alpha, an online crowd-sourced investor reporting platform, as well as in Activist Shorts Research, a newsletter that tracks high-profile incidents of negative activism.[49] Zhao confirmed that negative activism was associated with a statistically significant negative market reaction[50] Zhao and Yu Ting Forester Wong later used the same data sources to confirm that companies targeted by negative activists suffered decreases in investing, financing, and payout activities.[51]

Most recently, Joshua Mitts also analyzed a set of almost 3,000 anonymous negative activist reports in Seeking Alpha and found that reports are associated with significant, but short-term, decreases in the prices of targeted stocks.[52] Mitts characterized the results as consistent with "misstatement manipulation," with the authors fabricating negative information to drive down stock prices.[53] Authors also reportedly adopted new anonymous profiles once their credibility had been exhausted by the fabricated reports.[54]

Finally, in a current working paper, Ian Appel, Jordan Bulka, and Vyacheslav Fos used a sample of 280 publicly disclosed short positions culled from Factiva's media coverage from 1996 through 2015 to show these campaigns result in an average -7% abnormal return to the target.[55] The authors provide detailed findings broken down by allegation and several other factors and conclude that much of the abnormal return is driven by "active" allegations, rather than allegations about general firm overvaluation.[56]

Amidst this increasing interest in short activism, studies have left mostly unexamined the important issues about the nature and categories of negative activism. We turn to these issues in the remainder of this section.

We develop a dataset of informational negative activism based on Activist Shorts Research reports from 2009 to 2016. We collect 825 reports of negative activism and, following the coding methodology of Activist Shorts Research, we label each negative activist intervention as involving primary allegations of accounting fraud; competitive pressure/industry issues; an upcoming dividend cut; an ineffective roll-up;

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[49]*See* Wuyang Zhao, *Activist Short Selling*, Jan. 1, 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2852041.
[50] *Id.* at 3.
[51] Yu Ting Forester Wong & Wuyang Zhao, *Post-Apocalyptic: The Real Consequences of Activist Short-Selling*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2941015 (Mar. 26, 2017).
[52] For a recent study critiquing specifically pseudonymous negative publications on Seeking Alpha, see Joshua Mitts, *Short and Distort*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3198384.
[53] *Id.*
[54] *Id.*
[55] Ian Appel et al., *Public Selling by Activist Hedge Funds* (Aug. 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3242516. The authors find similar results, although of lower magnitude, when considering CARs of more traditional shorter windows. *Id*. Table 4.
[56] *Id.*

major business fraud; questioning medical effectiveness; misleading accounting; overvaluation; over-levered; ineffective product; fraudulent stock promotion; upcoming earnings miss; and other allegations of illegality. While we know the alleging party, we do not know the extent of the alleging party's short position.

We find a mean cumulative abnormal return (CAR)[57] for targeted securities from one day before the negative activist's public announcement through one day after the announcement of -6.99%. This finding is robust to other specifications of event windows: the CAR from three days before through three days after announcement is -7.20%, and from ten days before through one day after the return is -5.65%.[58]

Table 1 dissects the announcement returns by primary allegation type. Allegations of major business fraud are associated with significant negative returns (-15.58%), as are allegations related to accounting fraud (-10.41%), ineffective products (-9.21%), and fraudulent stock promotion (-11.64%).

As mentioned above, informational negative activism can involve either forward or backwards-looking information. Table 1 therefore also categorizes the allegations into forwards and backwards looking. The average CAR associated with backwards-looking allegations is -8.77%, while the average CAR associated with forward-looking allegations is -4.15%.[59] The results are sorted by aggregate market cap loss within backwards and forwards-looking allegations.

Table 1 – Returns to Informational Negative Activism by Primary Allegation Category

Allegation	**N**	**Mean CAR[-1,1]**	**Mean CAR[-3,3]**	**Mean CAR[-10,1]**	**Market Cap. Loss [-1,1] (millions)**
All	825	-6.99%	-7.20%	-5.65%	$ (116.45)
All backwards-looking:	507	-8.77%	-9.75%	-8.53%	$ (104.53)
Ineffective roll-up	36	-5.01%	-6.99%	-4.33%	$ (196.73)
Accounting fraud	63	-10.41%	-13.71%	-17.00%	$ (175.38)
Product ineffective	42	-9.21%	-8.70%	-2.02%	$ (135.12)
Misleading accounting	73	-3.94%	-4.55%	-6.13%	$ (114.36)
Over-levered	37	-8.79%	-11.98%	-6.50%	$ (109.25)
Major business fraud	77	-15.58%	-17.88%	-21.73%	$ (82.63)
Medical effectiveness	74	-5.82%	-3.60%	-0.12%	$ (81.56)
Other illegal	52	-7.01%	-9.91%	-8.47%	$ (65.74)
Stock promotion	53	-11.64%	-9.99%	-3.83%	$ (18.57)
All forward-looking:	318	-4.15%	-3.13%	-1.06%	$ (135.44)
Competitive pressures	127	-3.43%	-3.87%	-3.52%	$ (155.67)

[57] CARs are calculated as the abnormal stock return relative to the value-weighted CRSP index return surrounding the announcement period.

[58] The median numbers are slightly lower, but comparable.

[59] The difference in CAR between forward-and backwards-looking allegations is statistically significant at the one percent level.

Overvalued	159	-4.57%	-1.60%	1.87%	$ (129.54)
Dividend cut coming	10	-12.80%	-16.90%	-16.14%	$ (91.19)
Upcoming earnings miss	22	-1.28%	-3.60%	-1.19%	$ (81.59)

Of course, because activists voluntarily choose to make these reports, the sample is expected to be biased towards statistical significance. It is likely that many short sellers do not disclose their positions. There are two important points about such undisclosed short selling. First, to the extent undisclosed informational negative activism occurs, the aggregate amount of all informational negative activism obviously is higher. Second, it is likely that undisclosed informational negative activism would, if it were disclosed, result in a comparatively lower cumulative abnormal returns than the negative activism in our sample. Public disclosure brings the increased likelihood of litigation, regulatory, and reputational costs,[60] leading activists to disclose instances that promise the largest expected stock movements.

To determine activists' success when braving these costs through public disclosure, we next examine how shorting success varies by activist. We identify 51 separate informational negative activists with at least three interventions. The list includes a wide range of short sellers, encompassing dedicated short-only activists and activists that implement strategies other than shorting. The complete list, along with associated mean returns, is set forth in Table 2.

We sort the data in Table 2 by average market capitalization loss to illustrate the relative economic impact of individual informational negative activists. The results are consistent with anecdotal evidence regarding negative activism. Many of the negative activists in the first rows of the chart are those with the most publicized reputations as short sellers. Out of the 51 negative activists, 48 have average CARs that are less than zero, in the negative activist's desired direction. Overall, the announcement of negative information activism is associated with negative returns, although there is significant variation.

Table 2 – Returns to Individual Informational Negative Activists

Short seller	**N**	**Mean CAR[-1,1]**	**Mean CAR[-3,3]**	**Mean CAR[-10,1]**	**Avg. Market Cap. Change Per Event [-1,1] (millions)**
Greenlight Capital	12	-9.97%	-15.51%	-20.15%	$(839.92)
Dialectic Capital	9	-1.17%	-0.03%	1.95%	$(451.09)
Kynikos Associates	28	-1.84%	-2.50%	-5.45%	$(388.36)
Prescience Point	9	-13.88%	-21.11%	-26.40%	$(356.85)
Muddy Waters	15	-18.60%	-22.45%	-22.52%	$(299.21)
Infitialis	5	-5.97%	-6.20%	-8.99%	$(278.97)
Gotham City Research	5	-19.30%	-16.08%	-15.64%	$(261.64)

[60] *See supra* notes 45–46 and accompanying text.

Citron Research	61	-10.16%	-7.66%	-4.09%	$(258.78)
J Capital Research	4	-1.32%	-4.33%	-4.27%	$(253.79)
Bronte Capital	25	-10.79%	-13.61%	-18.20%	$(217.68)
BlueMountain Capital	4	-9.32%	-15.55%	-20.69%	$(217.49)
Whitney Tilson	19	-4.47%	-4.92%	-0.73%	$(203.89)
Trinity Research	3	-18.03%	-7.62%	-35.19%	$(172.49)
Anonymous Analytics	4	-3.51%	-2.75%	-7.51%	$(149.45)
Greenwich Research	5	-8.72%	-13.62%	-3.27%	$(142.89)
Spotlight Research	5	-4.23%	-9.04%	-5.56%	$(137.05)
Friendly Bear	9	-9.44%	-5.01%	-3.17%	$(133.79)
Asensio	4	4.97%	2.04%	1.63%	$ (96.61)
Kerrisdale Capital	26	-8.80%	-8.11%	-11.37%	$ (72.65)
Gravity Research	4	-11.36%	-15.10%	-5.93%	$ (71.72)
Suhail Capital	8	-2.97%	-1.44%	-1.28%	$ (70.34)
Spruce Point Capital	22	-4.79%	-5.11%	-8.58%	$ (70.06)
Shareholder Watchdog	10	-10.44%	-2.68%	-9.35%	$ (62.98)
Forensic Factor	6	-18.67%	-11.66%	-15.05%	$ (62.41)
Cannell Capital	5	-3.20%	4.03%	4.74%	$ (60.89)
Cliffside Research	5	-14.10%	-14.65%	-28.79%	$ (51.85)
Lemelson Capital	3	-1.39%	-0.98%	8.84%	$ (50.04)
Glaucus Research	11	-7.08%	-8.40%	-16.19%	$ (47.05)
Alfred Little	14	-12.43%	-17.00%	-23.58%	$ (45.92)
GeoInvesting	46	-7.07%	-11.02%	-11.96%	$ (42.53)
Xuhua Zhou	11	-1.28%	-1.73%	1.32%	$ (36.48)
Alecto Research	3	-4.03%	-3.32%	5.71%	$ (35.99)
SkyTides	4	-8.68%	-9.45%	-40.85%	$ (35.63)
Bleecker Street Research	14	-12.48%	-8.56%	8.67%	$ (34.41)
Prescience Investment	9	-9.75%	-13.33%	-14.06%	$ (31.07)
Pump Stopper	18	-14.90%	-13.05%	-7.18%	$ (30.66)
Martin Shkreli	13	-8.67%	-7.76%	-13.92%	$ (27.62)
Absaroka Capital	5	-17.21%	-10.24%	-6.01%	$ (26.54)
Real Talk Investments	6	-3.55%	-2.51%	-8.04%	$ (22.82)
Alpha Exposure	17	-5.95%	-8.69%	-12.72%	$ (18.53)
Street Sweeper	132	-3.99%	-2.60%	6.76%	$ (13.33)
Melissa Davis	6	-6.20%	-5.96%	-11.35%	$ (11.65)
Off Wall Street	3	-0.58%	-0.28%	-1.31%	$ (6.86)
Mako Research	6	-2.38%	-6.54%	-2.79%	$ (5.59)
Richard Pearson	55	-7.11%	-6.73%	0.51%	$ (1.39)
Lakewood Capital	25	-1.81%	-1.67%	-1.70%	$ 1.14
Aristides Capital	6	-3.10%	3.57%	-2.67%	$ 8.18
Copperfield Research	14	-5.65%	-8.15%	-7.08%	$ 41.62
Marc Cohodes	6	1.06%	0.00%	-2.12%	$ 42.50
Matt Berry	6	4.26%	2.87%	11.46%	$ 66.89
Cable Car Capital	5	-0.45%	-2.74%	0.21%	$ 130.81

Next, we examine long-run returns of the firms targeted by negative informational activists to determine if the market reaction is temporary or persists over the long term. Figure 1 plots the mean and median buy-and-hold return from 30 trading days prior to the negative activist's campaign to 300 trading days afterwards. The market reaction at the announcement is not fleeting. Target firms' poor performance persists after the initial revelation. These results are robust to various asset-pricing models. In unreported tests, we conduct formal long-term return analyses using calendar-time portfolio regressions. We form a portfolio by holding all target firms for 12 months after the activists' announcement, and we estimate a regression of the portfolio's excess returns on the Fama-French three factor model as well as the momentum factor. The monthly alpha for the three-factor and four-factor model ranges from -1.959% to -1.734% for equal-weighted portfolios and are statistically significant at the one percent level.

Figure 1 – Informational Negative Activism Long-Run Returns

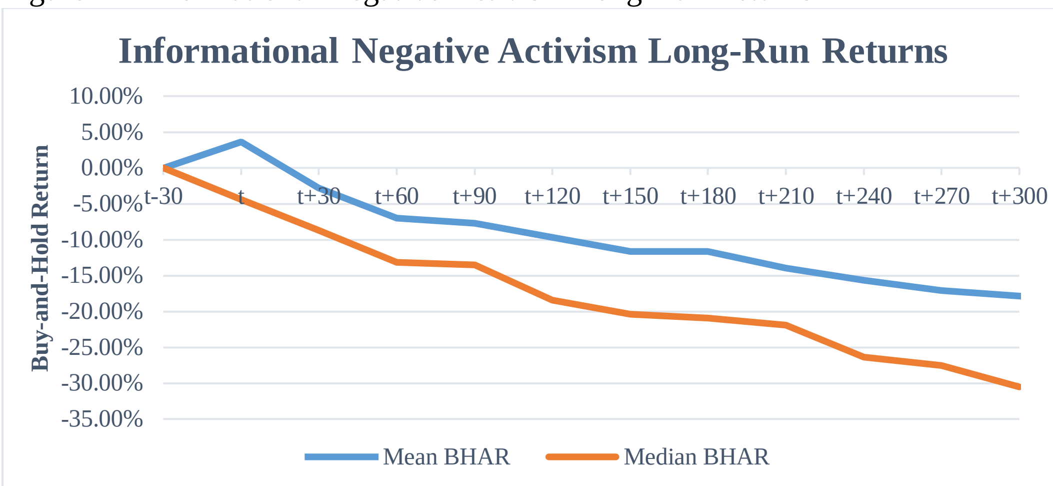

Table 3 shows long-run returns by allegation type for the one-year period after the announcement. For consistency, we report the allegations in the same order as in Table 1. For the full sample, the average (median) buy-and-hold abnormal return is -22.43% (-29.51%). The magnitude of the abnormal long-run returns are slightly larger for backwards looking allegations versus forward looking allegations. Out of the 825 campaigns, 71.88% have abnormal long-run returns that are negative.

Table 3 – Long-Run Returns by Allegation

Allegation	**N**	**One-Year Average Buy-And-Hold Abnormal Return**	**One-Year Median Buy-And-Hold Abnormal Return**
All	825	-22.43%	-29.51%
Backwards looking:	507	-24.27%	-36.61%
Stock promotion	53	-46.64%	-56.60%
Product ineffective	42	-44.58%	-43.32%
Major business fraud	77	-34.90%	-47.51%
Medical effectiveness	74	-20.50%	-38.09%
Other illegal	52	-17.26%	-28.70%
Accounting fraud	63	-15.70%	-33.22%
Misleading accounting	73	-13.84%	-16.64%

Ineffective roll-up	36	-13.42%	-15.08%
Over-levered	37	-10.28%	-33.35%
Forward looking:	318	-19.49%	-20.83%
Dividend cut coming	10	-27.68%	-26.46%
Overvalued	159	-22.90%	-27.02%
Competitive pressures	127	-16.82%	-17.67%
Upcoming earnings miss	22	-6.60%	-1.90%

As Table 3 shows, the announcement of informational negative activism is associated with significant and negative cumulative abnormal returns, which persist during the subsequent one-year holding period. Informational negative activism occurs in a variety of ways with significant variation.

2. Operational Negative Activism

What we label *operational* negative activism is distinguished from *informational* negative activism in that it tries to change the operational aspects of a company's business in some substantive way. Whereas informational negative activism seeks to inform the markets about the true valuation a company, based on the assumption that the current prices reflect an inflated valuation, operational negative activism seeks actually to change the underlying state of the company, and hence its valuation.

It is worth noting upfront that the line between informational and operational negative activism may not be clear in every instance. We suggest that one way to delineate between operational and informational negative activism is to consider whether the activist does more than merely revealing information to the marketplace. Thus, merely publishing a report stating that a patent is invalid would be informational; actually filing an action to challenge the patent's validity would be operational. The two types of activism can, of course, be linked in circumstances like these.

We are not aware of any databases that systematically collect instances of operational negative activism. Accordingly, our examination operational negative activism must necessarily be anecdotal. Nevertheless, it is apparent that, as with informational negative activism, there is a wide range of behavior that constitutes operational negative activism that yields a wide range of effects.

We are aware of two prominent categories of operational negative activism for which some data are available. The first involves challenging a firm's patents. In 2015, a group of hedge funds managed by Kyle Bass shorted shares in target pharmaceutical companies and then filed more than two dozen challenges to those companies' patents using the U.S. Patent and Trademark Office *inter partes* review process.[61] This review process enables a party to "request to cancel as unpatentable [one] or more

[61] *See* Sidak & Skog, *supra* note 5 at 123 n.8 (2015).

claims of a patent" based on doctrines of novelty and obviousness.[62] Bass's strategy of attempting to disable patents held by targeted firms was controversial and received extensive media attention.[63]

Bass's initial challenges were associated with statistically significant declines in the stock prices of targeted firms.[64] The first challenge, on February 10, 2015, was associated with abnormal returns of -11.94%, and subsequent challenges imposed movements of -4.63% and -2.59%.[65] These patent challenges are an example of operational negative activism: they seek to profit by disabling a company's patents and harming that company's future profits.

However, in Bass's case, the ultimate success of the strategy was mixed at best. Over time, market reactions to his challenges grew less predictable, perhaps reflecting a perception that the strategy was unlikely to impact the targeted companies' values.[66] Only 26% of his challenges were met with favorable rulings from the PTAB.[67]

A second well-documented category of operational negative activism involves the practice of coupling a short position with voting shares associated with long positions, giving rise to what have been described as "empty voting" or "encumbered shares."[68] For example, Mason Capital took a long position in Telus voting shares and a countervailing short position in Telus non-voting shares, and then attempted to deter Telus from undertaking a desirable recapitalization in which its voting and non-voting

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[62] 35 U.S.C. § 311 (2012). For more on that patent review process, see Christopher J. Walker & Melissa F. Wasserman, *The New World of Agency Adjudication*, 107 CAL. L. REV. __ (forthcoming 2019).

[63] *See, e.g.*, Joseph Walker & Rob Copeland, *New Hedge Fund Strategy: Dispute the Patent, Short the Stock*, WALL ST. J., Apr. 7, 2015, https://www.wsj.com/articles/hedge-fund-manager-kyle-bass-challenges-jazz-pharmaceuticals-patent-1428417408; Joseph Walker, *Hayman Capital's Kyle Bass Vows to Continue Drug-Patent Challenges*, WALL ST. J., Sept. 3, 2015, https://www.wsj.com/articles/hayman-capitals-kyle-bass-vows-to-continue-drug-patent-challenges-1441320971; Daniel Fisher, *Hard Times for Patent Trolls and Challengers As Courts, Targets Fight Back*, FORBES, Mar. 24, 2017, https://www.forbes.com/sites/danielfisher/2017/03/24/hard-times-for-patent-trolls-and-challengers-as-courts-targets-fight-back/#248963b42e7f; Susan Decker, *Bass Battled U.S. Drug Patents and Prices but Lost to 'Cabal'*, BLOOMBERG, Apr. 10, 2017, https://www.bloomberg.com/news/articles/2017-04-10/bass-battled-u-s-drug-patents-and-prices-but-lost-to-cabal.

[64] *See* Sidak & Skog, *supra* note 5, at 136–38.

[65] *See id.* at 138. These negative returns quickly dissipated, and many of the later challenges were associated with positive abnormal returns, perhaps because Bass's initial challenges were later denied by the PTAB. *Id*. at 138–42, 147–48.

[66] *Id*.

[67] Jeffrey Kuo & Afia Naaz, *Attack on Pharma Patents: Checking in on the Kyle Bass IPRs*, POSINELLI ON POST-GRANT, June 2, 2017, https://polsinellionpostgrant.com/blog/2017/6/2/attack-on-pharma-patents-checking-in-on-the-kyle-bass-iprs.

[68] *See* Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775; Hu & Black, *supra* note 8.

shares would collapse into a single class.[69] Another example involved a group of hedge funds accused of shorting shares in a Henderson Land subsidiary.[70] The funds acquired significant voting rights while maintaining a net short position and used their voting right to block the favorable acquisition of the subsidiary.[71] Finally, a prominent example is the case of activist Perry Corporation's failed attempt to push through Mylan Laboratories' takeover of King Pharmaceuticals.[72] Mylan had proposed an acquisition of King on terms that were favorable to King, which would have led to a sizeable increase in King's stock price and a decrease in Mylan's. Perry held a long interest of 5 million shares in King and a short interest of approximately 4 million shares in Mylan; both positions would have paid off if the acquisition went through. In an attempt to push the transaction through against mounting Mylan shareholder resistance, Perry acquired the right to vote 9.89% of Mylan's shares, while still maintaining a net short position in Mylan. Perry then used those votes to encourage a transaction that, apparently, would have been bad for Mylan but profitable for Perry, given Perry's short Mylan and long King positions.

In addition to these two categories of operational negative activism, there is some anecdotal evidence regarding other strategies. The first two examples in the introduction are examples: the employee-saboteur at Tesla and the soccer team bus bomber. There are other examples as well, such as Andrew Auernheimer, a "hacktivist" known as "weev." He had been convicted for revealing a privacy flat in an AT&T server, but the conviction was later reversed and vacated. He then announced plans to start a hedge fund, to be called TRO LLC. The notion was that this company would profit from taking short positions in companies and then targeting their technological vulnerabilities.[73]

In the extreme, operational negative activism can be obviously detrimental to a company, and is socially deleterious as well. Consider, for example, the potential effects of terrorist activities on stock prices.[74] In the aftermath of the 9/11 attacks in New York, scholars and regulators examined whether terrorists might have profited by trading before the

[69] *See* Frank Partnoy, *U.S. Hedge Fund Activism*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER 99, 104 (Jennifer Hill and Randall Thomas, eds. 2015).
[70] Hu & Black, *supra* note 8, at 834–35.
[71] *Id*.
[72] For coverage of this transaction, see SEC Administrative Proceeding File No. 3-13561, July 21, 2009, https://www.sec.gov/litigation/admin/2009/34-60351.pdf.
[73] John Biggs, *Weev Talks About Life in Prison and His Plans to Open a Hedge Fund, TRO LLC*, TECHCRUNCH, Apr. 15, 2014, https://techcrunch.com/2014/04/15/weev-talks-about-life-in-prison-and-his-plans-to-open-a-hedge-fund-tro-llc/. It does not appear that TRO LLC has yet been successful in raising significant amounts of money
[74] *See, e.g.*, Andrew Karolyi & Rodolfo Martell, *Terrorism and the Stock Market*, 2 INT'L REV. APPLIED FIN. ISS. & ECON. 285 (2010) (assessing the relationship between terrorist activity and stock performance); Andrew Karolyi, *An Assessment of Terrorism-Related Investing Strategies*, 34 J. PORTFOLIO MGT. 108 (2008) (finding a small but statistically significant return from terrorist-related investment strategies).

attacks. Investigations were made into whether terrorists, or related individuals or entities, took short positions in shares of American and United Airlines, the two companies whose planes were involved in the terrorists incidents.[75] Note the perhaps obvious point: terrorist attacks negatively impact stock prices by doing more than simply revealing negative information: they actually negatively impact the operations of the target company, both by destroying corporate assets and potentially increasing future costs and risks.

More generally, an individual or organization could seek to profit from actions that damage a company by taking a short position in advance of those actions. Short sellers can use corporate espionage and industry warfare to harm the operations of a company. Existing concerns include cyberattacks and bioterrorism, which have raised fears about targeting a wide range of vulnerable potential corporate victims, particularly including the transportation and food industries.[76]

On the other hand, operational activism might be more benign, even if it involves competitors. For example, a competitor might short a target in the same industry and then seek changes that would generate operational benefits for itself at the expense of the target. Of course, the competitor would be constrained to the extent it lacks governance rights, but a competitor, or even a third party, could acquire a small long position along with its short position and then attempt operational negative activism.

Employees are another potential example of operational negative activism, especially when they leave their employment. Numerous companies report employees engaging in sabotage and other criminal conduct when they are fired from their jobs.[77] Many such activities have the potential to impact a company's stock price.

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[75] The events of 9/11 clearly impacted many stocks, bonds, and commodities. Studies of the potential link between the attacks and the increased trading in put options of American and United Airlines were inconclusive. *See, e.g.*, Neil A. Doherty, Joan Lamm-Tennant & Laura T. Starks, *Insuring September 11th: Market Recovery and Transparency*, 26 J. RISK & UNCERTAINTY 179 (2003).

[76] *See, e.g.*, Joshua Mitts & Eric Talley, *Informed Trading and Cybersecurity Breaches*, 8 HARV. BUS. L. REV. __ (forthcoming) (studying trading in securities in advance of cybersecurity attacks); Vince Bond Jr., *Automakers Grapple with Rising Tide of Industrial Espionage*, AUTOMOTIVE NEWS, Sep. 30, 2012, http://www.autonews.com/article/20120930/OEM01/120929845/automakers-grapple-with-rising-tide-of-industrial-espionage (describing increases industrial espionage at car manufacturers, including Toyota, Ford, and General Motors); Mike Adams, *Chipotle Is a Victim of Corporate Sabotage*, NATURAL NEWS, Dec. 23, 2015, https://www.naturalnews.com/052405_Chipotle_ecoli_outbreak_corporate_sabotage_biotech_bioterrorism.html (speculating, without evidence, that biotech industry food terrorists planted e-coli at Chipotle restaurants in retaliation for its anti-genetically modified foods menu).

[77] *See, e.g.,* Anca Bradley, *How to Handle the Disgruntled Employee Out to Sabotage Your Business*, ENTREPRENEUR, Oct. 30, 2015, https://www.entrepreneur.com/article/250920 (describing examples of employee sabotage including a "digital bomb" designed to delete all of a company's programs to

Finally, one could foresee that investment funds that have sold their investment position between a company's record date and its voting date would have reason to engage in operational negative activism. Since the fund no longer has an economic stake in the company, it can vote its shares without any of the economic ramifications from the vote. Engaging in operational negative activism by voting those shares to harm the company can actually benefit the fund, if competitor funds hold shares in that company.

In all, operational negative activism encompasses a hodgepodge of strategies. Some of these strategies might seem unlikely to occur in practice; others have already occurred, in limited ways.

3. Unintentional Negative Activism

Our third category of negative activism involves attempts at positive activism that are nevertheless associated with negative announcement returns. Unintentional negative activism is therefore positive activism that is regarded negatively in the market. A positive shareholder activist taking a long position in a targeted company's shares does not intend (and loses from) a negative market reaction: hence, our use of the term "unintentional."[78]

Unintentional negative activism is a phenomenon that has not been addressed in the literature on hedge fund activism. Empirical studies of positive activism have recognized that there is a range of announcement returns, but the distribution of those returns has received little attention.[79] For example, in a recent study, C.N.V. Krishnan, Frank Partnoy, and Randall Thomas examined the announcement returns for hedge fund activists from 2008 through 2014 to determine which hedge fund characteristics and behavior were associated with positive announcement returns.[80] They found, for example, that measures of clout and expertise were associated with higher returns, whereas frequency of intervention was not.[81] They did not, however, examine specifically those interventions in their data that produced negative announcement returns.[82]

We obtained data from Krishnan, Partnoy, and Thomas to examine how positive activist interventions were associated with negative announcement returns. We find that a significant number of attempted

cost it millions of dollars in sales, and noting that half of employees who leave a company take confidential corporate data).

[78] Analogously, we might think of the concept of unintentional positive activists: activists taking short positions whose efforts instead produce increases in share prices. Table 2, *supra*, reveals several of these unintentional positive activists, which we discuss later in this section.

[79] For example, Partnoy & Thomas, *supra* note 23; Brav, Jiang, Partnoy & Thomas, *supra* note 32.

[80] Krishnan, Partnoy, & Thomas, *supra* note 10.

[81] *Id*.

[82] *Id*.

positive interventions are associated with abnormal negative returns.[83] As shown in Figure 2 and Table 5, roughly one third of interventions have announcement returns that were negative. For the subgroup of positive activism campaigns that resulted in an initial negative market reaction, the average CAR[-10,1] was -7.26%, compared to 11.26% for subgroup of campaigns that resulted in an initial positive market reaction.

Figure 2 – Histogram of Positive Activism CAR

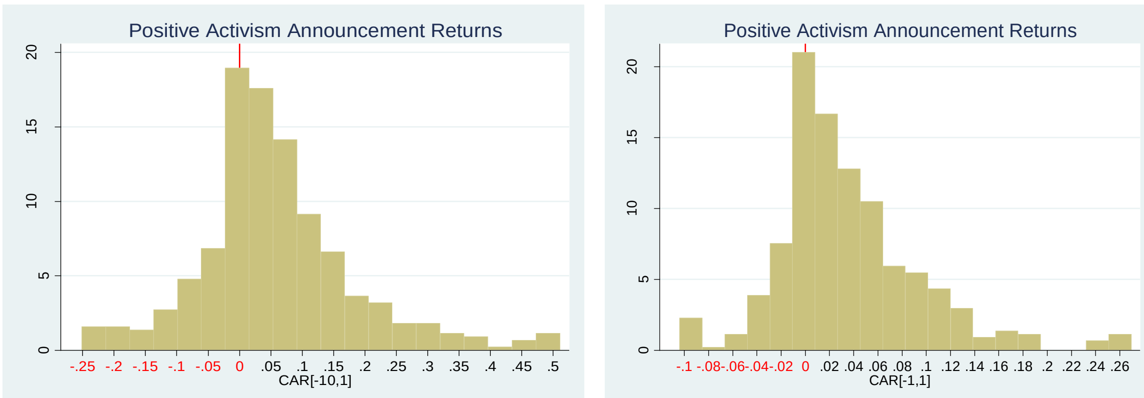

Table 5 Unintentional Negative Activism From 13-D filings

Returns	N	% Negative	P25	Median	Mean	P75
CAR[-10,1]	438	29.22%	-0.68%	3.95%	5.86%	11.72%
CAR[-1,1]	438	26.94%	-0.15%	2.32%	3.62%	6.35%
CAR[-3,3]	438	29.68%	-0.75%	2.63%	3.84%	7.96%

The incidence of unintentional negative activism varies across the sample of positive activist hedge funds. Numerous funds have at least one intervention during the sample period that was associated with negative returns upon announcement. Measuring the return from ten days before announcement to one day after, several activists have negative announcement returns for half or more of their interventions.[84]

We report the 20 lowest announcement returns in the sample in Table 6. We are not suggesting any particular reason for the market reaction in any specific instance. Each example is associated with a unique set of facts.

Table 6: Top 20 Worst Announcement Returns of Positive Activists

Date	Name	CAR [-10,1]	Hedge Fund

[83] Because the data come from filings required when the activist acquires at least 5% of a voting share, it is typically assumed that these activists attempt positive changes. *Id.* An alternative explanation could be that these activists have significant, undisclosed short interests that outweigh their positive stake, and are actually operational negative activists.

[84] These funds include Clover Partners, Red Mountain Capital, Greggory Schneider, Meson Capital Partners, Mill Road Capital, Western Investment, Discovery Capital, and GAMCO Partners. There are, of course, a range of explanations for the market reactions to each of these interventions.

2/23/2011	LECG CORP	-81.26%	T2 Partners
8/22/2011	ALLIANCE HEALTHCARE	-36.05%	Discovery Group
8/13/2012	HORIZON PHARMA PLC	-32.61%	Discovery Capital
11/7/2011	AMBASSADORS GROUP INC	-25.25%	Lane Five Capital Management
9/27/2011	CHINA CERAMICS CO LTD	-25.12%	James Dunning
8/18/2011	INDUSTRIAL SERVICES AM	-25.04%	David Russell
7/2/2013	GOLDEN MINERALS CO	-21.89%	Trishield Special Situations
11/4/2013	VOLCANO CORP	-20.95%	Engaged Capital
9/26/2011	CELSION CORP	-20.68%	Mangrove Partners
3/20/2014	NOVATEL WIRELESS INC	-20.25%	Novatel Shareholders for Change
8/9/2013	PENNEY (J C) CO	-19.20%	Perry Corp.
2/7/2014	CARBONITE INC	-18.68%	Discovery Group
7/18/2013	US AUTO PARTS NETWORK	-18.36%	Maguire Asset Management
12/23/2011	SILICON GRAPHICS INTL	-18.11%	Wasatch Advisors, Inc.
2/22/2013	BLOUNT INTL INC	-17.30%	P2 Capital
1/12/2012	LIVEDEAL INC	-16.74%	Isaac Capital Group LLC
8/16/2013	JAVELIN MORTGAGE	-16.43%	Bulldog Investors
2/13/2012	BRINKS CO	-16.40%	GAMCO Investors
11/13/2012	SANDRIDGE ENERGY INC	-16.32%	TPG -Axon Management
9/27/2012	QUALSTAR CORP	-16.31%	Lloyd Miller

These negative returns can be categorized into two groups. One category includes negative reactions that occur for reasons independent of the activist's disclosure and impending activism. These are the unlucky (for the activist) situations where independent negative developments coincide by chance with the activist's disclosure. Given the number of activist campaigns, sheer chance dictates that the positive activist will occasionally be unlucky in this way. Some of the events in Table 6 fall into this category; since we selected for the most significant negative returns, this finding is unsurprising. For example, just after T2 Partners acquired its stake in LECG, stating that they acquired the shares with a "belief that the [s]hares, when purchased, were undervalued,"[85] the company announced a credit event and, within the month, was liquidated.[86] While T2's investment thesis may not have worked out, it can hardly be said that they caused LECG's credit event; instead, they appear the victims of an unlucky external event.

[85] T2 Partners Management, LP, 13D (filed Feb. 23, 2011), https://www.sec.gov/Archives/edgar/data/1192305/000139834411000422/fp0002576_sc13d.htm.
[86] Joe Weisenthal, *Whitney Tilson's Latest Embarassment*, Business Insider, Feb. 28, 2011, https://www.businessinsider.com/whitney-tilson-lecg-2011-2.

The other category of negative returns, and the one that we view as unintentional negative activism, encompasses instances where the activist's disclosure of her stake leads to a share price decline. The market sees the activist as bad for the company's future performance. For example, the activist might have, in the market's opinion, bad plans for the target's future business. Or, in the market's opinion, the activist might impose costs on the company's capable management, perhaps by distracting management by waging a costly proxy contest.

Bill Ackman's activism at Target provides a representative example. Although he and his fund have had several successful investments, his long stake in Target was not one of them. Fresh off a successful engagement with Wendy's restaurant chain, Ackman acquired a 9.6% ownership stake in Target in July 2007. Target's price increased leading up to Ackman's public disclosure on July 16, but upon the actual disclosure, the stock traded sharply lower, down 2% on the announcement date.[87] Investors were disappointed that the bulk of Ackman's investment took the form of call options, rather than traditional long stakes, leading to his later being derided as a "short-term speculator."[88] Others were puzzled at the lack of specificity in Ackman's plans for Target: he disclosed only that he believed Target's common stock "is undervalued and intend to discuss with management ways in which this undervaluation can be corrected."[89] The lack of specificity led investors to speculate fairly widely about Ackman's future plans. Some thought he might increase Target's leverage or spin off its real estate holdings.[90] Others believed he would increase Target's credit card business, while still others believed he would instead spin off its credit card business.[91] Finally, several thought Ackman would provide little positive change. An analyst at HSBC summed up this position by noting, "I don't see how you can make this company perform significantly better."[92] By the end of the month, Target's share price had dropped well below the levels leading up to Ackman's announcement.

During the following two years, Ackman pushed for various reforms at Target, but his efforts met with little success from Target's board.[93] Finally, he waged a proxy contest in 2009 to get five of his nominees

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[87] Lisa Gewirtz-Ward & John E. Morris, *Pershing Buys 9.6% Stake in Target*, DAILY DEAL, July 17, 2007.

[88] *See, e.g.*, Zachery Kouwe, *Shareholder Support Target over Ackman*, N.Y. TIMES DEALBOOK, May 28, 2009, https://dealbook.nytimes.com/2009/05/28/shareholder-support-target-in-blow-to-ackman/.

[89] Schedule 13D, July 16, 2007, https://www.sec.gov/Archives/edgar/data/27419/000090266407002284/sc13d.txt.

[90] Gewirtz-Ward & Morris, *supra* note 87.

[91] *Id.*; Parija B. Kavilanz, *Hedge Fund Takes Aim at Target*, CNNMONEY, July 16, 2007, https://money.cnn.com/2007/07/16/news/companies/target_pershing/index.htm?postversion=2007071612.

[92] *Id.*

[93] Joe Nocera, *Investor Exits and leaves Puzzlement*, N.Y. TIMES, May 29, 2009, https://www.nytimes.com/2009/05/30/business/30nocera.html.

elected to Target's board. None of his nominees was ultimately elected; none received more than 20% or so of the vote.[94] The proxy contest cost Ackman approximately $9 million and Target $11 million, in addition to the distraction from running their business.[95] Ackman finally exited his position in 2011 at a substantial loss.[96]

GAMCO Investors provides another useful perspective into how unintentional negative activism occurs. The rationale for focusing on GAMCO is twofold. First, GAMCO is not a typical positive shareholder activist. Founded by Mario Gabelli in 1977, GAMCO was for decades a fundamental value investor, only later forming an activist fund.[97] Unlike most U.S. activists, GAMCO is not located in Manhattan; instead, its $36 billion is managed from the suburb of Rye. Moreover, GAMCO holds many of its investments in mutual and closed-end funds, not hedge funds, and its average holding period for activist investments is over nine years.[98]

Second, GAMCO generally does not engage in activist tactics that have been found to be associated with the highest announcement returns.[99] GAMCO favors precatory, non-binding proposals, and it avoids mounting expensive proxy fights, instead relying on advisors or other shareholders to propose how a company might accommodate GAMCO.[100]

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[94] *Id.*

[95] Nicole Maestri, *Ackman Loses in Target Proxy Contest*, REUTERS, May 28, 2009, https://www.reuters.com/article/us-target/ackman-loses-in-target-proxy-contest-idUSTRE54R11420090528 (reporting estimated costs to Target of $11 million); Mike Coronato, *2017 Proxy Fights: High Cost, Low Volume*, FACTSET, Nov. 6, 2017, https://insight.factset.com/2017-proxy-fights-high-cost-low-volume (estimating overall proxy contest costs at $20 million). *See generally* Nocera, *supra* note 93 (characterizing the campaign as "a huge, expensive distraction for a company trying to struggle through a recession"); Zachery Kouwe, *Target's Shareholders Strongly Reject Dissident Slate, Ending Divisive Proxy Battle*, N.Y. TIMES, May 28, 2009, https://www.nytimes.com/2009/05/29/business/29target.html (quoting hedge fund activist advisor as saying, "I guarantee you that every single Target board discussion over the last six months has been about this proxy fight and not about setting the business strategy of the company.")

[96] Shira Ovide, *Bill Ackman Throws in the Towel on Target*, WALL ST. J., May 16, 2011, https://blogs.wsj.com/deals/2011/05/16/bill-ackman-throws-in-the-towel-on-target/?ns=prod/accounts-wsj.

[97] *See, e.g.*, Andy Kern, *A Private Market Value Primer from Mario Gabelli*, SEEKING ALPHA, Apr. 27, 2007, https://seekingalpha.com/article/33657-a-private-market-value-primer-from-mario-gabelli.; *Activist Gabelli Value Plus Trust Raises GBP101M At Launch*, WEALTH MANAGER, http://www.gabelli.co.uk/activist-gabelli-value-plus-trust-raises-101m-at-launch/ (last visited July 4, 2018).

[98] *See Gamco Investors' First Proxy Access Nomination To The Board Of National Fuel Gas*, VALUEWALK, Nov. 11, 2016, http://www.valuewalk.com/2016/11/gamco-proxy-access/.

[99] See Krishnan, Partnoy & Thomas, *supra* note 23 (finding that announcement returns are associated with the willingness to engage in proxy fights and litigation, among other variables demonstrating clout and expertise).

[100] *See 13D Filings: Gamco Gets Active: Mario Gabelli's Investment Firm Is Acting Like an Activist*, BARRON'S, Apr. 24, 2015, http://www.barrons.com/articles/13d-filings-gamco-gets-active-1429933831. Indeed, GAMCO's general counsel has cited the appeal of reduced-cost activism, saying "you can piggyback on someone else's proxy." *Id.*

We selected a random sample window from January 2016 to September 2018 to examine GAMCO's 13D filings. During this period, GAMCO regularly filed a new 13D every few weeks, forty-eight in all during the thirty three-month window.[101]

We find that the average [-10,1] CAR for forty-eight GAMCO 13D filings was 1.98%, well below the 7% average CAR for positive activists that has been widely documented in the literature. The returns are highly variable: of the forty-eight filings, twenty-six had negative CARs (54% of the announcements). These data are set forth in Table 7 below.

Table 7 GAMCO Positive Activism

Ticker	Event Date	Filing Date	CAR[-10,1]	CAR[-1,1]	CAR[-3,3]
OCAT	12/31/2015	1/6/2016	2.35%	4.41%	7.56%
GYRO	1/12/2016	1/21/2016	9.33%	-3.87%	0.42%
MLNK	2/8/2016	2/18/2016	-7.58%	4.19%	-14.36%
POWR	3/8/2016	3/17/2016	-3.55%	-2.18%	-1.66%
SNAK	3/30/2016	4/4/2016	-3.57%	-0.96%	-1.03%
AFOP	4/25/2016	5/5/2016	2.26%	0.43%	-0.59%
EPC	5/20/2016	5/25/2016	-0.53%	-0.97%	-0.15%
CST	6/2/2016	6/2/2016	16.71%	15.56%	16.51%
LORL	6/29/2016	7/6/2016	-10.55%	-4.72%	-3.29%
GDL	2/8/2016	7/18/2016	-2.76%	-0.06%	-0.85%
SGI	8/12/2016	8/22/2016	33.27%	-0.08%	0.16%
FLTX	8/31/2016	9/8/2016	2.34%	2.70%	1.90%
GI	10/13/2016	10/20/2016	1.18%	0.51%	-0.15%
HTZ	1/3/2017	1/4/2017	2.75%	7.07%	5.63%
CPPL	12/28/2016	1/4/2017	-1.24%	-1.88%	-1.07%
VASC	1/23/2017	1/31/2017	-0.16%	0.79%	0.12%
CLC	1/26/2017	2/2/2017	-1.28%	-0.84%	0.18%
CLCD	1/27/2017	2/2/2017	-0.98%	-0.66%	0.52%
RLJE	1/27/2017	2/6/2017	15.79%	2.50%	7.34%
AFI	3/7/2017	3/17/2017	-12.38%	3.37%	-0.67%
GSOL	3/17/2017	3/27/2017	-6.18%	-7.12%	-6.53%
INNL	4/11/2017	4/20/2017	15.78%	-3.44%	6.32%
MWA	5/16/2017	5/17/2017	0.18%	0.39%	0.33%
GENC	5/23/2017	6/1/2017	-0.51%	-0.26%	0.05%
NUTR	6/12/2017	6/21/2017	-0.31%	0.63%	-0.10%
LMCA	6/15/2017	6/23/2017	-1.30%	2.34%	7.46%

[101] The average lag between filing dates during the sample period was 20 days, with a minimum time between filing dates of 8 days and a maximum of 34 days.

TISI	7/1/2617	7/28/2017	-41.12%	-1.96%	-45.53%
NVDQ	8/4/2017	8/16/2017	0.91%	1.25%	0.31%
GUID	8/30/2017	9/7/2017	-0.69%	-0.31%	-0.95%
SMIT	10/11/2017	10/20/2017	5.99%	5.07%	18.19%
EXA	10/20/2017	10/25/2017	-0.28%	0.35%	-0.29%
OME	11/9/2017	11/13/2017	0.20%	0.49%	0.03%
MGCD	12/9/2017	12/19/2017	-1.57%	-0.60%	-0.74%
RDI	12/22/2017	12/26/2017	-2.36%	-1.34%	4.34%
TMST	12/28/2017	1/2/2018	19.21%	9.79%	7.06%
CCC	12/29/2017	1/8/2018	-2.77%	-0.40%	-2.33%
KTEC	1/25/2018	2/1/2018	46.88%	1.89%	5.98%
ONDK	2/5/2018	2/15/2018	21.90%	8.18%	22.16%
RLJE	2/26/2018	2/28/2018	14.73%	5.40%	15.52%
SPA	3/5/2018	3/9/2018	-25.29%	2.29%	2.52%
GEF	3/16/2018	3/20/2018	12.14%	5.57%	2.52%
FLL	3/23/2018	3/28/2018	5.01%	2.59%	-6.14%
GDL	3/26/2018	3/29/2018	3.16%	0.55%	-1.36%
NPO	6/6/2018	6/12/2018	-0.95%	1.44%	1.28%
INFU	8/14/2018	8/24/2018	-7.31%	-4.26%	-1.78%
JMBA	8/30/2018	9/7/2018	-0.27%	0.37%	0.78%
GCP	9/19/2018	9/20/2018	0.29%	1.76%	3.81%
XRM	9/14/2018	9/24/2018	-1.71%	0.61%	0.53%
		Average	1.98%	1.18%	1.04%

The point of singling out GAMCO is not criticism. The data illustrate the significant variation in market reactions to announcements of attempted positive activism. It was not apparent from our analysis of GAMCO's announcements that there is an easily discernible pattern to predict which of the announced interventions will be associated with negative market reactions. Market reactions vary widely for different interventions, and likely for different activists.

In sum, although positive activism is associated with positive returns on average, that conclusion does not always hold. Many interventions, and many funds, are associated with negative announcement returns. It is these interventions that we label as unintentional negative activism.

Finally, we briefly assess the opposite of unintentional negative activism: unintentional positive activism. Of the examples of informational negative activism in our database, approximately one quarter were associated with positive abnormal CARs. In other words, the market reaction to the short seller's announcement was positive, leading to losses for the short seller. The data are summarized in Figure 3 and Table 8.[102]

Figure 3 – Histogram of Negative Activism [-1,1] and [-10,1] CARs

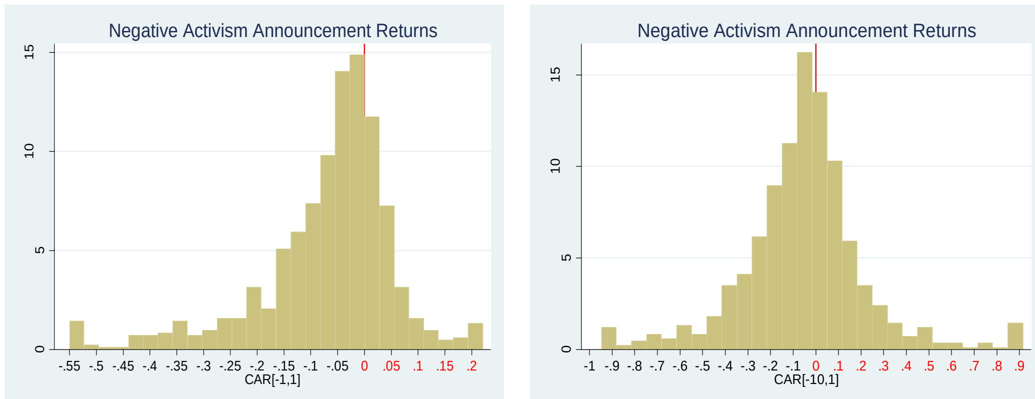

Table 8 Unintentional Positive Activism

Returns	**N**	**% Positive**	**P25**	**Median**	**Mean**	**P75**
CAR[-10,1]	825	38.66%	-19.15%	-4.97%	-5.63%	7.29%
CAR[-1,1]	825	27.52%	-11.53%	-4.36%	-6.98%	0.46%
CAR[-3,3]	825	29.09%	-14.12%	-5.15%	-7.20%	0.94%

As with unintentional negative activism, we find that the incidence of unintentional positive activism varies across the sample of negative activists. Out of the 825 observations, 319 campaigns induced a positive market reaction, with an average (median) CAR[-10,1] of 18.06% (11.05%). Numerous funds have at least one event during the sample period that was associated with positive returns upon announcement, with several having positive announcement returns for half or more of their short allegations.[103]

III. REGULATING NEGATIVE ACTIVISM

As the prior Part reveals, negative activism not only comprises a significant portion of activism as a whole, but also can be grouped into three distinct categories. Before turning to the policy implications from this analysis, we review the current state of activism regulation.

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[102] The fact that the percentage of failed short activism matches the percentage of failed positive activism may suggest minimal bias from the short dataset's reliance on self-reporting.

[103] As measured by [-10,1] CARs, these funds include Dialectic Capital, Lemelson Capital, Matt Berry, Bleeker Street Research, Cannell Capital, Street Sweeper, Asensio, GeoInvesting, Gravity Research Group, and Mako Research. There are, of course, a range of explanations for the market reactions to each of these announcements.

Financial markets are governed by several significant regulatory regimes. Although hedge funds and other activist investors commonly use exemptions to escape many of them,[104] this is not to say that activist investing is an unregulated space. In addition to certain provisions that directly affect either positive or negative activism, activism of any sort is governed by general securities antifraud statutes. The Exchange Act's section 10(b) general antifraud provision attaches to deceptive conduct in connection with the purchase or sale of securities.[105] With no direct disclosure mechanism,[106] section 10(b) is instead primarily aimed at deterring undesirable behavior.

Section 10(b) encompasses securities manipulation (deceptive conduct that controls or artificially affects the market for a security),[107] securities fraud (deceptive or false statements, often made by company management, that affects a security's price),[108] and insider trading (trading based on nonpublic information when facing a duty to disclose that information).[109] Activism can potentially fall within any of these three activities. For example, activists with an investment stake might engage in market manipulation by spreading false rumors to raise that security's price, and then sell the stake before the false information is corrected.[110] Another activist might acquire seats on the board of a company and use that position to make deceptive statements about that company's operation, engaging in securities fraud to prop up the stock price and the activist's investment returns. Or finally, an activist might acquire private inside

[104] For example, the Securities Act's registration requirements for the offer and sale of securities exempts private offerings to accredited investors; consequently, activist investment funds avoid registration and disclosure requirements by having exclusively accredited investors. Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(2); 17 C.F.R. 230.506 (Rule 506's accredited investor safe harbor for meeting section 4(a)(2) of the Securities Act). The Securities Exchange Act requires registration of broker-dealers as well as issuers of more than $10 million of securities to more than 2,000 shareholders of record; hedge funds and individual activist investors, however, are traditionally not treated as broker-dealers, and they limit their holders of record to fewer than 2,000 shareholders of record. Securities Exchange Act of 1934 §§ 12(g), 15(b), 15 U.S.C. §§ 78l(g), 78o(b); U.S. SEC. & EXCH. COMM'N, *supra* note 97, *at* 18 (distinguishing between "dealers," which are required to register, and "traders," which are not).

[105] Exchange Act § 10(b), 15 U.S.C. § 78j(b). In addition to section 10(b)'s antifraud prohibition, section 9 applies to fraud in market manipulation, and section 18 applies to fraud in documents with the SEC. 15 U.S.C. §§ 78i, (r). Causes of action within these two sections are generally subsumed within section 10(b).

[106] Although section 10(b) does not require disclosure, it may indirectly lead to disclosure as a means of defeating its deceptive conduct element. *See, e.g.*, U.S. v. O'Hagan, 521 U.S. 642, 665 (1997) ("[I]f the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation.")

[107] *See, e.g.*, ATSI Commc'ns, Inc. v. Shaar Fund, Ltd, 493 F.3d 89, 101 (2d Cir. 2007) (analyzing securities manipulation claim).

[108] *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 244 (1988).

[109] *See, e.g.*, U.S. v. O'Hagan, 521 U.S. 642 (1997).

[110] *See, e.g.*, *Jim Cramer's Guide to Market Manipulation*, Dealbook, N.Y. TIMES, Mar. 20, 2007 (describing this practice in the hedge fund industry); Mitts, *supra* note 52 (analyzing anonymous shorters' manipulation of securities prices).

information about a company, using that information to trade profitably in that company's shares.[111] Consequences from violating section 10(b) antifraud prohibitions range from a variety of monetary damages measures[112] to criminal imprisonment.[113]

Beyond general antifraud prohibitions, we review below the regulatory framework that specifically applies to positive activism and negative activism.[114]

A. Current Regulation of Positive Activism

Even though much of positive activism may occur through entities designed to avoid most federal regulation, it is still subject to important provisions. Several of these are aimed at disclosure. Section 13(d) of the Exchange Act requires any entity, including positive activist funds and individual investors, to disclose any beneficial ownership interests that exceed five percent of any class of public voting shares.[115] These disclosures must be made within ten days of acquiring the five percent position and are publicly available for inspection.[116] It also requires disclosing the purpose in accumulating a five percent stake, to help

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[111] *See, e.g.*, U.S. v. Newman, 773 F.3d 438 (2d Cir. 2014); U.S. v. Rajaratnam, 719 F.3d 139 (2d Cir. 2013).

[112] Insider trading cases commonly result in disgorgement damages, while other section 10(b) violations result in financial damages loosely tied to the impact that the violation had on the securities market. *See, e.g.*, 15 U.S.C. § 78u-4(e) (private securities litigation reform act damage measure for private section 10(b) causes of action); U.S. v. Contorinis, 692 F.3d 136 (2012) (disgorgement in criminal insider trading context); S.E.C. v. Contorinis, 743 F.3d 296 (2014) (disgorgement in civil insider trading context).

[113] *See, e.g.*, *Rajaratnam*, 719 F.3d 139.

[114] We consider here only federal regulation. Although states have adopted "blue sky" laws that regulate the offer and sale of securities, and also often regulate investment advisors, federal preemption and other exemption typically renders this regulation inapplicable to hedge funds. *See, e.g.*, U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 31 (2003) ("Because of federal preemption and the availability of exemptions from adviser registration, only some states exercise regulatory authority over some hedge fund advisers, and most do not regulate the offer and sale of interests in hedge funds.") In addition, depending on activists' operations, they may find themselves potentially subject to other bodies of federal law that we do not consider here, such as ERISA or the Commodities Exchange Act. *See* SCOTT J. LEDERMAN, HEDGE FUND REGULATION §§ 4:5, 6:13, 7:2 (2007) (considering regulations related to these areas). Finally, external legal constraints are not the sole means of shaping activist investor behavior. Hedge funds in particular adopt a variety of organizational constraints to align investors' incentives with management's. *See, e.g.*, LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010) (describing the organizational tools used by hedge funds and similar entities to achieve this alignment); Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections?*, 42 J. CORP. L. 503 (2017) (analyzing how private companies use these organizational tools to align management and investor incentives).

[115] Exchange Act § 13(d), 15 U.S.C. § 78m(d). Section 13(g) contains a similar disclosure provision for hedge fund advisors. Exchange Act § 13(g), 15 U.S.C. § 78m(g).

[116] *See, e.g.*, U.S. Sec. & Exch. Comm'n, Schedule 13D, https://www.sec.gov/fast-answers/answerssched13htm.html (last visited Dec. 2, 2017).

regulate the market for corporate control of public companies.[117] Although section 13(d) is not aimed directly at activists, it applies any time activists accumulate a sufficiently sizable long position in voting shares, often a precondition of engaging in activism.

Section 13(d) applies to five percent long holdings of publicly traded voting equity shares, equity options,[118] shares of closed-end investment funds, and certain convertible debt securities.[119] It therefore covers a wide swath of positive activism. Because positive activists seeks to increase share prices, they adopt long share positions and equity options, since these are the positions that pay off from increased prices.[120]

Nevertheless, many other instances of positive activism fall outside section 13(d)'s disclosure requirement. In particular, holdings under five percent of voting shares, holdings of non-public companies, holdings of non-voting shares, and holdings of certain financial derivative instruments all fall outside section 13(d)'s disclosure obligation, yet all can be used to accomplish positive activism.[121]

Section 13(d) is not the sole disclosure provision. Section 13(f) of the Exchange Act fills in some of the remaining gaps. Passed to enhance public disclosure of institutional investor holdings, the section requires investment managers of more than $100 million to file quarterly reports of their holdings within 45 days of the quarter's close.[122] Not all holdings fall

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[117] 17 C.F.R. § 240.13d-1(a); Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 260 (2009) (noting that the section is designed "[t]o regulate the market for control of public companies"); Piper v. Chris-Craft Industries, Inc, 430 U.S. 1, 22–25 (discussing the history of section 13(d)'s attempt to impose disclosure requirements on cash tender offers for control).

[118] More precisely, "call" options that are exercisable within sixty days count towards section 13(d)'s five percent number. "Put" options that provide the right to sell securities, but not acquire them, do not count towards the threshold. Neither do call options that cannot be exercised within sixty days. 17 C.F.R. § 240.13d-3(d)(1)(i).

[119] Exchange Act § 13(d)(1), 15 U.S.C. § 78m(d)(1); SEC Rule 13(d)-1(i), 17 C.F.R. § 240.13d-1(i) (removing non-voting securities from section 13(d)'s purview).

[120] *See supra* Part I; Partnoy & Thomas, *supra* note 23 (noting how funds might purchase options, rather than shares, to profit from price changes).

[121] Although it is difficult to gauge the extent of this undisclosed activism, because by definition it is undisclosed, both anecdotal and systematic empirical evidence suggest it is appreciable in scope. *See, e.g.*, Lazard's Shareholder Advisory Group, Review of Shareholder Activism – 1H 2017, June 2017, https://corpgov.law.harvard.edu/wp-content/uploads/2017/07/Lazards-Review-of-Shareholder-Activism-1H-2017.pdf (finding three cases of activist campaigns led by activists holding 4.9% of outstanding shares in the first half of 2017); Stephan Jank, Cristoph Roling, & Esad Smajlbegovic, *Flying under the Radar: The Effects of Short-Sale Disclosure Rules on Investor Behavior and Stock Prices*, July 14, 2016, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2809498 (finding investors cluster below investment disclosure thresholds).

[122] 15 U.S.C. § 78m(f) (section 13(f)); 17 C.F.R. § 240.13f-1 (45 day filing window); *see generally* Kahan & Rock, *supra* note 10, at 1063 (discussing the scope of section 13(f)'s application). In addition, the SEC has raised concerns about compliance with section 13(f)'s reporting requirement. *Review of the SEC's Section 13(f) Reporting Requirements*,

within section 13(f)'s disclosure requirement; the disclosure requirement includes the same securities as section 13(d), without the five percent requirement.[123] Again, this means that many long positions constituting positive activism will be disclosed, but activism built on holdings of non-public companies, holdings of non-voting shares, or holdings of certain financial derivatives need not be reported pursuant to section 13(f). And, of course, section 13(f) requirements do not apply to individual investors, or to investment managers with under $100 million in assets under management.[124]

In addition to disclosure required by sections 13(d) and 13(f) of the Exchange Act, investment managers of all types, including hedge funds, must register as investment managers with the SEC under the Investment Advisers Act of 1940 and make additional periodic required disclosures.[125] These disclosures occur through Forms ADV and PF. Form ADV requires investment managers to disclose basic information about management strategy, organizational and operational characteristics of the managed funds, the size of assets under management, the services that the advisor provides, and whether managed funds use certain types of service providers.[126] Much of this information is then made available to the public, although certain sensitive advisor-specific information is disclosed only to the SEC.[127] Detailed information about fund holdings need not be filed pursuant to Form ADV.

Form PF, on the other hand, requires hedge funds and other private investment funds with at least $150 million in assets under management to submit non-public annual reports about these funds and their trading strategies.[128] Although the SEC provides summary reports based on Form

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U.S. SEC. & EXCHANGE COMMISSION vi (Sept. 27, 2010) (finding that no SEC division audits section 13(f) filings; the SEC does not does not systematically use the data disclosed in section 13(f) filings; and that section 13(f) filings often contain significant errors or omissions.)

[123] Exchange Act § 13(f), 15 U.S.C. § 78m; 17 C.F.R. § 240.13f-1(c) (defining 13(f) securities, and cross-referencing 15 U.S.C. § 78m(d).

[124] 15 U.S.C. § 78m(f).

[125] Investment Advisers Act of 1940 § 203, 15 U.S.C. § 80b-3. The Act was amended in 2010 to remove the "private adviser" exemption that hedge funds had traditionally used to avoid registration. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. IV, § 403, 124 Stat. 1376, 1570 (2010) (eliminating the exemption); Kahan & Rock, *supra* note 10, at 1050 n. 152 (noting that hedge funds were "typically exempt from registration" under the private adviser exemption). A limited exemption was enacted for investment advisors with under $150 million in assets under management. Investment Advisers Act of 1940 § 203(m), 15 U.S.C. § 80b-3(m), Dodd-Frank § 408, 124 Stat. at 1575.

[126] *See, e.g.*, Wulf A. Kaal, *The Post Dodd-Frank Act Evolution of the Private Fund Industry: Comparative Evidence from 2012 and 2015*, 71 BUS. LAW. 1151, 1160 (2016).

[127] Securities and Exchange Commission, *Investment Adviser Public Disclosure*, https://www.adviserinfo.sec.gov (last visited Nov. 9, 2017) (providing a searchable database of publicly available portions of filed Forms ADV).

[128] Wulf A. Kaal, *Hedge Fund Manager Registration under the Dodd-Frank Act*, 50 SAN DIEGO L. REV. 243, 269–73 (2013) (discussing the Form PF reporting requirements).

PF data, the underlying data are not themselves publicly available.[129] Form PF requires managers to disclose the aggregate value of long positions across different asset types, although the individual holdings need not be identified.[130]

Most recently, the Dodd-Frank Act added swap market reporting requirements via Regulation SBSR. Activists may use derivative instruments to gain disproportionate voting clout relative to their shareholdings.[131] As a result of Regulation SBSR, the SEC requires that various information about security-based swaps be reported, including contractual information about the swaps being traded, the date, time, quantity, and price of trades, counterparty identities, information about the clearing process, and more.[132] Most of this information is reported only to the SEC; only limited information about trading prices and the transaction, without identifying information about traders, is subject to public disclosure requirements.[133]

B.Current Regulation of Negative Activism

Negative activism is, in principle, subject to the same regulations that apply to positive activism as well as certain rules that specifically govern negative activism through their regulation of short selling. Regulation SHO[134] prohibits "naked" short selling, in which the short seller sells securities that she does not own or has not arranged to borrow.[135] Broker-dealers are also prohibited from executing customers' short sales if a short selling client has failed to deliver shares within three days of the sale.[136] Problems from naked short selling can occur when the shorter of securities is unable to deliver the shorted shares, leaving the purchaser unable to vote the shares she thought she purchased and leaving the short seller

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[129] Frank Partnoy, *U.S. Hedge Fund Activism*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER 99, 104 (Jennifer Hill and Randall Thomas, eds. 2015).

[130] Sec. & Exch. Comm'n, Form PF, Item 30, https://www.sec.gov/files/formpf.pdf.

[131] *See*, *e.g.*, Hu & Black, *supra* note 8, at 823–46 (discussing strategic use of derivative financial instruments to avoid various regulations); CSX Corp. v. The Children's Investment Fund (UK) LLP,, 654 F.3d 276, 288 (Winter, concurring) ("The district court's legal analysis concluded that the one role of such swaps was to avoid the disclosure requirements of Section 13(d) – no doubt true.")

[132] Regulation SBSR, 17 C.F.R. pt. 242 (2018); *see generally* Sullivan & Cromwell, *Security-Based Swaps: Recently Adopted and Proposed Rules under Title VII*, Sept. 10, 2015, 5–16, *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Security_Based_Swaps_09_10_2015.pdf (summarizing reporting obligations for security-based swaps).

[133] Sullivan & Cromwell, *supra* note 132, at 9–10.

[134] Short Sales, Exchange Act Release No. 48.709, 68 Fed. Reg. 62,972 (Nov. 6, 2003).

[135] *Id*. at 62,975. Regulation SHO is buttressed by special antifraud liability for those who misrepresent to broker-dealers that they can deliver shorted shares. SEC Rule 10b-21; *cf*. Naked Short Selling Antifraud Rule, Exchange Act Release No. 58,774, 73 Fed. Reg. 61,666 (Oct. 17, 2008) (noting that Rule 10b-21 imposes no additional liability beyond that already contained within section 10 and Rule 10b-5).

[136] Amendments to Regulation SHO, Exchange Act Release No. 60,388, 74 Fed. Reg. 38,265 (July 31, 2009) (enacting Rule 204).

subject to large financial exposure.[137] Others have raised concerns about naked shorting's potential to manipulate securities downward.[138] Because of the concerns, Regulation SHO prohibits the practice.

In addition, Section 16 of the Securities Exchange Act prohibits statutory insiders from shorting shares of that company's stock.[139] Statutory insiders include key company executives as well as any holder of a 10% long position, conceivably limiting some forms of negative activism.[140]

Other rules govern the margins that the short seller must satisfy when selling shares short. Short sales are executed on margin – the seller effectively borrows shares that she does not yet own – making them subject to margin regulations. These regulations require the shorter to post 125% to 150% of the short position's value as collateral, with the shorter required to make up any shortfalls that emerge over time.[141] Many brokers and dealers used by short sellers set their own margin requirements in excess of these minimums.[142]

Short sales are also subject to an "alternative uptick rule." Through 2007,[143] the SEC employed the original "uptick rule," which imposed no restrictions on short selling when prices were rising but which prohibited

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[137] *See, e.g.*, Hu, *supra* note 8, at 1690. The worry is that without a predetermined ability to cover short positions, the shorter may have to pay an extraordinarily high price ultimately to buy them. This financial exposure concern, of course, could be addressed by margin or other requirements that did not disproportionately restrict certain types of behavior like naked shorting.

[138] *See generally id.* Some argue that naked short selling also brings market benefits, such as higher liquidity and greater pricing efficiency of the shorted securities. Veljko Fotak, Vikas Raman, & Pradeep K. Yadav, *Fails-to-Deliver, Short Selling, and Market Quality*, 114 J. FIN. ECON. 493 (2014).

[139] Exchange Act § 16(c), 15 U.S.C. § 78p(c). The provision also is known for its limits short-swing profits by requiring disgorgement of profits gained (or losses avoided) by purchases followed by sales (or sales followed by purchases) within any six month period. 15 U.S.C. § 78p(a)(2)(C).

[140] 15 U.S.C. § 78p(a)(1).

[141] Regulation T requires short-sellers to post collateral equal to 150% of the initial market value of the shorted shares. Regulation T, 12 C.F.R. § 220.12(a). FINRA, an organization governing the behavior of most brokers and dealers, requires shorts to be funded by at least 125% of the shorted amount on an ongoing basis, after the trade has already been executed. FINRA Rule 4210(c).

[142] *See, e.g.*, U.S. Sec. & Exch. Comm'n, *Margin: Borrowing Money to Pay for Stocks*, https://www.sec.gov/reportspubs/investor-publications/investorpubsmarginhtm.html (Apr. 17, 2009) (stating that "many brokerage firms have higher maintenance requirements" than FINRA's minimum threshold); Charles Schwab, *Nine Frequently Asked Questions About Short Selling*, https://www.schwab.com/active-trader/insights/content/9-frequently-asked-questions-about-short-selling (last visited Dec. 13, 2017) (imposing maintenance margin requirements ranging from 130% to 200%).

[143] Amendments to Regulation SHO, Exchange Act Release No. 59,748, 74 Fed. Reg. 18,042, 18,042 (Apr. 20, 2009). The uptick rule had been enacted 70 years before, in 1938. *Id*. at 18,044.

short sales when prices were falling.[144] The original uptick rule was replaced by the alternative uptick rule in February 2010, which imposes restrictions on shorting securities only when prices have declined by at least 10% relative to the prior day's closing price.[145] Prohibiting short sales during falling markets is meant to slow down price declines and remove incentives to manipulate prices downward.[146]

Occasionally, short sales are banned in their entirety. During the dramatic stock market fall in September 2008, for example, shorting was banned in financial firms' securities.[147]

Forms ADV and PF also require investment managers to disclose certain information about their activities to the SEC, irrespective of whether those activities involve long or short positions. Regulation SBSR, which requires disclosure to the SEC (and limited public disclosure) of information related to security-based swap transactions, also applies to derivative instruments that give negative activists a net short position.[148]

Notably, however, other disclosure obligations for positive activism – principally sections 13(d), 13(f), and 13(g) – are triggered only by long holdings of securities.[149] In other words, negative activists can adopt negative positions of any amount, far in excess of sections 13(d) and 13(g)'s five percent long threshold, without giving rise to disclosure requirements. In other parts of the world, such as the European Union, funds are required to disclose short positions of 0.5% or more of a firm's share value,[150] but no analogue is present in U.S. securities markets.

C. Rationalizing Negative versus Positive Activism Regulation

As the prior discussion shows, positive and negative activism are regulated rather differently. Positive activism regulation relies principally upon disclosure rules, while negative activism instead adopts rules to govern the manner that short sales occur. The two approaches share the similar trait of invariance based on the *type* of positive or negative activism, however.

Here, we analyze whether these regulatory techniques make sense from a policy perspective. Since positive and negative activism involve taking long and short positions, respectively, the optimal regulatory

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[144] *See generally* Jonathan R. Macey et al., *Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash*, 74 CORNELL L. REV. 799, 803–04 (1989) (summarizing the uptick rule).

[145] Amendments to Regulation SHO, Exchange Act Release No. 61,595, 75 Fed. Reg. 11,232 (May 10, 2010).

[146] *See, e.g.*, Hu, *supra* note 137, at 1690.

[147] *Id.* at 1694. The last time short selling experienced blanket bans in the United States was in 1931. *Id.*

[148] *See supra* notes 131–133 and accompanying text (discussing Regulation SBSR reporting requirements).

[149] Exchange Act §§ 13(d), 13(f), 13(g).

[150] *Short Selling*, EUROPEAN SEC. & MKTS. AUTHORITY, https://www.esma.europa.eu/regulation/trading/short-selling (last visited July 4, 2018).

techniques for each could reasonably differ. Moreover, since the *type* of activism can also vary within each of positive and negative activism, optimal regulation could differ even further. We therefore discuss optimal approaches across operational, informational, and unintentional negative activism – the framework developed in Part II – as comparisons to current policy.

At first blush, negative activism might appear to present straightforward and simple questions. If social welfare is enhanced by maximizing shareholder value, then surely activities that reduce shareholder value, such as negative activism, are socially deleterious. Indeed, short selling is often criticized as involving controversial, generally undesirable trading practices.[151] But a closer examination reveals that negative activists can play an important, and indeed helpful, role in financial markets. These costs and benefits vary based on the category of negative activism.

Before we turn to how public policy might address this variation, we pause briefly to consider the costs borne by short sellers as a result of the current regulatory regime. These costs are important and considerable, and typically do not apply to positive activism.

First, the risk-return profile of a short position differs significantly from that of a long position. By selling short, the investor profits only when the stock price decreases. Thus, the maximum profit from a short position is the price of the stock (stock price falling to zero), whereas the potential loss is infinite (stock price rising indefinitely). Moreover, the asset pricing literature suggests that long positions in equity earn a risk premium over time.[152] The short investor, therefore, starts from behind and must overcome the expected market rate of return before expecting a profit. In other words, absent some advantage associated with a particular short position, short selling is a risky proposition that expects to lose

[151] *See, e.g.*, Joanna Lee, *Activist Short Sellers: Market Manipulators or Market Predators?*, 32 REV. BANKING & FIN. 274 (2013); Feng Ye, *Trading on the Outcomes of Patent Challenges Short-Selling Petitioners and Possible Modifications to the Inter Partes Review Process*, 98 J. PAT. & TRADEMARK OFF. SOC'Y 557 (2016).

[152] For example, one recent survey suggests that the equity risk premium are in the range of 4%, meaning that the return on a diversified index of stocks was expected to outperform risk-free yields by approximately 4%. *See* John R. Graham & Campbell R. Harvey, *The Equity Risk Premium in 2018*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3151162 (reporting an average equity risk premium of 4.42%). The average short position, then, is expected to cost the short seller the equity premium plus the risk free rate, or approximately the market rate of return, over time. *See, e.g.*, Bill Barker, *How Have Stocks Fared the Past 50 Years? You'll Be Surprised*, THE MOTLEY FOOL, Apr. 22, 2016, https://www.fool.com/investing/general/2016/04/22/how-have-stocks-fared-the-last-50-years-youll-be-s.aspx; *see generally* DQYDJ, *S&P 500 Return Calculator, with Dividend Reinvestment*, https://dqydj.com/sp-500-return-calculator/ (last visited Feb. 18, 2018) (allowing for calculation of average annualized S&P 500 returns over various periods of time, and showing historical nominal stock market returns of approximately 9%).

money. Positive activists can ride the winds of the market; negative activists must fight against them.

Second, short selling's margin requirements tie up the short seller's assets as collateral.[153] These assets could otherwise be put to other uses. The opportunity cost of posting collateral adds to the difficulty and expense of short selling as a strategy.

Third, while short positions are open, short-sellers must reimburse the stock lender for any dividends or distributions paid to the shareholder of the shorted stock, representing a real cost to the short-seller.[154] Moreover, depending on the requirements of particular brokers, short sellers can be required to pay an additional "special" premium for shares that are difficult to borrow.

Fourth, short-sellers are required to repay the stock loan on demand, exposing them to the risk of a short squeeze.[155] If a short-seller is unable to find an alternative lender, then the short-seller must purchase the shares on the open market to repay the loan, effectively closing the position prematurely at whatever current market prices happen to be.

Fifth, public short sellers risk invoking the ire of regulators and private companies when engaging in short selling. As mentioned earlier, disclosures of short interests have brought allegations of criminal conduct investigations by public and private parties, and the threat of legal action.[156] Taking long positions and attempting to raise stock prices typically (absent fraud) does not invoke these responses, particularly from the target of those long positions, again making shorting disproportionately costly.

Finally, the tax treatment of gains from shorting are less favorable than gains on long positions. Long positions that are held for more than one year are eligible for favorable long-term capital gain tax rates, which are less than ordinary income tax rates.[157] The tax treatment for call options, which can be used for positive activism,[158] follows a similar rule, where the holding period is measured from the date that the option is exercised.[159] In comparison, any profits from short positions are taxed at

[153] *See supra* notes 141–142 and accompanying text.

[154] *See, e.g.*, Dan Caplinger, *Dividends Paid on Short Sales*, THE MOTLEY FOOL, Jan. 15, 2015, https://www.fool.com/taxes/2015/01/15/dividends-paid-on-short-sales.aspx.

[155] *See, e.g., Key Points About Regulation SHO*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/investor/pubs/regsho.htm (last visited June 29, 2018).

[156] Lamont, *supra* note 46; Appel et al., *supra* note 55; Stefan Nagel, *Short Sales, Institutional Investors and the Cross-Section of Stock Returns*, 78 J. FIN. ECON. 277 (2005) (noting the indirect constraints to institutional short selling).

[157] 26 U.S.C. §§ 1(h) (tax rates); 1222(3) (defining long-term capital gain).

[158] *See, e.g.*, *supra* note 88 and accompanying text (discussing Bill Ackman's use of call options in his attempted positive activism at Target).

[159] IRS Pub. 550, Capital Gains & Losses: Options, https://www.irs.gov/publications/p550 ("Any gain or loss on the sale of the underlying stock is long term or short term depending on your holding period for the underlying stock"). Selling the call option before exercising it is taxed based on the length of time for which the call option was held. *See, e.g.*, Robert A. Green, *Assessing the Tax*

higher short-term ordinary income rates, regardless of the period for which the activist maintained the short position.[160]

In sum, short sellers face significant costs and barriers. To some extent, it is possible to use derivatives, including swaps and options, to avoid some of these costs, although derivatives also pose unique challenges of their own. We now turn to a policy analysis that assesses negative activism in light of these comparative costs.

1. Informational Negative Activism

Informational activism seeks to profit from share price movements after the activist releases new information into the marketplace. Typically we associate this behavior with activists' promulgating *good* information about a company; informational negative activism, however decreases stock prices by revealing *bad* information about a company.

Yet regardless of whether the information is positive or negative in nature, scholars typically view new accurate information about securities as a good thing.[161] When more information is available in the marketplace, securities prices are better indicators of company values and price discovery is enhanced.[162] Accurate securities prices are instrumental in making sure that limited investment funds are put towards their most valued uses. Firms whose shares are inaccurately overvalued attract too much capital relative to their economic contributions; firms whose shares are inaccurately undervalued attract too little.[163] To ensure capital is

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Treatment of Options Trading, FORBES, May 29, 2015, https://www.forbes.com/sites/greatspeculations/2015/05/29/assessing-the-tax-treatment-of-options-trading/.

160 IRS Pub. 550, Capital Gains & Losses: Options, https://www.irs.gov/publications/p550 ("As a general rule, you determine whether you have short-term or long-term capital gain or loss on a short sale by the amount of time you actually hold the property eventually delivered to the lender to close the short sale.") Thus, the negative activist could achieve long-term capital gains on a short position only if she held the underlying asset for at least twelve months before the short position closed (a "covered" short). Activists who short securities without holding the underlying shares, or who have held the underlying shares for fewer than twelve months before the short closes, will have gains taxed at short-term capital gains rates.

161 *See generally* Merritt B. Fox & Kevin S. Haeberle, *Evaluating Stock-Trading Practices and Their Regulation*, 42 J. CORP. L. 887 (2017) (reviewing the economic benefits from accurate securities prices); Peter Molk, *Protecting LLC Owners While Preserving LLC Flexibility*, 51 U.C. DAVIS L. REV. __ (forthcoming 2018) (using the mispricing of investment interests as an argument in favor of changing LLC governance law).

162 *See, e.g.*, Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 415 (1970) (describing the semi-strong efficient capital markets hypothesis, which presumes that securities prices reflect all publicly available information); Basic v. Levinson, 485 U.S. 247 n.24 (assuming that "market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices"); Halliburton Co. v. Erica P. John Fund., Inc., 134 S. Ct. 2398, 2409–13 (2014) (reaffirming courts' presumption of the efficient capital markets hypothesis when securities markets meet certain requirements).

163 *See, e.g.*, Fox & Haeberle, *supra* note 161, at 895–904.

efficiently deployed, securities prices should reflect the value of their respective enterprises, which relies on information entering the securities markets.

Importantly, both positive and negative information must enter the securities markets for prices to be accurate. If only positive information were reflected, securities would be systematically overpriced. Moreover, some securities would be more overpriced than others, depending on their underlying firms' relative ratios of (unrevealed) negative information. This mispricing leads to misallocation of capital, which securities market regulators actively seek to avoid.[164]

Therefore, negative informational activism is desirable simply to the extent it introduces new information about securities into securities markets. But even the *threat* of discovering and disclosing negative information can be valuable. The disciplining hypothesis set forth by Massa, Zhang, and Zhang states that as short sellers increase price information and attack the misconduct of firms, their presence, by increasing the probability and speed with which the market uncovers earnings management, reduces managers' incentives to manipulate earnings.[165] Consistent with the disciplining hypothesis, Fang, Huang, and Karpoff find evidence that short selling, or its prospect, reduces firms' manipulation of earnings numbers, helps detect fraud, and improves asset pricing efficiency.[166] The mere potential for uncovering and disclosing negative information can therefore align manager and shareholder interests.

Uncovering and disclosing negative information is therefore particularly valuable. The need is particularly great given companies' disparate incentives for voluntary disclosure of positive but not negative information. Positive news boosts share prices. Increasing one's share price not only makes raising future capital easier,[167] but also makes management of those companies look like they are successful at their stewardship. A higher share price also means that any management performance-based compensation is higher,[168] making these individuals financially better off by releasing of positive news.

On the other hand, companies have little financial incentive to release negative information voluntarily. In fact, companies have reason to devote

[164] *See, e.g.*, 15 U.S.C. §§ 77b(b), 78c(f) (directing the SEC to assess whether "action[s] will promote efficiency, competition, and capital formation.")

[165] Massimo Massa, Bohui Zhang, & Hong Zhang, *The Invisible Hand of Short Selling: Does Short Selling Discipline Earnings Management?*, 28 REV. FIN. STUD. 1701 (2015).

[166] Vivian W. Fang, Allen H. Huang, & Jonathan M. Karpoff, *Short Selling and Earnings Management: A Controlled Experiment*, 71 J. OF FIN. 1251 (2016).

[167] Higher share prices in secondary markets mean the company can raise relatively more funds from later selling new securities into those secondary markets.

[168] Alex Edmans, Xavier Gabaix, & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence* Fig. 6 (July 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3023787 (showing widespread use of performance-based pay among company management). Even when management's compensation is not directly tied to firm performance, management may voluntarily hold shares in their managed firms, giving them the same incentive to increase share prices.

efforts to prevent this information from becoming public at all. Because negative information reduces share prices, the same forces that act to encourage management to release positive information encourage them to keep the negative information under wraps. Of course, companies' ability to hide negative information is limited in some respects. Periodic disclosure rules require public companies to release information that falls within enumerated categories.[169] Anti-fraud rules also prohibit companies from releasing false or misleading information when those companies choose to communicate.[170] But the resulting downward pressure on share prices from releasing negative information means that management has little reason to go beyond required disclosures.

If having negative information (or the threat of discovering negative information) in the marketplace is valuable,[171] yet companies lack the incentive to release this information unless required, another way for this information to become available is through private efforts to discover and release it. Insider trading restrictions keep company insiders from disclosing this information for personal gain,[172] and the SEC's private

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[169] Filing requirements can be found in section 13 of the Exchange Act, which applies to companies that are listed on national securities exchanges, large companies with a large number of shareholders, and companies that have made a public offering of their securities under the Securities Act of 1933. Exchange Act §§ 13 (periodic filing requirements), 12(a) (national securities exchange), § 12(g) (size), § 15(d)(1) (public offering). Even if negative information falls within a required disclosure category, the negative repercussions from disclosing this information suggest the company will delay disclosing this information until required. Positive information, on the other hand, might be expected to be disclosed fairly quickly, because of its positive effect on stock prices. *See, e.g.*, Kristoffel Grechenig, *Positive and Negative Information – Insider Trading Rethought* 10 (Univ. of St. Gallen Law Sch. Law and Economics Research Paper Series, Working Paper No. 2007-28), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1019425 (last visited Feb. 11, 2018).

[170] Exchange Act § 10 (general antifraud provision); Exchange Act Rule 10b-5 (banning fraudulent statements or omissions of information that would be required to render statements not misleading); Securities Act § 11 (providing private cause of action for fraud in a registration statement); Securities Act § 12(a)(2) (civil liability for fraud in a prospectus).

[171] *Cf.* Mitts & Talley, *supra* note 76 (asserting that disclosing cybersecurity vulnerabilities can be undesirable, to the extent that it causes others to tap into these vulnerabilities and expose sensitive information). As a more general matter, we might be concerned to the extent that revealing negative information gives rise to negative operational changes by another. One would hope, of course, that the increased prospect of negative disclosures would encourage firms to prevent against these vulnerabilities and quickly manage them when exposed. However, these preventative steps impose costs of their own, although they may also bring collateral benefits, to the extent they deter additional undesirable behavior. For example, the firm that locks sensitive documents in the safe to deter information breaches also deters garden-variety burglars. *Cf. id* (discussing the costs of prevention); Darius Lakdawalla & Eric Talley, *Optimal Liability for Terrorism*, NBER Working Paper 12578 (draft Feb. 13, 2007) (discussing the costs of prevention).

[172] Liberalizing insider trading restrictions for negative information would be one method of encouraging dissemination of negative information. Grechenig, *supra* note 169, at 9–10; Matthew Barbabella et al., *Insider Trading in Congress: The Need for Regulation*, 9 J.

whistleblower program has been met with only modest success so far,[173] so another route must be found for this information to enter the marketplace via private means. Enter informational negative activism. Activists typically face no insider trading restrictions to prevent them from profiting by revealing negative information about a company. As long as the activist is not a statutory insider (an executive of the company or a holder of at least 10% of the company's shares[174]) and as long as the activist does not inherit fiduciary duties of trust and confidence from the information's source (which is unlikely to happen in many circumstances[175]), the activist is free to profit from shorting a company stock and then revealing the negative information.[176]

Firms' disincentive to disclose negative information, as opposed to positive information, is not the only reason we might want to encourage public revelation of new negative information. As we noted at the start of this section, short sellers face substantial additional difficulties and costs unique to taking a short position.[177] Profiting from price decreases is systematically more difficult and riskier than profiting from price increases, given stock markets' expected increases over time, and short-

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BUS. & SEC. L. 199, 231–32 (2009) (applying this argument to insider trading by Congressional representatives); Peter Molk, *Insider Trading in Alternative Entities* (draft, on file with authors) (applying this argument to unincorporated entities); *see generally* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 59–62 (1966) (describing how insider purchases can transfer information to public markets).

[173] *See, e.g.*, Mengqi Sun, *SEC Whistleblower Program Has Record-Breaking Year*, WALL ST. J., Nov. 16, 2018, https://www.wsj.com/articles/sec-whistleblower-program-has-record-breaking-year-1542413518?ns=prod/accounts-wsj (noting that the SEC paid out a record amount of whistleblower rewards in fiscal year 2017-18, although awards were paid to only thirteen individuals, comprising fewer than ten targets).

[174] 15 U.S.C. § 78p(a)(1).

[175] For the activist to inherit a prohibition against trading based on material nonpublic information, the information's original source must possess such a duty, that source must pass the information for personal gain, and the activist must be aware that the original source is passing the information for gain. *Dirks*, 463 U.S. 646. When information reaches the activist through a remote tipping chain, the probability that the activist will be aware of anything regarding the information's original source grows small, eliminating liability for insider trading. *See, e.g.*, U.S. v. Newman, 773 F.3d 438, 453–54 (2014); *Salman*, 137 S. Ct. at 425 n.1 (declining to rule on this issue). Moreover, if the original source does not breach a fiduciary duty in passing the information, the activist faces no trading restrictions. *Dirks*, 473 U.S. 646 (requiring the breach of a fiduciary duty for traders to be liable). Finally, if the activist learns of the information independently, the activist faces no insider trading restrictions, which generally do not attach to "outsiders" who acquire and trade on material nonpublic information. John Reed Stark, *Think the SEC EDGAR Data Breach Involved Insider Trading? Think Again*, D&O DIARY (Oct. 2, 2017), https://www.dandodiary.com/2017/10/articles/cyber-liability/guest-post-think-sec-edgar-data-breach-involved-insider-trading-think/ (describing SEC attempts to recognize a new "outsider trading" theory).

[176] Indeed, the SEC recognizes the value that comes from private shorting of stocks. SEC, *SEC Approves Short Selling Restrictions*, Feb. 24, 2010, https://www.sec.gov/news/press/2010/2010-26.htm ("Short selling can serve useful market purposes, including providing market liquidity and pricing efficiency.")

[177] *See supra* notes 152–160 and accompanying text.

sellers must shoulder the other financial and regulatory burdens unique to short selling. These disproportionate costs make the returns from investing in negative information discovery comparatively low, discouraging investment in its discovery and dissemination.

For all these reasons, the policy argument in favor of encouraging informational negative activism is a strong one. Informational negative is not only valuable, but also arguably more valuable than informational positive activism. While both should be encouraged, the policy argument in favor of informational negative activism is stronger once existing private incentives to disseminate positive information are taken into account. To the extent policy makers want to encourage the dissemination of information associated with informational negative activism, regulation arguably should not impose excessive costs that would deter this kind of activism, and may even seek to subsidize it.

How does current regulatory policy address these challenges? In many cases, fairly well.

First, as discussed above, informational activism of all types is in some ways lightly regulated, which makes informational activism a comparatively attractive form of activism. One potentially significant regulatory barrier, insider trading restrictions, is easily overcome as long as the trader makes sure she has not inherited disclosure duties from the information's original source. Most of the other substantive regulation focuses on disclosure obligations. Although disclosure makes it more difficult for traders to acquire shares privately over an extended time period, this should provide little burden to informational activists, who seek to profit from a relatively quick movement in price following revelation of their information that might be entirely accomplished before the disclosure window comes due. By contrast, the operational activist, who might devote considerable effort to achieving operational reform (and price movements) over an extended period, suffers a far greater burden from being required to disclose her holdings and intentions early in the process.

In addition to imposing a comparatively light regulatory burden on informational activism, some activist regulation also appears to favor informational negative activism over informational positive activism. Given the greater need for private disclosure of negative information,[178] this balance seems appropriate. The disclosure obligation is fairly manageable for positive informational activism, but it is nonexistent for most negative informational activism.[179] Lowering the regulatory burden to informational negative activism, even if only modestly,[180] not only

[178] *See* discussion accompanying notes 167–177 and accompanying text.
[179] *See supra* note 149 and accompanying text.
[180] Given the short duration of most informational activists' holdings, the disclosure regimes may provide little burden for either positive or negative informational activism, since the disclosure obligation might not be triggered until the activist has already exited her position. *See supra* note 116 and accompanying text (noting that disclosure is required within ten days after acquiring a 5% voting share stake).

reduces its costs, but also makes it easier for the activist her to amass a greater position that increases her eventual payoff. Even though activism policy may not have been set up with this implicit comparative subsidy in mind, its existence is nevertheless an attractive feature of the current regime.[181]

On the other hand, other regulatory aspects – the alternative uptick rule, Regulation SHO, and tax policy – disadvantage informational negative activism relative to positive activism. Some of these relative costs are only slight, and so are perhaps not overly troubling. For instance, negative activism-specific restrictions from the alternative uptick rule and Regulation SHO likely will not apply to informational negative activism: informational activism does not typically follow dramatic stock declines, making the alternative uptick rule non-binding[182] and making it comparatively easy to line up covered shorts to comply with Regulation SHO.[183] In addition, tax rules may penalize short positions and negative activism relative to long positions and positive activism, but only when the long position is held for a year or longer.[184] Given informational activism's short holding periods for both positive and negative information, it is likely that the tax treatment will be the same for both positive and negative activism.[185]

Finally, some regulations unquestionably disadvantage informational negative activism. Firms' ability to employ leverage to short shares is limited by government regulation,[186] making informational negative activism comparatively costly. Andrei Shleifer and Robert Vishny have pointed to this cost as potentially limiting arbitrage possibilities in stock markets, inefficiently impeding share prices' movement from reflecting fundamental values.[187] These regulations may be desirable for other reasons, but their presence further reinforces the need to comparatively advantage informational negative activism.

Given the potential for informational negative activism to improve market efficiency, policy makers should at least consider efforts to reduce the difficulties and costs associated with shorting. To the extent there are future calls for imposing costs on short sellers, regulators should

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[181] Notably, this analysis supports continuing the asymmetric disclosure regimes that require 13D and 13F disclosures for long positions, but not short positions. Although some have pushed for mandatory public disclosure of short positions, a system tilted in favor of informational negative activism over positive activism may strike the appropriate balance, given the comparative value of disclosing new negative information over positive information. *See, e.g.*, Hu & Black, *supra* note 8, at 875–886; Massa, *supra* note 45 (arguing for disclosure).
[182] *See supra* note 145 and accompanying text.
[183] *See supra* note 135 and accompanying text.
[184] *See supra* note 160 and accompanying text.
[185] Tax rules could be changed to provide a means of subsidizing negative versus positive informational activism, but we do not consider the details of that potential change here.
[186] *See supra* notes 141-142 and accompanying text.
[187] Andrei Shleifer & Robert W. Vishny, *The Limits of Arbitrage*, 52 J. OF FIN. 35, 49–50 & n.6 (1997).

presumptively resist such calls. Since the evidence supports subsidizing this form of activism, not restricting it, a compelling case must be made to overcome that presumption.

Indeed, regulators might even consider implementing new rules designed to subsidize informational negative activism. For example, long-term capital gains taxes from short selling might be substantially reduced, perhaps to zero. Regulators might encourage reforms related to the disparate riskiness and cost of short selling, including reforms related to share lending. Regulation of large institutional investors might be relaxed, to permit or encourage these institutions to invest and engage in informational negative activism, or at least to allocate greater resources to such activists.[188] Securities regulators might create safe harbors for short sellers, to protect them from litigation or enforcement actions as long as they do not take specified deleterious actions. Our bottom line normative conclusion is straightforward: informational negative activism should be encouraged.

2. Operational Negative Activism

Our recommendation is very different for operational negative activism. Consider the contrasts between operational negative activism and operational positive activism. Recall that in positive operational activism, activists work to change a company's operations to move asset prices in their desired direction. Whereas positive activists act to increase the value of companies, negative activists try to destroy it. This characteristic leads to a sharp separation between the desirability of positive and negative operational activism.

A case can be made that positive operational activism justifies a regulatory subsidy. It enhances the fundamental value of companies and the economy as a whole, as evidenced by share price returns after activist interventions.[189] While the financial rewards from positive activism already incentivize this desirable activity, from a policy perspective these rewards arguably are suboptimally low. Positive activists can bear significant expenses to achieve positive change, which are not always reimbursed.[190]

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[188] Molk & Partnoy, *supra* note 38.

[189] *See supra* note 22 and accompanying text (noting 7% average abnormal share response to positive activist interventions). As discussed above, however, not all agree that operational positive activism improves companies over the long term. *See, e.g.*, *supra* note 37; Coffee, *supra* note 37 (noting the often divergent goals between activists and other shareholders).

[190] For instance, activists' costs to replace incumbent management through a proxy contest that are generally reimbursed only if the activist wins. *See, e.g.*, RANDALL S. THOMAS & CATHERINE T. DIXON, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL § 21.01 (3d ed. 1998) (reporting insurgent proxy contest expenses to average $1.8 million in the 1980s); Carl Icahn, *We're Not the Boss of A.I.G.*, N.Y. TIMES, Mar. 29, 2009, at WK9 (noting that proxy contests at large public companies "can run into the millions of dollars"); Rosenfeld v. Fairchild Engine Airplane Corp., 128 N.E.

Although the positive operational activist often bears the full cost of her efforts, she often captures only a portion of the improvements she generates.[191] This is because the positive activist, like any investor, has only a partial ownership stake in a targeted company; consequently, much of the benefit they generate can be viewed as a positive externality.[192] Carl Icahn, for example, spent considerable effort lobbying Apple to change its corporate financial structure in 2013. At the time, he owned only 0.9% of the company's outstanding shares, meaning 99.1% of the gains generated by his positive activism would have accrued to other owners.[193] Therefore, unless the expected benefits to Apple as a whole were at least 100 times Icahn's expected uncompensated cost in obtaining them, we would not expect him to engage in positive activism.

Of course, the positive externalities problem is not unique to activism. In other contexts, legal systems manage it in various ways. Even in the corporate sphere, the problem arises elsewhere, such as in convincing any individual shareholder to engage in company management or exercise control powers.[194] The typical response is to subsidize the activity.

Some current regulation incentivizes positive operational activism relative to other activities. As noted above, tax policy creates incentives for activists to hold positions for more than one year, and in fact studies

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2d 291 (N.Y. 1955) (formulating the typical rule that failed insurgents' proxy contest expenses are not reimbursable by the company). Shareholders' attempts to change this reimbursement rule have been unsuccessful. *See, e.g.*, CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008) (allowing board to exclude a shareholder proposal that would have amended the company bylaws to require reimbursing any proxy contest that was successful in electing at least one new director). Less drastic interventions than waging proxy contests, such as lobbying existing management to change without replacing that management, also can involve financial expenses as well as a significant investment of the activist's time that go uncompensated.

[191] In an important recent working paper, John Coffee raises the concern that activists often settle with firms for private benefits unavailable to other shareholders, which may mitigate these costs. Coffee, *supra* note 37.

[192] *See generally* Ronald Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review* (draft Aug. 14, 2012, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2129502) (analyzing the analogous problem of providing compensation to controlling shareholders who reap only a portion of their positive changes). Activists can increase the comparative magnitude of these gains through leverage or buying call options or other similar financial derivatives. Leverage amounts, however, are limited by Regulation T and by brokers and dealers. *See supra* notes 141-142 and accompanying text. Call options include transaction costs and practical volume limitations that limit their usefulness. *See generally* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973) (developing a model to determine option prices); 12 C.F.R. § 220.122(d) (noting exchange and endorsing firm margin requirements that act to limit the volume of options that are written).

[193] Pat Regnier, *Here's Why Carl Icahn Wants Apple to Buy Back Shares*, TIME, Oct. 9, 2014, http://time.com/money/3484599/icahn-letter-apple-cash/.

[194] Some have argued that this situation justifies tolerating limited private tunneling of benefits by controlling shareholders. Gilson & Schwartz, *supra* note 192.

show positive activist median holding periods exceed one year.[195] Disclosure requirements are designed to generate transparency benefits at minimal cost.[196] Private ordering solutions also can encourage activism.[197]

The arguments favoring positive operational activism usually do not apply to negative operational activism. Negative operational activism typically imposes negative externalities on investors and society, harming companies' efficiency and profitability solely for the activist's individual profits. Because of these negative externalities, negative operational activists' incentives are not aligned with those of shareholders or the public.

The current regulatory framework does not directly deter operational negative activism. Moreover, other regulations that potentially affect negative activism do not apply to negative operational activism.

Consider, for example, the alternative uptick rule, which prohibits shorting securities whose prices have fallen by at least 10% relative to the prior trading day's closing price.[198] This rule does little to deter negative operational activism. The negative operational activist shorts shares before the price begins to fall, later causing the decline through imposing operational changes.[199] While the alternative uptick rule might limit the activist's ability to add to her position once the operational changes have begun to take effect, this limitation does not impact earlier profits.

Likewise, securities antifraud provisions do little to deter many instances of negative operational activism. Traditional insider trading restrictions would not apply to negative operational activism, since they apply when the activist faces a duty to disclose her informational advantage.[200] This duty typically arises when the trader breaches a confidential or fiduciary relationship with the information's source or the trading partner.[201] Short activists, however, generally owe no such duty. They trade on their own information about their operational plans, rather than information acquired confidentially from the company;[202] and they

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[195] *See* Brav, Jiang, Partnoy & Thomas, *supra* note 32.

[196] As a practical matter, we also doubt whether reducing disclosure requirements would provide much subsidy in this area. Operational activists often publicize their ideas to other shareholders to gain traction for their suggested intervention, effectively disclosing their positions in the process. *See, e.g.*, *supra* note 193 and accompanying text (discussing Carl Icahn's operational activism, which he publicized despite not having an ownership stake that had to be disclosed).

[197] *But see AFSCME*, 953 A.2d 227 (allowing exclusion of shareholder proposal designed to encourage activism).

[198] *See supra* note 145 and accompanying text.

[199] *See supra* Part II.B.2.

[200] U.S. v. O'Hagan, 521 U.S. 642 (1997).

[201] *Id*.

[202] *See supra* Part II.B.2 (examples of negative operational activism). *Cf.* Mitts & Talley, *supra* note 76 (analyzing whether shorting based on cybersecurity breaches could fit within existing insider trading restrictions).

own short rather than long positions in the company, keeping them from being treated as statutory insiders with disclosure duties.[203]

Prohibitions against market manipulation also typically would not apply to negative operational activism. Claims of market manipulation require some type of manipulative activity, which "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[204] A short activist who spread false information about her activities might be liable for market manipulation,[205] but an honest activist who did not mischaracterize any activities, or who just refused to speak, would seemingly avoid this prohibition. Shorting alone does not constitute market manipulation.[206]

Finally, although statutory insiders are directly prohibited from shorting shares of company's stock,[207] this prohibition does little to deter negative operational activism. To be a statutory insider, the negative operational activist would need to be either a key executive of the company or hold a 10% long position in the company's stock.[208] But negative operational activists typically have no formal employment position within a targeted company,[209] and they seek to profit from short positions, not long positions.

Given that existing restraints do little to deter negative operational activism, and given the negative externalities that usually follow this type of activism, there is a need for more regulation, including a serious threat of ex post enforcement. The need for such serious regulatory enforcement is particularly warranted given the comparatively limited ability of company management to respond, especially when (as with most of the examples discussed in Part II.B.2) the activist can achieve her goals without management's involvement. Management is limited in its ability to deter negative activism, since standard techniques that devalue the activist's holdings, like poison pills, don't deter investors with short

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[203] *See supra* notes 139–140 and accompanying text.

[204] Santa Fe Industries v. Green, 430 U.S. 462, 476 (1977); Fezzani v. Bear Stearns & Co., Inc., 716 F.3d 18, 22 (2d Cir. 2013) (noting the manipulative act requirement for manipulation claims).

[205] *See, e.g.*, Mitts, *supra* note 52 (noting some of the difficulties that can arise in proving market manipulation cases).

[206] ATSI Commc'ns, Inc. v. Shaar Fund, Ltd, 493 F.3d 89, 101 (2d Cir. 2007) ("In essence, taking a short position is no different than taking a long position. To be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security.")

[207] *See supra* notes 139–140 and accompanying text.

[208] 15 U.S.C. § 78p(a)(1).

[209] For example, Bill Ackman pushed for operational changes at Proctor and Gamble despite holding only a 1% ownership stake in the company and no executive position. Chris Isidore, *Ackman Wins, P&G Dumps CEO*, CNNMONEY, May 24, 2013, http://money.cnn.com/2013/05/24/news/companies/pg-ceo-ackman/index.html.

positions.[210] Companies potentially could implement negative poison pill "vitamin pills," which would dilute a short sellers interest above a particular percentage threshold upon a triggering event, but it is unclear how such devices could be operationalized, and whether the courts would uphold them. [211]

If operational negative activism is to be deterred but informational negative activism is to be encouraged, the ability to categorize negative activism grows particularly important. As discussed above, there are likely to be "mixed" cases of informational and operational activism. Although operational and informational activism are distinct categories – operational activism seeks to impact a firm's intrinsic value, while informational seeks to impact the public reflection of a firm's intrinsic value – the lines between the two can blur.

For instance, consider the informational negative activist who discloses a firm's cyber vulnerability, which leads others to disrupt the firm's operations and impose negative operational changes. On one hand, disclosure of new, accurate negative information is desirable, since it causes securities prices to be better representations of the underlying asset's value.[212] On the other hand, if that information obviously *causes* negative operational changes that would not otherwise have occurred, the costs of those negative changes could more than outweigh the value of the initial information.[213]

It would be undesirable for the negative activist to escape consequences of operational negative activism merely by disclosing information and then allowing another to do the operational work. A regulatory framework would therefore need to attribute operational changes to the informational activist when those operational changes would naturally follow from the information disclosure. Current activist policy fails to do so, but this predictive link occurs in other areas of financial regulation, and we think it would also be well suited here. For example, Regulation FD prohibits disclosures by an issuer to holders of that issuer's securities if it is reasonably foreseeable that the holder would purchase or sell the issuer's securities based on that information. A similar

[210] Wachtell, Lipton, Rosen & Katz, *The Share Purchase Rights Plan, reprinted in* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 10–18 (2d ed. Supp. 1999) (discussing standard poison pill characteristics).

[211] An effective response would need to increase the value of company stock, so that share prices increase and reduce the value of the negative activist's short position. Other than through financial manipulations that may be ineffective in an efficient capital market, we presume that management is already implementing all value-enhancing plans, as is their job. In that case, the analogue of a poison pill would have to make shareholder overpay for new shares at a premium to market prices, to increase share prices. We suspect few shareholders would jump at that offer.

[212] *See supra* notes 161–163 and accompanying text.

[213] But if the information disclosure merely hastens negative operation changes that would happen anyway, our concerns are less, particularly if earlier implementation of those changes would impose lower costs, such as with the breach that happens early, before more sensitive data are assembled and lost.

exercise could attribute later operational changes to an informational activist if it would be reasonably foreseeable that revealing the information would give rise to the negative operational changes. Then, to the extent operational negative activism is penalized, those penalties could be applied to deter the negative informational activist who publicly discloses information that likely has negative social value.[214] In turn, desirable informational activism that is *not* likely to lead to negative operational changes, such as disclosing financial fraud, would therefore not be penalized.

In designing a rule that penalized operational negative activism, we have assumed that operational negative activism is harmful to society. This assumption will not always hold, in which case we would lose out on the few cases of beneficial negative operational activism. Sometimes operational negative activism dismantles illegitimate sources of company value, those activities would be deterred. Kyle Bass's challenges to what were potentially illegitimate company patents, for example, would be deterred under a system that penalized all negative operational activism,[215] even though challenging invalid patents could be a socially desirable way of policing these patents.[216] But given operational negative activism's potential for abuse, deterring some beneficial activism along with deterring harmful activism could be a favorable regulatory tradeoff. Of course, if we could accurately distinguish ex ante between socially desirable and undesirable operational negative activism, then we should carve the good cases out from the prohibition.

3. Unintentional Negative Activism

Finally, we turn briefly to an assessment of optimal regulatory policy for unintentional negative activism. Recall that this category of activist acquires shares with the hope that she will improve company value but, upon disclosing her position, share prices decline. Unintentional negative activism has few redeeming qualities.[217] As with operational negative activism, the unintentional negative activist is not expected to benefit either the targeted company or society overall.[218]

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[214] Of course, nothing would prevent the activist from disclosing the information to the company privately, or for the company to compensate the activist for doing so. In this scenario, the company gets the first opportunity to address the problem without its necessarily giving rise to negative operational changes. We view this as a desirable outcome.

[215] *See supra* notes 61-71 and accompanying text.

[216] The PTO is widely believed to issue excessive bad patents, making this form of private policing potentially important. *See, e.g.*, Michael Frakes & Melissa Wasserman, *Irrational Ignorance at the Patent Office*, 72 VAND. L. REV. __ (forthcoming 2019). But if Bass's mixed success is representative of operational negative activism's potential, even his challenges might have done more harm than good, given that the challenges were successful only approximately one-quarter of the time.

[217] At least the activist could say that he or she tried.

[218] It is therefore important to distinguish this activist from the activist who is expected to improve company value but unluckily proves unsuccessful down the road. We envision

Even absent regulation intervention, private market forces may already provide an adequate deterrent. Unintentional negative activists lose money immediately upon the share price decline. Repeated instances will make it hard for them to raise funds from outside investors. As with financial actors generally, market forces should punish those positive activists with poor reputations, as evidenced by empirical evidence linking reputation to investment inflows.[219]

If needed, an additional deterrent could come from courts, which could empower management to resist unintentional negative activism by broadly tolerating defensive actions, particularly when the announcement of a long intervention is associated with a negative market reaction. Delaware courts' framework for determining the acceptability of management's response to a perceived threat has been developed in Unocal v. Mesa[220] and Unitrin v. American General.[221] This framework often requires assessing whether management's response falls into the range of reasonableness relative to the threat posed.[222] Although the range of reasonableness is quite expansive, it is broader when a company faces more severe threats to its value.[223]

Because unintentional negative activism represents just such a potential fundamental threat, the analysis of the reasonableness of responses under the *Unocal* and *Unitrin* frameworks could explicitly incorporate an assessment of the market's reaction to the announcement of an activist intervention. An activist's prior track record as well as stock price reactions could be a useful way for courts to distinguish unintentional negative activism, which could warrant warranting a greater defensive response. In contrast, courts could view defensive efforts more skeptically if they occur in response to activism that was associated with a significant positive return upon announcement.

As a final note, consider the opposite of unintentional negative activism: unintentional positive activism. This puzzling form of activism occurs when the announcement by a negative activist is associated with a positive cumulative abnormal return to the targeted company's shares. What is the appropriate policy response to activist behavior that profits from reduced company value but, unintentionally, might instead improve company value? Perhaps, for example, a negative activist's attempt leave the company stronger for having countered it; a company's decisive victory might deter future negative activists, for example, leaving the company freer to pursue value.

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this latter activist as producing a positive (or at least neutral) stock price reaction upon disclosing her position, suggesting that market actors expect to her to add value on average.

[219] *See* Krishnan, Partnoy & Thomas, *supra* 10 (documenting details about funds with the strongest reputations for clout and expertise)

[220] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[221] Unitrin v. American General Corp., 651 A.2d 1361 (Del. 1995).

[222] *Unitrin*, 651 A.2d at 1367, 1373.

[223] *Unocal*, 593 A.2d at 755; *Unitrin*, 651 A.2d at 1387.

Theoretically, this kind of attempted negative activism should be encouraged as a policy matter when it ultimately makes the company's shares more valuable. But in practice, we think it would be challenging to identify this type of failed, yet desirable, negative activism ex ante, and selectively subsidize it while still deterring successful negative operational activism. Accordingly, the current regulatory approach, which does not single out this unusual phenomenon, seems appropriate.

CONCLUSION

We have introduced the concept of negative activism, provided a typology of its three main forms, and examined empirically the extent to which it occurs. Using this framework, we have assessed the areas in which current regulation of negative activism is potentially inadequate. In general terms, we favor less regulation of informational negative activism, greater regulation of operational negative activism, and perhaps a more nuanced approach to unintentional negative activism. Our hope is that our framework will prove useful as the field of activist investing continues to evolve.

We conclude by observing that our analysis of negative activism has implications for the ongoing debate about corporate short-termism. On one side of the issue, people like Martin Lipton argue that activists contribute to a "short-term myopic approach to management and investing that promises to impede long-term economic prosperity."[224] For these critics, activism is seen as generally sacrificing long-term value for (attempted) short-term profits, such as by disrupting long-term investments, reducing activities with uncertain distant payoffs, and focusing on quarterly profits rather than long-term growth.[225]

Others see activism as offering positive effects on long-term corporate performance. Lucian Bebchuk, Alon Brav, and Wei Jiang, for example, find empirical evidence that activist interventions result in immediate positive returns which "are followed by long-term improvements, rather than declines, in performance."[226] Activists can improve long-term performance by providing an active check on management, reducing the agency costs that typically exist between management and shareholders. To take two common examples, reducing inefficient long-term R&D investments improves current value and allows capital to be redeployed to

[224] Martin Lipton, *Some Thoughts for Boards of Directors in 2018*, https://corpgov.law.harvard.edu/2017/11/30/some-thoughts-for-boards-of-directors-in-2018/#more-103243 (Nov. 30, 2017).

[225] *See, e.g.*, Ira M. Millstein, Re-Examining Board Priorities in an Era of Activism, N.Y. TIMES, DEALBOOK (Mar. 8, 2013, 3:52 PM), https://dealbook.nytimes.com/2013/03/08/re-examining-board-priorities-in-an-era-of-activism/; Martijn Cremers et al., *Hedge Fund Activism and Long-Term Value*, Dec. 14, 2015, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2693231. For a summary of arguments critical of activism, see Lucian A. Bebchuk, Alon Brav, & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1093–96 (2015).

[226] Bebchuk et al., *supra* note 225, at 1122, 1155.

better uses, while increasing leverage imposes debt servicing costs to hold management's feet to the fire; and reducing cost or other inefficiencies.[227]

The debate about activism's impact on long-term value is still relatively new. But both sides in the debate rely on data about positive activism, and not negative activism. For example, in their recent study supporting on activism's long-term effects, Bebchuk, Brav, and Jiang consider only activism disclosed pursuant to section 13(d) filings,[228] but these filings capture principally long, or positive, activists.[229] Critics of activism have relied on the same dataset,[230] while other like Martin Lipton who generally argue that activists sacrifice long-term gains for short-term returns implicitly consider the case of (attempted) positive activism only, not negative.[231] In other words, the debate to date largely revolves around studying only one subset of activism.

Negative activism adds a new wrinkle to the short-termism debate. Consider arguments by critics of positive activism that there is a disconnect between short-term market reaction and long-term value, with short-term price increases followed by long-term declines. Might then short selling be long-term value enhancing to the extent it is associated with short-term price declines? Or consider arguments by proponents of positive activism that short-term increases reflect expected increases in future corporate earnings. Does it follow that short selling is long-term value destroying? More generally, how should scholars interpret the puzzling ranges of short-term price responses to the announcement of negative activism? How should one measure the potential benefits associated with negative activism that potentially might outweigh the decline in the value of the targeted company's shares? In other areas of law, such as free speech jurisprudence, instances of individual harm are tolerated in furtherance of a more general principle. Might negative activism be yet another example? We look forward to a robust future debate on these and other issues related to negative activism.

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[227] *See* Coffee & Palia, *supra* note 24, at 64-65; Brav, Jiang, Partnoy & Thomas, *supra* note 32.

[228] Bebchuk et al., *supra* note 225, at 1098–1101. Bebchuk et al., discuss their sample of activism in a section titled "The Universe of Hedge Fund Activism." *Id.*

[229] *See supra* notes 115-124 and respective accompanying texts (discussing the scope of section 13(d) requirements).

[230] *See, e.g.*, Cremers et al., *supra* note 225.

[231] *See, e.g.*, Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (Feb. 26, 2013, 9:22 AM) ([V]oting power is being harnessed by a gaggle of activist hedge funds who troll through SEC filings looking for opportunities to demand a change in a company's strategy or portfolio that will create a short-term profit without regard to the impact on the company's long-term prospects.").