Supplementary Material

for

Loss-Driven Activism

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Appendix A. Active (13D) versus Passive (13G) Hedge Funds' Filings

In January 2001, Tocqueville Asset Management filed a Schedule 13G with the Securities and Exchange Commission (SEC) disclosing a 5.4% stake in Systems & Computers Technology Corporation. Blockholders file the Schedule 13G if they own more than 5% of the outstanding shares of a firm and if they are passive investors, that is, if they hold the stock without the intention of influencing the control of the target firm. In April 2003, however, Tocqueville changed its filing status and switched to the Schedule 13D. Blockholders that want to engage with the management must file the Schedule 13D. In the filing, Tocqueville expressed its "dissatisfaction with the current share price," and "strongly urged" the firm "to develop new strategies to enhance shareholder value." At the time of the switch, Tocqueville was sitting on a loss of 39%, or \$10M of its \$25.6M initial investment.

Any blockholder that acquires beneficial ownership of more than 5% of a voting class of a company's equity securities must disclose its holdings in a regulatory filing with the SEC.[1] Hedge funds intending to influence the control of the company are required by law to file the Schedule 13D, while those who want to remain passive file the Schedule 13G. Prior literature uses the Schedule 13D and 13G to identify the hedge funds' active and passive positions (Brav et al. (2008), Greenwood and Schor (2009), Klein and Zur (2009), Edmans et al. (2013), Brav

[1] Section 13(d)(1) of the Securities Exchange Act of 1934.

et al. (2015), Gantchev et al. (2019)) and documents that hedge funds stay passive in the majority of their holdings (Clifford (2008), Edmans et al. (2013)).

If hedge funds have the intention to engage with the management, they are extremely attentive in filing the Schedule 13D, because misstating the true intentions and filing the Schedule 13G instead can lead to lawsuits that can be filed by the SEC, the management of the firm, or by other shareholders. Clifford (2008) provides anecdotal evidence that the SEC and target firms utilize the court to enforce truthful disclosure by blockholders.[2]

On the other hand, Edmans et al. (2013) claim that a passive investor is unlikely to file the Schedule 13D. This filing allows the hedge fund to intervene, but it also requires to disclose costly information that is not required by the 13G filing, such as the amount and the source of funds used to acquire the shares, and the detailed trade information during the 60 days prior to the filing date. Active 13D filers must also declare how they intend to influence the control of the company. Failing to disclose this information can lead to litigation. Furthermore, the Schedule 13D must be filed within 10 days after crossing the 5% threshold, while the 13G allows for a significantly longer delay in disclosure.[3] Both filings require the prompt filing of an amendment if there is any variation to the information previously disclosed in the initial filing. However, 13G filers are subject to less stringent requirements. In particular, the filing of an amendment is triggered by changes in the ownership by more than 1% for 13D filers, and by more than 5% for 13G filers. The lower 13D threshold generally causes the price of the stock to move more promptly against the hedge fund that either wants to increase or decrease its stake, making the 13D filing particularly unattractive for passive investors.

[2] See the case of NACCO industries vs. Applica. Ronson Corp. vs. Steel Partners II (2005) and SEC vs. Montgomery Medical Ventures, LP (1996).

[3] The Schedule 13G must be filed within 45 days after the end of the calendar year in which the hedge fund crossed the 5% threshold. If the ownership exceeds 10% the hedge fund must file the initial Schedule 13G within 10 days after the end of the month in which the ownership exceeds this level.

Hedge funds can decide to change their filing status if their intentions have changed. If, after having previously filed a Schedule 13G, a hedge fund decides to take actions to influence the control of the firm, then it is required by law to publicly disclose that its intentions have changed by switching to the 13D filing (Brav et al. (2015)). In my sample, of the total hedge funds' 13D filings (activist positions), about 20% of them were initially 13G filings (passive holdings). That is, 20% of the activists' 13D filings are actually switches from former passive holdings.

Appendix B. Hedge Funds' Strategies

Hedge funds' strategies vary significantly in the extent to which they engage with the management. Although all hedge funds have the option to engage in activism, several never do so and "focus entirely on trading as this is their core skill" (Edmans et al. (2013)). Jim Simons' Renaissance Technologies, for instance, is a hedge fund that uses quantitative trading. All its holdings are passive, that is, it buys blocks of stocks following quantitative models without the intention to intervene and to become an activist in any of the target firms. Jeff Smith's Starboard Value, on the other side, always follows an activist strategy. Its investment philosophy is to "actively engage with management teams and boards of directors to identify and execute opportunities to unlock value for the benefit of all shareholders" (Starboard Value website). Finally, Barry Rosenstein's Jana Partners is a hedge fund that follows both strategies. "Jana typically applies a fundamental value discipline to identify undervalued companies that have one or more specific catalysts to unlock value. In certain cases, Jana can be the instrument for value creation by becoming an actively engaged shareholder" (Jana Partners website).

Appendix C. Use of the Switches in Prior Literature

Brav et al. (2015) use 299 switches over the period 1994-2007 to identify the real effects of activism over a passive investment. Active and passive investments of the same hedge funds in different firms could not be comparable because of unobservable firm characteristics. The switch overcomes this problem by identifying the treatment effect of activism for the same hedge fund-firm pair. They find that the operating performance of the target firms increases after the switch.

Aslan and Kumar (2016) consider 228 switches from 1996 to 2008 to study the causal effect of activism on rivals' performance. They find negative effects on the market shares and profit margins of rival firms during the three years after the switch.

Boyson et al. (2017) use 159 switches to investigate the channel of value creation of hedge fund activism. They claim that after the switch, the portfolio company has a higher probability of receiving a takeover bid. They conclude that "the hedge fund's activist intervention has an incremental effect in fostering takeovers above and beyond stock picking ability."

Finally, Brav et al. (2018) identify 79 activist campaigns that are the result of a switch. They find that the target firm increases innovation, as proxied by the number of new patents and their citations, after the hedge fund changes its stance from passive to active. They claim that, compared to other tests, the switch provides a cleaner identification of the treatment effect of activism beyond stock picking.[4]

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[4] Kim, Kim, and Kwon (2009) exploit similar disclosure requirements for active and passive blockholders on the Korean market to study the consequences of the switches.