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# Shareholder activism is non-monotonic in market liquidity

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## Abstract

Building on work of Maug [Journal of Finance 53 (1998)], we characterize the relationship between market liquidity and large shareholder activism when a minimum ownership share is required to change the management. We show that the sign of this relationship depends on whether the block constraint is binding. Specifically, the probability of intervention is decreasing in the liquidity of the stock when the constraint is binding (which happens in markets with intermediate liquidity), and it is increasing when it is not (which happens in highly liquid markets). We also show that the probability of intervention is zero in illiquid markets.

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## 1. Introduction

Maug (1998) analyzes the relationship between market liquidity and shareholder activism. He considers a firm with a large shareholder and a continuum of small investors who are subject to liquidity shocks. The large shareholder can increase the firm's value if she changes the management and restructures it at a certain cost. The firm's stock is quoted in a secondary market by a risk neutral and uninformed market maker who sets the share price equal to the expected value of the firm conditional on the information contained in the order flow. The liquidity of this market is directly related to the size of the liquidity

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shocks of the small investors. Maug's main result is that an increase in the liquidity of the secondary market leads to an increase in the probability of intervention of the large shareholder. Exceptions can, however, occur if the minimum ownership share required for restructuring is high.

Maug's claim that the impact of market liquidity on large shareholder activism is in general positive contrasts with the commonly held view. For example, Bhidé (1993, p. 31) argues that "active stockholders who reduce agency costs by providing internal monitoring also reduce stock liquidity by creating information asymmetry problems. Conversely, stock liquidity discourages internal monitoring by reducing the costs of 'exit' for unhappy stockholders." Hence, he concludes, "the benefits of stock market liquidity must be weighted against the costs of impaired corporate governance."

This paper reviews Maug's analysis in order to provide a complete characterization of the effect of market liquidity on large shareholder activism. Specifically, we show that if the size of the required control block is smaller than  $\frac{2}{3}$ , the probability of intervention is zero for low liquidity, there is a negative relationship between market liquidity and shareholder activism for intermediate liquidity, and the relationship is positive in highly liquid markets. Moreover, if the size of the required control block is greater than or equal to  $\frac{2}{3}$  (i.e., a large supermajority requirement), the probability of intervention is always zero.

The intuition for the non-monotonicity result is the following. For any given majority requirement (smaller than  $\frac{2}{3}$ ), the large shareholder has to acquire a sufficient block in order to be able to restructure the firm. When the secondary market is very liquid, this constraint will not be binding, in which case the probability of intervention is increasing in liquidity, because in a more liquid market it is easier to buy shares and profit from the subsequent restructuring. On the other hand, when the secondary market is not very liquid, the block constraint will be binding, which implies that the shareholder must have a larger initial toehold. In such case, an increase in market liquidity relaxes the constraint and reduces the size of the required toehold, which leads to a lower probability of intervention.

We conclude that the impact of market liquidity on corporate governance is ambiguous. Depending on whether block constraints are binding, liquid stock markets may impact negatively on effective governance, as Bhidé argues, or facilitate shareholder intervention, as Maug claims. These results may be useful for formulating testable hypothesis on the determinants of large shareholder behavior, which we believe is an important topic for future research.

## 2. Maug's model

Consider a model of a stock market with three dates ( $t = 0, 1, 2$ ) and three types of risk neutral agents: a large investor, a continuum of small investors, and a market maker. There are two assets: a risk-free asset with return normalized to zero, and the shares of a firm whose value at  $t = 2$  is either  $H$ , if the firm is restructured at  $t = 1$ , or  $L < H$ , if it is not. Only the large investor can restructure the firm at a cost  $c$ , but for this she must hold an ownership share of the stock of at least  $\mu$ . It is assumed that  $c < H - L$ , so the minimum stake  $x$  that allows her to recover the cost of intervention, i.e., that satisfies  $x(H - L) = c$ , is smaller than 1.

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