Discussion for: Do Hedge Funds Exploit Material Nonpublic Information? Evidence from Corporate Bankruptcies

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Summary

- RQ: Can distressed-style hedge funds (HFs) obtain **private information** about the **competitors** of a company undergoing bankruptcy restructuring by participating in the unsecured creditors' committee (UCC)? If so, do they **benefit from this information?**

- Findings
  1. Following their participation in the UCC of distressed firms, HFs demonstrate **increased turnover** and higher probability of **large trades**. Furthermore, these large trades primarily focus on **firms closely linked** to the distressed firms.
  2. No such behaviors are observed when **no UCC** is formed or when a **UCC is formed but the HFs** do not sit the committee

Contribution

- My initial reaction was that many of the analyses were foreshadowed in prior literature
  - One body of prior research demonstrates that **HFs use creative way to gain private information** and profit from it (e.g., Klein et al. 2020)
  - Another stream indicates that institutional investors **acquire private information from the debt market** through activities like loan renegotiation and capitalize on on it (e.g., Massoud et al. 2011; Bushman, Smith and Wittenberg-Moerman 2010; Ivashina and Sun 2011 and etc.)
- But that's not to say that there isn't room to **make a contribution**.
- On the contrary: carefully examining the business model employed by distressed-style HFs strikes me as an important step in gaining a more **comprehensive understanding in the role that HFs plays in the restructure process**

Contribution

- In particular, distressed-style HFs are gaining prominence, and numerous empirical studies provide evidence of their positive impact on restructuring processes.(e.g., Jiang, Li, and Wang 2012; Lim 2015; Elias 2016)
- **<u>This study can contribute in at least two important ways:</u>**
  1. Demonstrate that there are two distinct benefits for destressed-style HFs: **<u>direct</u>** and **<u>indirect</u>**. The direct benefits include trading gains on the underlying firms. The indirect benefits involve obtaining private information about other firms that HFs can leverage
  2. Provide the magnitude/importance of these indirect benefits
     - Is the indirect gains 1%, 50% or 99% of the overall gain? Is the indirect benefits the main or a side show? Is it done to limit downside, while the debt in the underlying firm give option like gains?

Contribution

- The answer to these questions has **important policy consequences**, regulators should be aware distressed-style HF bring benefits to the restructuring process, and if they were to **banning side trading**, it may result in a net social loss
- A side benefit of pitching the paper as studying the business model on distressed-style HFs is that the paper can be **more descriptive** in nature and less focus on addressing **endogeneity**
  - For example, under this framing, it would be meaningful for the authors **compare and contrast** the direct and indirect gains
  - Whereas, if the focus is on trading on private information, unless the indirect gains is order of magnitude larger than the direct gains, it's not very helpful

Key Element # 1 of hypothesis: Private information

- Distressed style HFs gain access to ”private information” by being on the UCC
    - Prior literature demonstrated that institutional investors can uncover private information on the **target firm**, but less clear what kind of information they gain **for other firms**
    - The authors provide empirical evidence supporting this by demonstrating that HFs are more likely to have **large trades** in **economically similar firms (same FF 12 industries, or Hoberg and Phillips industry measures)**
- A perhaps more direct way to identify firms with info. spillover: look for firms that have high co-movement with the distressed firms during earnings announcement OR firms with very ”comparable accounting” (see e.g., de Franco et al. 2011)

Key Element # 2 of hypothesis: Trading on it

- Distressed style HFs trade on these privately obtained information
  - The current draft argues that the traded information is "**material and nonpublic**", making the trading strictly "**illegal**". This also implies a potential **enforcement issue**
- I think the authors can actually **softening** this stand a little
  - Usually private information are **relatively short-lived**, but here it seem to last for 6 quarters, maybe something else is going on
  - For example, being on the UCC helps **direct the attention** of HFs towards significant public information about the competitors of the firms, thereby enabling them to interpret and analyze it effectively (i.e. reduce processing cost)
  - If can observe end of UCC, look at trading after UCC end, if results continue then it's not just private information

Endogeneity

- I think the authors have done an excellent job addressing endogeneity, they have done a battery of tests ruling out many alternative explanations

	UCC	Non-UCC
HF	Treatment	Control
Non-HF	Control	

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	UCC	Non-UCC
HF	Treatment • Table 4 and 5	Control • Table 6: UCC was not formed • Table 7: Pseudo date • Table 8: UCC was formed but HF not part of the UCC
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	UCC		Non-UCC
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Potential ”exogenous” shock

- Over last three decades, there has been multiple courts cases that have marked significant shifts in determining what constitute unlawful insider trading
  - For example, in 2017 the case United States vs. Newman marked a shift in the courts attitude towards what constitute “insider trading” and made it significantly harder for prosecutors to satisfy the bar for insider trading

- **I wonder if these court cases can be used as potential exogenous shocks to incentives for trading on other stocks**

Parallel-Shift UCC Event

- Table 7 create a pseudo event by shifting the UCC forwards by 12 months
- Instead of going forward, I wonder if it's possible to go backwards 6 quarters immediately before the bankruptcy event
- That way the pseudo event does not overlap with the actual event window

Other minor suggestions

- For 13F post 2013, use WRDS SEC Data
- How is turnover calculated? It needs to be change in shares* price. If it's value (t) – value (t-1), then it will be influenced by change in price
- Are results robust to alternative definition of turnover? Like (abs(buy)+abs(sell))/AUM
- How robust are results to other cutoff for large trades? Robust to ranked definition?
- Table 11: how about large trade in firms that are closely linked vs large trade in firms that are not closely linked?
- Are the dates of UCC meetings disclosed? Any examples of the type of information being disclosed in UCC meetings? Maybe look for this in press releases or 8k immediately after Chapter 11

Conclusion

I look forward to reading the final version in a top finance/accounting journal in the near future