Discussion of Risk-Taking, Rent-Seeking, and CEO Incentives by Albagli, Hellwig and Tsyvinski

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Conjecture: IS&M's option to sell firm shares may produce distortion in investment decisions ("short-termism" or "price manipulation")

Is this conjecture compatible with (i) optimal contracts (ii) IS&M rational behavior?

Framework

- θ = shock affecting firm dividend
- u = market noise
- k = Manager's (non-contractible) investment
- $\pi(\theta, k) = R(\theta)k - C(k)$ = firm dividend
- $p(\theta, u, k)$ = REE price

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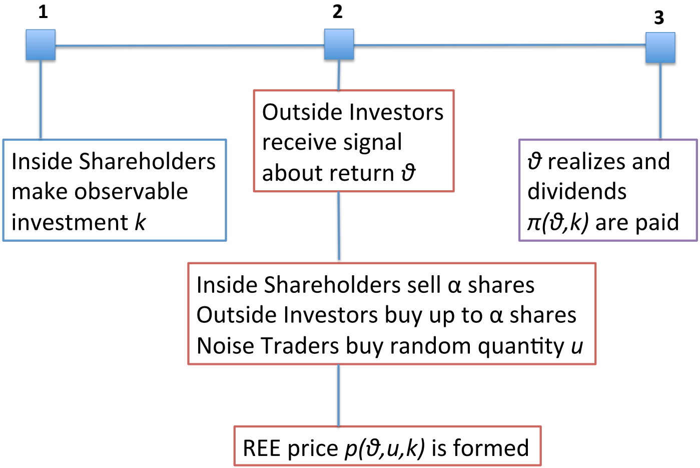
Problem is not "weak" corporate governance, but speculative opportunities exploited by incumbent shareholders

Interests of Insiders and Outside Shareholders may not be aligned

Simple Standard Framework



Basic Set-Up

Model stage 2 as a REE where active traders are:

- Informed Investors receiving private signals x about θ
- Noise traders whose demand is r.v. u (price is not fully revealing)

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REE price is a price function $p = p(\theta, u)$

The Inside Shareholder's Problem

$$\max_k \mathbb{E}[\alpha p(\theta, u, k) \quad + \quad (1-\alpha)\pi(\theta, k)]$$

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Market Power?

Efficient Markets

NO **short-termism** *or* **price manipulation** *if share price is unbiased estimator of firm's fundamental (Eff. Market Hyp.), i.e.:*

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Managers maximize unconditional expected profits because, by deviating from expected profit maximization, they would lower the share price (not in their own interest)

$\Rightarrow$ Efficient Allocation

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- Bolton et al. (2006): investors have different priors about precision of signals and are subject to short-sale constraints

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Solution: Assume limited arbitrage (fixed bounds on allowed asset trades)

Characterizing the REE price:

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Let z be the signal of the marginal investor

$$\text{i.e., } z \text{ is s.t.:} \qquad p = \mathbb{E}[\pi(\theta, k)|z, p],$$

Then, at a REE, $z = z(\theta, u)$ is sufficient statistic for price and

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Key observation:

$$p = \mathbb{E}[\pi(\theta, k)|x = z, z] \neq \mathbb{E}[\pi(\theta, k)|z]$$

$=$ Exp. dividend conditional on public information

Inside Shareholder's Expected Payoff at Stage 1:

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$$\mathbb{E}\left[\alpha p + (1-\alpha)\pi(\theta, k)\right]$$
$$= \mathbb{E}\left[\pi(\theta, k)\right] + \alpha\mathbb{E}\left[\Omega(\theta, k, u)\right]$$

where

$$\Omega(\theta, k, u) = p(\theta, u, k) - \pi(\theta, k) = \text{Info. Wedge}$$

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$$\Omega(\theta,k,u) = p(\theta,u,k) - \pi(\theta,k) = \text{Info. Wedge}$$

If $\mathbb{E}[\Omega] \neq 0$ it may be in the Inside Shareholders' interest to deviate from Expected Dividend Maximization (EDM)

How general is $\mathbb{E}[\Omega] \neq 0$?

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Should the ass. of limited arbitrage be maintained? What role does this assumption play? I would like to see more elaboration on this point!

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- Should not $p \neq \mathbb{E}[\pi]$ induce entry of uninformed risk-neutral investors to exploit profit opportunity?
- Why this type of market inefficiency?

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If Planner gives more weight to Outside Investors than to Inside Shareholders, any deviation from EDM that decreases information wedge will increase social welfare.

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- What is θ?
- Do agents understand how R respond to θ?

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$\Rightarrow$ a risk neutral Inside Shareholder may manipulate prices by affecting the variance of future dividends?

Assume:

- A representative Outside Investor (OI) with quadratic utility
- Inside Shareholder (IS) is risk-neutral
- Define: $\mathbb{E}[\pi] \equiv \bar{\pi}(k)$, $\mathbb{V}ar[\pi] \equiv \sigma_\pi^2(k)$

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Market-Clearing share price

$$p = p(\bar{\pi}, \sigma_\pi^2, u)$$

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$\alpha > 0$ implies inefficiency? Scope for price manipulation?

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- A lot of applications (maybe too many in the paper)
- How relevant is it? Is it useful for quantitative examinations?
- Is it more important than other (maybe more intuitive) factors having similar consequences?