NADIA MASSOUD, York University

Hedge Funds in M&A Deals: Is there Exploitation of Private Information?

This paper investigates recent allegations regarding the misuse of private insider information by hedge funds prior to the public announcement of M&A deals. We analyze this issue by using a unique and comprehensive dataset which allows us to analyze the trading pattern of hedge funds around corporate mergers and acquisitions in both the equity and derivatives markets. In general, our results are consistent with hedge funds, with short- term investment horizons (henceforth, short-term hedge funds) taking advantage of private information and engaging in trading based on such information. We show that short-term hedge funds holdings of a target's shares in the quarter prior to the M&A announcement date are positively related to the profitability of the deal as measured by the target premium. In addition, we also find that the target price run-up before the deal announcement date is significantly greater for deals with greater short term hedge fund holdings. We also find evidence consistent with informed abnormal short selling and put buying in the corresponding acquirer's stock prior to M&A announcements. This is particularly evident when hedge funds take larger stakes in target firms. In addition, we show that such a strategy is potentially very profitable. We consider alternative explanations for such short term hedge fund holdings in target firms; however our results seem inconsistent with these alternative explanations but rather, seem to be consistent with trading based on insider information. Overall, our results have important implications regarding the recent policy debate on hedge fund regulation.