Liquidity and Governance

Kerry Back, Tao Li, Alexander Ljungqvist

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Is greater trading liquidity good or bad for corporate governance? We address this question both theoretically and empirically. We solve a model consisting of an optimal IPO followed by a dynamic Kyle market in which the large investor's private information concerns her own plans for taking an active role in governance. We show that an increase in the liquidity of the firm's stock increases the likelihood of the large investor 'taking the Wall Street walk.' Thus, higher liquidity is harmful for governance. Empirical tests using three distinct sources of exogenous variation in liquidity confirm the negative relation between liquidity and blockholder activism.

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