Liquidity Versus Control: The Institutional Investor as Corporate Monitor

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LIQUIDITY VERSUS CONTROL: THE INSTITUTIONAL INVESTOR AS CORPORATE MONITOR

John C. Coffee, Jr.*

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INTRODUCTION

Within academia, paradigm shifts occur regularly, some more important than others. As the takeover wave of the 1980s ebbs,¹ a significant shift now appears to be in progress in the way the public corporation is understood. Above all, the new thinking emphasizes that political forces shaped the modern corporation. While the old paradigm saw the structure of the corporation as the product of a Darwinian competition in which the most efficient design emerged victorious,²

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¹ The rate of takeovers and other acquisitions has declined significantly and continues to decline. During the first quarter of 1991, merger and acquisition activity declined 18% over the corresponding quarter in the preceding year and hit an eleven year low. See Mergers at an 11-year Low, N.Y. Times, Apr. 18, 1991, at D10. The reasons for this decline are various: The drying up of the junk bond market; restrictive state antitakeover legislation, see infra note 5 and accompanying text; and judicial decisions that have accepted preemptive defensive tactics by target management. See, e.g., Paramount Communications Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989). This decline in takeover activity, particularly as a result of restrictive state legislation, has supplied the impetus, in my judgment, for scholars to consider the thesis that politics, more than economics, shaped the modern American corporation.

² What I am terming the “old paradigm” of the public corporation rests on two basic structural pillars: (1) the view of the public corporation as a private and largely contractual undertaking and thus devoid of much “public law” significance, see, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416 (1989), and (2) the view that the separation of ownership and control is both inevitable and efficient. The separation of ownership and control was first identified by Adolf A. Berle and Gardiner C. Means in their path-breaking book, The Modern Corporation and Private Property (1932). Recent theorists have argued that this separation is efficient because it allows entrepreneurs to obtain capital from risk-neutral shareholders who, because they are diversified, can accept business risks that would deter undiversi-
this new perspective sees political forces as constraining that evolutionary process and possibly foreclosing the adoption of a superior organizational form. Thus, my colleague Professor Mark Roe has argued that the Berle/Means corporation, in which ownership and control are separated, was not "an inevitably natural consequence" of the economic and technological forces that shaped modern capitalism, but rather was an adaptation to political forces that limited the scale, scope, and power of financial institutions.\(^3\) Absent these politically imposed constraints, he suggests, the evolution of the modern corporation might have resulted in the emergence of a very different dominant organizational form, one more nearly resembling the Japanese or German industrial system in which financial institutions are the major shareholders of, and closely monitor, industrial corporations.\(^4\)

Perhaps it should not be surprising that this new focus on political constraints has surfaced just as the combination of state antitakeover statutes and adverse judicial decisions has largely succeeded in eclipsing the hostile takeover as a mechanism of corporate accountability.\(^5\) During the late 1980s, political constraints seemed puny in comparison to the power of the market to drive corporate control transactions, but today the political vulnerability of the takeover movement is obvious. Still, there is an irony to the assertion that political forces crippled the potential monitoring capacity of financial institutions. Academics are raising the claim at the same time that (1) Congress is proposing to repeal or substantially relax the Glass-Steagall Act, which separates commercial from investment banking, and to amend related legislation that restricts interstate branching,\(^6\) and (2) the SEC is proposing to re-
lax its proxy rules to facilitate shareholder collective action, particularly by institutional shareholders. If the public at large has a concern about financial institutions today, it is not their strength, but their weakness, that worries them. To the extent that the public perceives banks as reckless, unstable, or infirm, it may still favor their paternalistic regulation, but the populist image of a domineering J.P. Morgan seems to have been forever erased from the public's mind by the recent wave of insolvencies.

Without challenging the historical accuracy of the thesis that political and ideological forces inhibited the growth of financial monitoring in the United States, this Article doubts that this thesis takes us very far. In particular, its contemporary relevance is undercut by the fact that most of the barriers that confined commercial banks to limited sectors of the economy appear to be facing a demolition that is as sudden and complete as the collapse of the Berlin Wall. More importantly, even if the new theorists are correct in their view that, but for political constraints, U.S. financial institutions could have developed into efficient corporate monitors—much as they believe that they have in Japan, Germany and elsewhere—that this scenario raises two major questions that their political history of institutional development alone cannot adequately answer: (1) Is a similar system of corporate monitoring

ing securities affiliates and to interstate branching. See Stephen Labaton, Riegle Offers a Third Bill on Banking, N.Y. Times, July 17, 1991, at D6. In June, 1991, the House Banking Committee approved legislation that would permit the expansion of banks into both the securities and insurance fields. See Stephen Labaton, House Panel Approves Sweeping New Bank Rules, N.Y. Times, June 29, 1991, at A35. To the extent that restrictions on commercial banks' ability to engage in interstate banking or investment banking was the primary evidence relied upon to prove that political forces constrained the development of financial monitoring in the United States, see supra note 3 and accompanying text, this political theory seems to have limited predictive power.

7. In June, 1991, the SEC proposed to amend its proxy rules under § 14(a) of the Securities Exchange Act of 1934 to facilitate inter-shareholder communications and to reduce the costs of compliance for persons engaged in a proxy solicitation. See Regulation of Securityholder Communications, Exchange Act Release No. 29,315, 56 Fed. Reg. 28,987 (June 25, 1991). This proposed relaxation of the proxy rules was in response to a request made by the California Public Employees Retirement System (CalPERS) that their impact on institutional investors be reexamined. See infra note 46 and accompanying text. In light of the SEC's apparent willingness to relax at least some regulations that burden institutional investors, the overregulation thesis again loses some of its contemporary force.

8. In addition to Professor Roe, I would list Professors Bernard Black of Columbia, Ronald Gilson and Joseph Grundfest of Stanford, and Reinier Kraakman of Harvard as among those academics who have most notably advanced the overregulation thesis that the monitoring capacity of institutional investors has been inhibited by excessive regulation. See sources cited infra notes 10-13 and accompanying text. I should indicate that I do not disagree with them that there has been some overregulation which should be relaxed, but I believe other factors—most notably conflicts of interest, a preference for liquidity, and collective action problems—deserve greater weight in any theory of institutional investor behavior. As a result, deregulation alone is not an adequate policy response.
through institutional investors necessarily efficient or desirable? and (2) In the absence of political constraints, would other causes have impeded the development of a system of institutional monitoring within the United States?

These questions will be the focus of this Article. Although those dissatisfied with the current state of shareholder power in American corporate governance may find foreign models of corporate governance more attractive, the danger in such comparisons is the "grass-is-always-greener" fallacy: one can easily idealize foreign systems and see only their benefits and not their costs. Monitoring by financial institutions does not necessarily mean net gains for other shareholders, but may improve only the position of the monitoring financial institution. Similarly, assigning primary causal significance to political constraints may lead to overlooking deeper and more fundamental reasons why financial monitoring has not developed in the United States. Put simply, the agents controlling institutional investors have considerable reason to remain "rationally apathetic" about corporate governance and little reason to become active participants. Why? Various reasons will be advanced, but one stands out that will be the centerpiece of this Article: a trade-off exists and must be recognized between liquidity and control. Investors that want liquidity may hesitate to accept control.

This assertion—that a preference for liquidity chills the willingness of institutional investors to participate in the control of major corporations—may sound heretical. With only a few exceptions, both practitioners and academics have shared the assumption that institutions are on the verge of becoming active monitors. On the one hand, proponents of the overregulation thesis have argued that SEC and banking regulation has hobbled institutional investors, resulting in high agency costs, weak capital market discipline, and managerial entrenchment. Former SEC Commissioner Joseph Grundfest aptly synthesized the views of these critics in a striking paragraph in a recent article:

America seems not to trust her capitalists. For more than half a century, state and federal governments have limited investors' influence over the governance of publicly traded corporations. Investors' ability to monitor corporate performance, and to control assets that they ultimately own, has been subordinated to the interests of other constituencies, most notably corporate management.10


In a similar vein, John Pound\(^{11}\) and Bernard Black\(^{12}\) have separately examined the legal rules and regulatory policies governing shareholder voting and have reported that this body of law, which was long thought to protect the shareholder's franchise, often operates to frustrate its effective exercise. Other scholars have taken a more activist stance and proposed specific courses of action by which institutional investors can directly influence substandard corporate managements.\(^{13}\) All these new critics tend to favor deregulation of financial institutions so that they can serve as more effective corporate monitors. For many of these critics, the relationship between financial institutions and corporate managements in the German and Japanese economies provides the relevant model.\(^{14}\)

On the other hand, defenders of corporate management seem equally convinced that, unless their power is checked, institutional investors will soon dominate corporate managements.\(^{15}\) As a result, they have advanced a very different set of policy proposals, which seek to subject institutional investors to greater oversight. Typically, these proposals have portrayed institutional investors not as highly constrained and overly regulated entities, but as financial adolescents, recklessly preoccupied with short-term profit maximization. One example is the 1989 Report of the New York State Task Force on Pension Fund Investment, which recommended that public pension funds be subjected to greater legislative control and guidance.\(^{16}\) Others have


\(^{14}\) This is particularly true in the case of Professor Roe. See Roe, Political Theory, supra note 3, at 59–62. See also Gilson & Kraakman, supra note 13, at 876; David P. Hale, Learning from Germany and Japan, Wall St. J., Feb. 4, 1991, at A10 (suggesting that until early in this century, American banks, such as the Morgan Bank, played such a monitoring role). Actually, both sides in the current debate cite the Japanese and German models to support their contentions. See Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187, 218–22 (1991).

\(^{15}\) See infra notes 16–20 and accompanying text.

\(^{16}\) New York State Task Force on Pension Fund Investments, Our Money's Worth: The Report of the Governor's Task Force on Pension Fund Investment (1989). Another even more ominous signal for institutional investors was the passage in 1990 of a Pennsylvania statute under which institutional investors could be forced to disgorge their profits on the sale of a Pennsylvania-chartered corporation’s stock, if they participated in a control group. See infra notes 187–189 and accompanying text. For the
made similar suggestions that (1) pension funds "pass through" their votes to their constituents, 17 (2) corporate managements reassert control over their pension fund investment and voting policies, 18 and (3) institutions invest in stocks principally through vehicles that are allied with corporate management. 19 Alarmed by the power and what they perceive as the short-term mentality of institutional investors, Martin Lipton and Steven Rosenblum have suggested an even more sweeping change: abolition of the annual election of directors in favor of a quinquennial election. 20 In short, two polar views of the institutional investor compete for supremacy today: (1) the academic view of financial institutions as Prometheus chained to the rock by outmoded regulations that serve only to entrench and insulate incumbent managements, and (2) corporate management's image of these same institutions as frenzied gamblers in a financial casino, each competing to outdo the other in short-term performance. Both sides in this debate share the common assumption that, for better or worse, institutional investors would soon dominate corporate managements in the absence of political constraints.

This Article disagrees with that assumption. It will argue that the primary explanation for institutional passivity is not overregulation, but the insufficiency of existing incentives to motivate institutional money managers to monitor. Although proponents of institutional activism have analyzed at length the potential ability of institutional investors to hold corporate managers accountable, they have largely ignored the question of who holds institutional money managers accountable. The problem of who will guard the guardian is a timeless one, but it is particularly complicated when the proposed guardian is the institutional investor. Not only do the same problems of agency cost arise at the institutional investor level, but there are persuasive reasons for believing that some institutional investors are less accountable to their "owners" than are corporate managements to their shareholders. Put simply, the usual mechanisms of corporate accountability are either unavailable or largely compromised at the institutional level. 21

18. A recent trend toward such reassertion of voting control has been reported. See Pension Fund Sponsors Urged to Retain Control of Proxy Voting, 22 Sec. Reg. & L. Rep. (BNA) No. 26, at 979 (June 29, 1990).
20. Lipton & Rosenblum, supra note 14, at 224 & n.53.
21. The point is obvious but fundamental: while corporate managements are sub-
clusion does not deny that there has been overregulation of institutional investors, but it suggests its impact may have been overstated by the new critics. More importantly, this perspective implies that deregulation alone is an inadequate policy response. If the diagnosis that rational apathy will continue to prevail at the institutional level is accurate, then the law must intervene to correct the market's failure by creating adequate incentives for institutional managers to monitor.

This Article will therefore explore possible strategies by which agency costs can be reduced at this second level in order that institutional investors will more effectively monitor corporate managements. But the larger problem of the institutional investor's role in corporate governance cannot be telescoped simply into one of reducing agency costs at the fund manager level. Rather, the nature of that role is itself problematic. In one key respect, American institutional investors are unlike both individual shareholders in the United States and the financial monitors in Japan and Germany. Potentially, American institutional investors have the capacity to unite liquidity and control. Although institutional investors do not appear to have achieved such a
union in any modern industrial economy to date, it is within reach in the United States in the near future—if institutional investors are "unleashed."

Thus, we return to a major concern of this Article: is such a union of liquidity and control desirable? Do we want the institutional monitor to have the same ability to exit the firm costlessly as does the individual shareholder? Would the institutional monitor who possessed such liquidity undertake the often costly burden of monitoring? These are difficult questions, but the choices are not limited to a simple yes or no. Rather, public policy could choose any of a number of possible positions along a continuum that runs from allowing investors to combine liquidity and control to requiring an election between them. This Article will seek to evaluate some of the risks and related considerations that should be weighed in making any choice.

To point to the dangers in uniting liquidity and control is not to reject, however, the claim that overregulation of institutional investors is both possible and undesirable. In fact, three distinct hypotheses can explain the passivity of institutional investors: (1) an "interest group" story that views regulation chilling institutional investor participation in corporate governance as the product of low-visibility political coalitions between management and other groups; 22 (2) a collective action story that views the costs of organizing dispersed investors to be sufficiently high as to make them rationally apathetic about participation in corporate governance; 23 and (3) a public interest story suggesting that pub-

22. Essentially, commentators such as Jensen, Pound, Roe, Black, and Grundfest, tell such a story (although they do not deny that collective action problems also exist). See supra notes 3, 8–13. State antitakeover legislation seems easily explained on this basis. See Romano, supra note 5, at 458–65.

23. This form of explanation begins with the work of Mancur Olson and focuses on the problems of dispersed shareholders in organizing to take action that is in their collective interest. See Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups 55–56 (2d ed. 1971). See also Russell Hardin, Collective Action (1982). Professor Rock relies on essentially such an argument to explain institutional passivity. See Rock, supra note 9, at 453–63. To define the collective action problem, it is useful to distinguish it from the problem of agency costs. Agency costs arise because the interests of shareholders and managers can conflict (over salary, corporate policy or whatever); thus, both shareholders and managers must undertake some costs to minimize these conflicts of interest through monitoring and bonding expenditures, and some losses will in any event remain because their prevention is too costly. The sum of these costs and the residual loss is called "agency costs." See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 308–10 (1976). In contrast, the collective action problem arises as soon as there is more than one owner. Corporate monitoring is an example of what economists call a collective good; that is, it benefits all shareholders whether or not they pay for it. See Robert C. Clark, Corporate Law § 9.5, at 389–400 (1986). Rationally, shareholders would prefer to "free ride" on the efforts of others than to subscribe to their pro rata share of the costs of corporate monitoring. Large shareholders will, however, subscribe to these costs to the extent that their share of the expected payoff exceeds the costs they must incur, thus permitting smaller shareholders
lic-regarding legislation and administrative rules have long and wisely resisted the union of liquidity and control. Although recent critics have focused on the first explanation, this Article will stress the second and third. None of these explanations is necessarily inconsistent with the others, but the latter two have received less attention, as economic theorists, always suspicious of regulation, have tended to view the regulation of financial institutions as intended to entrench corporate managements.

Yet there are demonstrable problems with the simple overregulation story. In fact, a close comparative analysis demonstrates that the actual limitations placed by American law on financial institutions as investors are not significantly more restrictive than, for example, the applicable laws in Japan and certain other comparable economies. Nor is it at all clear that in an unregulated legal environment, financial institutions will necessarily develop into corporate monitors. Thus, the assumption that—but for regulatory and political constraints—American financial institutions would have evolved into controlling shareholders, as German and Japanese banks have arguably done, seems shaky.

Equally important, the overregulation thesis simply overlooks the liquidity/control trade-off. Only once the uniqueness of the American context is understood can one assess intelligently this Article's claim that the union of liquidity and control would be socially undesirable. Both the German and Japanese economies (as do many others) depend on internal capital markets, as opposed to the external capital markets to free ride on their monitoring efforts. For example, if expenditures by shareholders of $1,000,000 would yield benefits of $2,000,000, it would not be rational for a 25% shareholder to expend $1,000,000, because it would benefit only to the extent of $500,000. But if the gains to shareholders exceed $4,000,000, then the 25% shareholder will rationally expend $1,000,000 (and thereby confer a benefit on the dispersed, but “free riding,” small shareholders). The key implication of a collective action analysis is that shareholder resistance to managerial actions that are adverse to their welfare will often be underfunded, because of the difficulty in taxing the “free riders.”


25. Although unconstrained by legal restrictions, banks in the United Kingdom have not developed into active corporate monitors, and institutional investors seldom hold more than 1%-2% of the stock of any individual corporation. See infra notes 143–147 and accompanying text. Even in Germany, where institutional investors are little regulated, they do not own a higher percentage of equity securities in individual corporations than current U.S. law would permit a bank holding company to own. See infra notes 99–102 and accompanying text.

26. One qualification here is necessary: federalism did restrict the growth of financial institutions in the United States. Because each state could charter banks and prevent the entry of out-of-state competition, the result was a highly fragmented financial industry in which even leading institutions could not grow to the same scale as Japanese and German banks. Federalism is not, however, a regulatory constraint that can be explained under an interest group theory that gives corporate management a central role, because use of the corporate form arose well after the adoption of the U.S. Constitution.
LIQUIDITY VERSUS CONTROL

that characterize the United States and the United Kingdom. In such internal capital markets, industrial firms obtain the bulk of their capital from a very limited number of capital suppliers in direct negotiations. In consequence, these capital suppliers have both greater leverage and less liquidity than do institutional investors in the United States. To some degree, this system of internal capital markets may be breaking down with the growth of an international capital market that will give all large firms access to public capital markets. But the critical point is that institutional investors in the United States have a degree of liquidity that their European and Japanese counterparts largely lack. At present, any attempt by institutional investors in the United States to exercise control over corporate managements will entail a probable sacrifice of this liquidity, which may be an unacceptable cost to them. Put more generally, when faced with the choice, U.S. institutional investors have traditionally preferred liquidity to control. This empirical observation leads in turn to a broader, normative contention: liquidity and control are antithetical. American law has said clearly and consistently since at least the 1930s that those who exercise control should not enjoy liquidity and vice versa. Ultimately, this Article will defend the proposition that the separation of liquidity and control is not only a cause of institutional passivity, but to some degree should be. In short, those institutions that most desire liquidity would make poor monitors.

Nor should this contention seem surprising: most other industrial societies seem to have reached a similar resolution (either by legal rule or by business adaptation). From a comparative perspective, advanced industrial economies can be classified along a continuum ranging from those, such as Japan and Germany, that permit financial institutions to control corporate managements, but effectively deny them liquidity, to those that inhibit institutional control, but maximize their liquidity. On such a continuum, the dominant American organizational form—the Berle/Means public corporation—represents the latter pole: investors have only limited ability to control management, but near-perfect li-

27. One recent survey finds that in Germany there are only 497 German corporations listed on the eight German stock exchanges, and of these “not more than 100” lacked a controlling shareholder. Similarly, in France, only “around 460” corporations (out of nearly 135,000 stock corporations chartered in France) were listed on the Paris Stock Exchange. This same pattern holds true also in Belgium, which has 35,000 stock corporations, but only 190 listed on the Brussels Stock Exchange. See Klaus J. Hopt, Takeover and Other General Bids in European Law 4 (paper delivered at conference sponsored by University of Ghent on May 30, 1991) (on file with the Columbia Law Review). In sharp contrast, there are some 2450 British corporations listed on the London Stock Exchange, even though the British economy is much smaller than that of either Germany or France. Id.

The point here is that because relatively few German or French corporations are publicly traded (and even those firms typically have a controlling stockholder or stockholder group), financial institutions that hold a substantial equity stake in these firms lack liquidity by definition.

28. See infra notes 221–223, 247–267 and accompanying text.
quidity in deep and relatively stable financial markets. The oft-repeated "Wall Street Rule" expressed the basic equilibrium that until recently prevailed: dissatisfied investors could sell, but they could not effectively challenge management. 29

The tension between liquidity and control can also explain why the historic passivity of the institutional investor is declining. Today, the press reports on an almost daily basis that institutional investors are displaying a new activism. 30 Clearly, some institutions—most typically, public pension funds—sponsor shareholder proposals, lobby state legislatures, and, in a few cases, support insurgents in proxy contests. 31 What explains this new activism? On a theoretical level, the trade-off between liquidity and control is simply a context-specific application of Albert O. Hirschman's famous generalization that the members of any organization face a choice between "exit" and "voice." 32 If an easy, low-cost "exit" is possible (such as that provided by securities markets), the members will rationally have little interest in exercising a more costly "voice." But if "exit" is blocked, the members will become more interested in exercising a "voice" in governance decisions. From this perspective, the new activism of American institutional investors can be explained as the product of "voice" becoming less costly, because of the growth in institutional ownership of securities and the resulting increased capacity for collective action, while "exit" has become more difficult, because institutional investors, who increasingly own large unm...
liquidate these blocks.33 These trends toward greater "voice" and lesser "exit" seem likely to continue for institutional investors.34 As a result, greater institutional activism is predictable, even in the face of a static legal environment.

The trade-off between "exit" and "voice" also suggests a regulatory strategy: restrict "exit" to encourage "voice." Undoubtedly, such a policy could be carried too far and might at some point induce institutional investors to prefer alternative investments to equity securities. Still, the new critics of regulation have not recognized the reverse side of this coin: simplified "exit" may mean less "voice." At a minimum then, a strategy for deregulation should accord a priority to relaxing those rules that inhibit "voice," while exercising considerable caution before making "exit" easier.35 In other words, rather than "unleashing" institutional investors en masse, the more sensible policy may be a selective one: deregulate first those institutions most likely to exercise "voice" rather than seek "exit."

This Article is divided into four parts. Part I surveys the relationship of financial institutions to corporate managements in several advanced industrial economies, particularly Germany and Japan. It finds that (1) ownership and other legal restrictions similar to those now said to hobble U.S. financial institutions also exist in many of these countries, but generally have had only a modest impact; (2) the relative control of financial institutions over industrial corporations appears to be declining in both Japan and Germany as successful corporate managements exploit international capital markets or retain cash flow in order to escape close monitoring and the conflicts posed by bank ownership;36 and (3) in those economies where financial institutions do dominate corporate managements, the industrial structure is organized around internal capital markets,37 thus making the "exit" option un-

33. For the conclusion that pension funds "cannot dispose of large blocks of stock easily" and face increasing illiquidity as their holdings grow, see Millstein, supra note 19, at 15. In addition, exit is less attractive because institutions have come to realize that they cannot outperform the market (at least without accepting additional risk). This is the central insight of the Efficient Capital Market Hypothesis, and based on it many institutions have turned to "indexed" investing, which implies a buy-and-hold policy. See infra notes 236–239 and accompanying text.
34. See infra notes 226–243 and accompanying text.
35. There may also be other diseconomies associated with uniting liquidity and control. An earlier era used the pejorative term "pools" to describe loose associations among large investors, which were thought to be able to manipulate securities prices. Prevention of such manipulation was a major focus of the Securities Exchange Act of 1934. See infra notes 221–223 and accompanying text.
37. The term "internal capital market" has been widely used to refer to the allocation of capital within a large conglomerate through bureaucratic decision-making centralized in the office of the chief executive. In theory, senior management redirects cash flows received from its subsidiaries and divisions to those having the best future prospects. See Oliver E. Williamson, Markets and Hierarchies: Analysis and Antitrust Impli-
available. The contrast between internal capital markets in Japan and Germany and the more developed external capital market in the United States casts considerable doubt on whether foreign economies provide relevant models for future regulatory reform within the United States. Part II assesses the extra-legal factors that have retarded participation by institutional investors in corporate governance in the United States and concludes that a strategy of deregulation is likely to produce only modest results. Part III considers the potential diseconomies that might follow if deregulation were to permit investors to combine liquidity and control. Finally, Part IV asks how regulation might encourage the development of institutional monitoring, particularly in light of the rise of "indexed" investing. Indexed investors, who may hold securities in a thousand or more corporations, have largely abandoned "exit," but also find the exercise of "voice" infeasible because their extensive holdings exceed their capacity to monitor. Part IV therefore suggests that new mechanisms must be created to make monitoring both feasible and mandatory. Although Part IV is not necessarily optimistic about the prospect of active institutional monitoring developing in the near future, it does outline the legal prerequisites necessary before indexed or other widely diversified institutional investors are likely to play an active monitoring role: First, "excessive" diversification must be discouraged; second, investment management services should be "unbundled" from monitoring services, so that a true market in the latter can develop; and, finally, incentive compensation formulas that align the interests of the institutional money manager, as agent, with those of its principal and thus encourage monitoring should be authorized and implemented. This may sound like a visionary, rather than realistic, scenario for reform. Perhaps it is, but it is less idealized than the expectation that, in the absence of such changes, institutional investors will naturally behave like individual shareholders who hold large equity stakes.

I. A COMPARATIVE EXAMINATION OF THE INSTITUTIONAL INVESTOR

Part I briefly examines the position of institutional investors in the United States and contrasts it with that of similar institutions in other developed economies. Part I begins with the United States and then
moves from internal capital market economies, such as Japan and Germany, to the purest example of an external market economy, Great Britain. Midway along this continuum are Sweden and Canada. Despite active stock markets in these nations, the rise of institutional ownership has produced defensive responses by corporate managements that effectively prevent the union of liquidity and control. Necessarily, this Part’s treatment of each country is incomplete and, in some respects, cursory. The intent, however, is (1) to contrast the essentially internal capital markets that characterize Germany and Japan with the external capital market in the United States, and (2) to note the institutions and practices that have developed in those other countries that have external capital markets in order to mediate conflicts between institutional investors and corporate managements.

A. The United States

As a result of Columbia University’s Institutional Investor Project, reliable statistical data on institutional ownership is now available. This data demonstrates that the percentage of equity in United States corporations held by institutional investors has skyrocketed, particularly during the last decade. In 1950, institutional investors owned only 8% of the equity in United States corporations. By 1980, this level had risen to 33%, and by 1988, it had reached 45%. Institutional ownership is disproportionately heavy at the upper end of corporate America. Among the top one hundred American corporations in terms of stock market value, the level of institutional ownership is now at 53%. Among some of the largest and best-known corporations, the percentage of institutional ownership nearly swallows the market, for example: General Motors Corp. (82%), Mobil Corp. (74%), Citicorp (70%), Amoco (86%), and Eli Lilly & Co. (71%).

39. The Institutional Investor Project is under the auspices of the Center for Law and Economic Studies at the Columbia University School of Law.

40. See Carolyn Kay Brancato & Patrick A. Gaughan, The Growth of Institutional Investors in U.S. Capital Markets (Nov. 1988). This study has been partially updated as of 1990. See Carolyn Kay Brancato, The Pivotal Role of Institutional Investors in Capital Markets, in Institutional Investing: The Challenges and Responsibilities of the 21st Century 3, 17–19 (Arnold W. Sametz ed., 1991) [hereinafter Brancato, Pivotal Role of Institutional Investors]. As Professor Black has pointed out, the definition of institution used in the Brancato study is incomplete, because it excludes investment banks, bank holding companies, and certain trustees. See Black, supra note 12, at 567 n.168. Thus, institutional ownership is probably even slightly higher than these numbers reveal.


42. See Carolyn Kay Brancato, The Momentum of the Big Investor, Directors & Boards, Winter 1990, at 38 [hereinafter Brancato, Big Investor]; Brancato, Pivotal Role of Institutional Investors, supra note 40, at 21. Perhaps more importantly, 29.6% of the companies in this top 1000 had institutional ownership levels above 60%. Id.

43. Brancato, Big Investor, supra note 42, at 39 (table listing percentage of institutional ownership of top fifty U.S. corporations). An earlier study by Professor Conard
The level of institutional ownership looks even greater from the perspective of the institutions themselves. As my colleague Professor Bernard Black has calculated, the thirteen largest institutions each held, on average, over 1% of the United States stock market at the end of 1989 and together the top fifty institutions owned 27%. Many institutions now own 2–3% of the stock of a single company, he reports, and some hold over 5%. Calculating the data a different way, another colleague, Professor Louis Lowenstein, has examined the Form 13F filings made by institutional investors with the SEC and found that for the average corporation listed in the Standard & Poor's 500, "it takes just twenty institutional holders to account for 34% of the outstanding stock." On this basis, it is entirely possible that twenty or fewer institutions could hold de facto control of a major industrial corporation without any individual institution acquiring so large a block as necessarily to impair its liquidity. Viewed in these terms, it may appear that the union of control and liquidity has already occurred.

Yet if one looks only at the size of institutional holdings, one may commit the classic mistake of confusing an ox for a bull. Although public pension funds are "bulls" who often engage in aggressive, outspoken criticism of corporate management, they constitute only a modest minority of institutional investors. Most other institutional investors seem closer to "oxen," because they have shown little willingness to oppose corporate managements or even to support dissidents in proxy

shows institutional ownership levels in publicly traded securities reaching up to 90%. Thirty companies in a sample of 100 randomly chosen exchange-listed firms had institutional ownership levels over 60%, and sixty had levels over 40%. See Alfred F. Conard, Beyond Managerialism: Investor Capitalism?, 22 U. Mich. J.L. Ref. 117, 132 (1989).


45. See Louis Lowenstein, Sense and Nonsense in Corporate Finance (forthcoming 1991) (manuscript at ch. 11, p. 3, on file with the Columbia Law Review). In truth, this calculation might underestimate the level of institutional ownership because it considers only institutional investors and only those required to file Form 13F. Thus excluded are individual owners and smaller institutions. Under Rule 13f-1, 17 C.F.R. § 240.13f-1 (1991), "institutional investment managers" having investment discretion over at least $100 million in certain defined equity securities must file Form 13F quarterly.

46. By some estimates, pension funds now hold as much as 40% of all equities. See Jay O. Light, The Privatization of Equity, Harv. Bus. Rev. Sept.–Oct. 1989, at 62–63. However, of the total assets controlled by pension funds, it is generally estimated that corporate pension funds control one half; public pension funds, one third; and the balance is held by union pension funds and funds of non-profit entities. See Letter from Richard Koppes, General Counsel, CalPERS, to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission 3 (Nov. 3, 1989) (on file with the Columbia Law Review) [hereinafter, CalPERS Letter]. CalPERS is an abbreviation for the California Public Employees' Retirement System. See also, America's Shareholders Break into the Boardroom, The Economist, Apr. 29, 1989, at 75 (public pension funds control $600 million of the $2 trillion in assets controlled by all pension funds).
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contests.\textsuperscript{47} Indeed, some evidence suggests that a high level of institutional ownership correlates with greater managerial success in proxy contests.\textsuperscript{48} Even the most enthusiastic proponents of institutional shareholder activism recognize that institutional investors historically have not opposed corporate management, but usually have supported them against insurgents.\textsuperscript{49} Despite recurrent press stories about the activism of institutional investors,\textsuperscript{50} most antitakeover amendments still pass,\textsuperscript{51} and surveys show that institutions support management proposals between 59\% and 74\% of the time.\textsuperscript{52} What is clearest, however, is that, within the United States, different institutions behave differently: public pension funds and, to a lesser degree, mutual funds and endowments appear "pressure resistant" and frequently vote against management, but banks and insurance companies seldom are willing to oppose management.\textsuperscript{53} The reasons for these differences are assessed later,\textsuperscript{54} but even those institutions that are described as the most "pressure resistant" appear eager to project themselves as "friendly" long-term investors.\textsuperscript{55} The bottom line to date then is that while some institutions have become more assertive in the limited context of takeover defensive tactics, their activism has not spread beyond this special arena nor led them to seek participation in corporate governance generally.\textsuperscript{56}

\textsuperscript{47} Recently, there has even been a decline in proxy fights for corporate control. From 41 contests in 1989, the number fell to 35 in 1990, and only 12 were under way by mid-March 1991. See Leslie Wayne, Behind the Drop in Proxy Fights, N.Y. Times, Mar. 19, 1991, at D10. See also With M&A in the Doldrums, Proxy Fights Plummet, Corp. Control Alert, May 1991, at 1 (noting 15 proxy contests under way at mid-year).

\textsuperscript{48} See John Pound, Proxy Contests and the Efficiency of Shareholder Oversight, 20 J. Fin. Econ. 237, 256-60 (1988). Pound's study relies on data from the early 1980s, which may be out of date. See Black, supra note 12, at 606.

\textsuperscript{49} See Gilson & Kraakman, supra note 13, at 892-93 ("Not only have institutional investors failed to oppose management's candidates for the board with their own nominees, but many institutions have even voted with management in proxy fights, including the Texaco and Lockheed contests. . . .").

\textsuperscript{50} See supra note 30.

\textsuperscript{51} See Jeffrey W. Biersach, Voting by Institutional Investors on Corporate Governance Issues in the 1990 Proxy Season 13 (IRRC). Admittedly, the margin by which they pass is slim, and managements do not propose amendments they think likely to fail.


\textsuperscript{53} See James A. Brickley, et al., Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267, 276-79 (1988); Biersach, supra note 51, at 3, 10.

\textsuperscript{54} See infra notes 180-191 and accompanying text.

\textsuperscript{55} For such an evaluation of the Fidelity group of mutual funds, see Henriques, supra note 31, at 10.

\textsuperscript{56} For example, only in extremely rare occasions have institutional investors sought to elect representatives to corporate boards. See id. at 10 (discussing general reluctance of Fidelity group to have representation on corporate boards). Indeed, in one recent case in which an executive of a major institutional investor agreed to serve as an insurgent group's nominee for election to the USX board, his employer appears to
B. Japan

To understand the relationship between financial institutions and industrial corporations in Japan, some history is necessary. During the early decades of the twentieth century, the zaibatsu—family-owned, bank-centered holding companies—expanded through both vertical integration and diversifying acquisitions. These institutions have been described as "the world's first multinational conglomerates."57 By the eve of World War II, they held most corporate equity and debt in Japan. During the occupation of Japan, the American authorities liquidated the zaibatsu, expecting that American-style public corporations would evolve in their absence.58 As part of this effort to decentralize economic power, a Japanese equivalent of the Glass-Steagall Act, which separates commercial and investment banking in the United States,59 was imposed on Japan. Under section 65 of Japan's Securities and Exchange Act of 1948,60 a Japanese bank may not engage in investment banking, and under section 11 of Japan's Anti-Monopoly Act,61 a Japanese bank may not own more than five percent of the stock of any domestic corporation.62 Ironically, these restrictions were even more clearly intended to prevent the concentration of economic power than have been angered. See Quirk's Role in Icahn Proxy Fight Lands them in Hot Water With Prim Board, Vol. XV Money Mgmt. Letter (No. 25) Dec. 10, 1990 at 1.

CalPERS is probably the leading exception to this generalization. As of late 1989, it reported that it had sponsored 28 shareholder proposals, and it has sought to reform the proxy rules. See Letter from Dale M. Hanson, Chief Executive Officer of CalPERS to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission 1 (Nov. 3, 1989) (on file with the Columbia Law Review) [hereinafter CalPERS Letters]. Yet, even CalPERS has not sought to fund or sponsor proxy contests for the election of directors.


58. During the post-World War II occupation of Japan, the American authorities required that the equity in the constituent members of the zaibatsu conglomerates be sold to Japanese individuals. As a result, on the reopening of the Japanese stock markets in the late 1940s, individuals held more than 69% of the outstanding shares in Japanese corporations. Viner, supra note 57, at 55.


61. Shiteki dokusen no kinshi oyobi kosei torihiki no kakuho ni kansuru horitsu (An act regarding the prohibition of private monopolies and the maintenance of fair trade), § 11(a), Law No. 54 of 1947 [hereinafter Anti-Monopoly Act].

62. Originally, the Anti-Monopoly Act placed the maximum level at 10%, but this was reduced to 5% in 1977. Banks were given until December, 1987, to divest excess holdings. See J. Mark Ramseyer, Legal Rules in Repeated Deals: Banking in the Shadow of Defection in Japan, 20 J. Legal Stud. 91, 99 n.21 (1991). I am grateful for the assistance of Professor Haruhiko Katagi of Hiroshima University for explaining the Japa-
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were the restrictions imposed on American banking institutions, which today prevent an American bank holding company from owning more than five percent of the voting stock of any nonbanking company.63

Yet, in Japan, these restrictions failed. Because the American occupational authorities underestimated the power and centrality of the banks within the *zaibatsu* confederations, they did not insist on the liquidation of these institutions, and this omission eventually resulted in the reemergence of a looser regrouping of the former *zaibatsu* interests.64 These successor coalitions became known as "*keiretsu.*"65 The internal structure of the *keiretsu* varies with the industry or the relationship upon which the coalition is based, but typically each consists of a diversified confederation of companies clustered around a "main bank" that provides loans to the members of the group as their chief source of financing. Although the main bank in the *keiretsu* is usually both a major shareholder and the principal creditor of the members of its constellation of companies,66 its position is clearly distinguishable from that of the parent company in a large American conglomerate, because the main bank—the putative "parent" in the *keiretsu*—is in turn owned by its subsidiaries and affiliates. It is probably more accurate to think of the *keiretsu* as a miniature common market in which each member generally relies on the others as its principal trading partners, preferring them to external sources as suppliers, customers, and creditors.

The legal force knitting together this structure is a system of inter-

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64. Viner, supra note 57, at 55–56.

65. There are today six major *keiretsu* groups in Japan. Three of these (Mitsui, Mitsubishi, and Sumitomo) are descended from former *zaibatsu*, while the other three are newer groups that have formed around major banks (Fuyo-Fuji, Dai-Ichi Kangyo, and Sanwa). The number of firms within a group varies widely, from the Sumitomo group's 16 to the Dai-Ichi Kangyo group's 57. See William G. Ouchi, The M-Form Society, app. at 290–91 (1984). The word "*keiretsu*" is derived from the words "*kei*" meaning "faction or group" and "*retsu*" meaning "arranged in order." See Viner, supra note 57, at 2. For a more detailed examination of the internal structure of a *keiretsu*, see Hiroshi Okumura, Interfirm Relations in an Enterprise Group: The Case of Mitsubishi in Kazuo Sato & Yasuo Hoshino, The Anatomy of Japanese Business, 166–75 (1984) (describing relations among 120 "principal allied companies" and over 300 subsidiaries of Mitsubishi group).

66. A recent study reports that, on average, a Japanese company's largest debtholder owned 6.2% of the company's equity; that the five largest debtholders owned 18.2% of the equity; and that out of 133 companies surveyed, the largest debtholder was the largest shareholder in 57 cases or was a member of the same *keiretsu* as the largest shareholder in an additional 67 cases. See Stephen D. Prowse, Institutional Investment Patterns and Corporate Financial Behavior in the United States and Japan, 27 J. Fin. Econ. 43, 46–47 (1990).
locking cross-ownership under which each constituent company owns from 0.5 to 3% of the equity in each other member in the keiretsu, thereby effectively locking control within the group.\(^{67}\) Originally, these reciprocal stock acquisitions were financed through loans provided by the main bank in the combine, and each member in the keiretsu understands that it may not dispose of the shares it owns in other members of the group.\(^{68}\) It is estimated that between 65% and 70% of the stock in all listed companies on the Tokyo Stock Exchange is now held in such interlocked cross-ownership.\(^{69}\) Indeed, because the stock held by the members of the keiretsu is illiquid, the float on many Japanese stocks is extremely thin and is held almost exclusively by individual investors.\(^{70}\) Over the years, the percentage of individual share ownership of all listed companies on Japanese stock exchanges has declined steadily, from 70% during the early days of the occupation to 22% today.\(^{71}\)

In terms of this Article’s focus on the trade-off between liquidity and control, the Japanese system seems based on an implicit understanding that liquidity is unavailable to those who participate in control. That is, individual investors and certain other non-controlling institutional investors do enjoy reasonable liquidity (albeit in a volatile market), but they have no hope of acquiring control or exercising significant influence over management.

Still, this explanation leaves the role of the main bank in the keiretsu ambiguous. Clearly, its role is pivotal, but who is it allied with? Several scenarios are plausible. First, the main bank could be providing consulting and monitoring services that benefit the minority shareholders and for which the latter reward the main bank by granting it preference in servicing the corporations’ financial needs (possibly at above market interest rates or fees). Such a deal might well be in the minority shareholders’ interests, depending on how generous the above market terms were, because it would reduce agency costs at the corporate manage-

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67. Id. at 56. A 1983 study found that the average shareholding of any single group member in other group members is down to 1.78% of each company’s outstanding stock, with each company holding stock in an average of half of all the other companies in the group. See Ouchi, supra note 65, at 291.

68. Viner, supra note 57, at 56. Of course, explicit agreements not to resell are unnecessary. A member of a keiretsu that sold stock in its fellow members could both lose its principal trading partners and customers and alienate a group holding the majority of its stock. Thus, its management would become vulnerable to ouster.

69. Viner estimates that 65% of the stock is held by other keiretsu members. Id. at 56. A more recent estimate is 70%. See Steven Barber, A Close Circle of Friends, Institutional Investor, Feb. 1991, at 35 (citing Robert Zielinski & Nigel Holloway, Unequal Equities: Power and Risk in Japan’s Stock Market (1990)).

70. Again, estimates vary. Viner estimates that “only an average 30 percent of the total float of shares in listed companies is traded.” Viner, supra note 57, at 328. A more recent estimate is 22%. See Barber, supra note 69, at 35. This may help explain the high volatility that has long characterized the Japanese stock market.

71. See Barber, supra note 69, at 35. For an earlier estimate that it had fallen to 25% as of 1985, see Viner, supra note 57, at 100–01.
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A second possibility is that the main bank could ally itself less with minority shareholders than with the incumbent management and receive above-market fees and interest for protecting them. A third interpretation postulates still another quid pro quo: the main bank lends to the corporate borrower at an attractive rate in return for the latter's agreement to support the bank's share price by purchasing the bank's securities in the secondary market. From this perspective, the main bank is less a financial monitor than a co-conspirator in stock manipulation. Still, whatever the scenario offered, only an implicit contract exists between the participants, and the main bank may on occasion defect and switch sides. Thus, whatever coalitions exist may to a degree be unstable.

Interestingly, although Japanese scholars have not framed the question of the main bank's role in terms this blunt, they have recognized the possibility that the main bank protects managerial interests more than shareholder interests. For example, one of the most popular explanations within Japan for the development of the keiretsu form of organization was that it protected wage differentials under which employees of keiretsu member firms received substantially higher wages than employees of smaller, independent firms. In a stockholder-controlled firm, employees presumably would be less able to escape the market's disciplinary effect on their wage rates. To the extent that this explanation of above market wages is valid, the main bank seems less an efficient monitor for its fellow shareholders than an ally of the incumbent management.

Another well-known theory asserts that the main bank provides a substitute for the bankruptcy and corporate reorganization procedures that have developed in the United States to reduce bankruptcy losses.

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72. See Marshall Auerback, Japan Inc.'s Days Are Numbered, Wall St. J., Sept. 3, 1991 at A18. By the of 1989, the free float in most Japanese bank stocks had fallen to as low as 8% of the total market capitalization, thus permitting price-earnings ratios to soar to “stratospheric multiples of 70, 80 or even 160.” Id. Because of special accounting rules, a high stock price enabled Japanese banks to engage in riskier lending activities, in which non-Japanese banks could not engage. With the 1989 stock market crash in Japan (in which the Nikkei Stock Averages fell a total of 42%), Japanese corporate borrowers found bank credit more difficult to obtain and in return, with less liquid funds, were less able to support the price of their main banks. Auerback suggests that the gradual unwinding of this reciprocal agreement “adds up to a death knell for Japan's cross-shareholding structure.” Id. At a minimum, it suggests that a large equity stakeholder need not necessarily be an efficient financial monitor, but may have other incentives.

73. See Okumura, supra note 65, at 175–76. Another theory was that it permitted the enterprise to engage in riskier activities. Id. at 176.

74. It can be argued that the keiretsu members pay above-market wages to induce their employees to invest in firm-specific human capital. Yet this argument seems implausible in the Japanese context, where full-time employees typically have life tenure. That is, employers both inside and outside the keiretsu have the same incentive to induce lifetime employees to invest in the acquisition of firm-specific human capital.

75. Okumura, supra note 65, at 177 (“Bankruptcy and the Corporation Reorganiza-
Assume that the main bank in the *keiretsu* is committed to bailing out any failing member, and, in return, is permitted to charge an above market interest rate on its loans to member firms. Who benefits most from such an arrangement? In economic terms, such a relationship is best described as an "implicit insurance contract." In the words of one expert, "The main-bank/corporate-borrower relation can be viewed in terms of the firm paying insurance premiums to the bank in normal times in the expectation of receiving assistance in times of corporate downturn." Yet would rational shareholders wish to pay such a premium to obtain this insurance? The answer is probably no, because shareholders can diversify to protect themselves from losses and so would not want expensive insurance purchased from banks at the price of above-market interest rates. The logical answer, then, is that this implicit insurance contract chiefly benefits the management of the borrower and the main bank, at the other shareholders' expense.

For some, this managerialist theory is implausible. They instead view the *keiretsu* as a continuation of a traditional Japanese form of organization, one that reflects Japan's social character with its much-noted emphasis on cooperation and a desire for stability. But of all possible theories about the *keiretsu*, this is the most tenuous. The surprising fact—to Westerners—is that Japanese firms regularly switch their main banks and smaller Japanese firms even switch their affiliations between *keiretsu* groups. So much for the picture of unchanging stability. As in the West, corporations quickly gravitate to the cheapest supplier of capital and seek to limit their dependence on any one firm.

How effective is the *keiretsu* as a monitoring system? In general, bank monitoring in Japan appears to be relatively slack and focused largely on the danger of insolvency or sustained unprofitability. Such a finding is consistent with the view that the *keiretsu* serves the interests of management more than shareholders. Interestingly, contemporary accounts stress that the stronger, more successful Japanese corporations have largely escaped bank control. Professor Ramseyer notes that once the Euromarket developed as an alternative source of credit, "Japanese Law are, in fact, being used by big enterprises as weapons for enterprise affiliation.".

76. See Ramseyer, supra note 62, at 111.
77. Id. at 111–12 (quoting Australian economist and Japanese scholar Paul Sheard, *Main Banks and Internal Capital Markets in Japan*, 157 Shoken Keizai 255 (1986)).
78. This is Professor Ramseyer's conclusion also. See id. at 112 n.66.
79. Ramseyer notes that over a five year period, 15% of a sample of the firms listed on the Tokyo Stock Exchange switched their main bank affiliation, and over a ten year period, as many as 33% may have. Id. at 98 n.18. Moreover, in the electric machinery industry, one-fifth of the subcontractors changed their affiliation with their general contractor each year. Id.
80. See James C. Abegglen & George Stalk, Jr., *Kaisha, The Japanese Corporation* 189 (1985) ("The conclusion is that dependence on a bank is no more to the liking of Japanese management than management in other countries, and for leading Japanese companies no longer a significant issue."). Strong firms can spread their borrowings
Japanese firms deserted the banks in droves. Absent a crisis, direct involvement by the main bank in the management of a member of the keiretsu is rare today. Only when a member firm in the keiretsu becomes financially distressed or otherwise embarrasses its colleagues does the main bank step in and reorganize the firm. In such a case, the main bank typically will insert its own executives into positions of control and even temporarily assume a direct management role in order to avert bankruptcy.

In sharp contrast to American institutional investors, the Japanese main bank seems relatively unconcerned about maximizing the current share value of the members of its keiretsu. Japanese corporations historically have paid dividends equal only to approximately ten percent of the par value of their stock, and dividend yields as a percentage of the market value of shares are much lower, usually between one and two percent of market value. These figures would be extraordinarily low for most U.S. corporations. More importantly, they may suggest that Japanese firms are pursuing an inefficient empire-building policy that hoards "free cash flow" that might be more efficiently paid out to shareholders. Indeed, during the 1980s, as Japanese corporations escaped their dependence on their main banks, their debt/equity ratios fell significantly.

Such a pattern in the United States might attract a between several banks "to ensure that no one bank will exert undue influence on the corporation." Id. at 166 (discussing Hitachi).

81. Ramseyer, supra note 62, at 98. Professor Ramseyer also finds that Japanese firms have recently developed multiple banking relationships to reduce their former dependence on their main bank. See id. at 107–08.

82. See Abegglen & Stalk, supra note 80, at 166–67. In a recent example, the Sumitomo Bank Ltd. sent in its own managers to rescue Itoman & Co., "a heavily indebted trading company closely affiliated with the bank," which was on the brink of bankruptcy. See Masayoshi Kanabayashi & Marcus W. Brauchli, Sumitomo to Send Managers to Help Troubled Itoman, Wall St. J., Nov. 19, 1990, at Al1. Eventually, Sumitomo, which held less than 5% of Itoman, forced the ouster of the latter's president, a former Sumitomo employee whom the bank had lent to Itoman to oversee its rehabilitation after a prior financial crisis. See James Sterngold, Ouster of Realty Leader Jolts Corporate Japan, N.Y. Times, Jan. 26, 1991, at 32.

83. See Abegglen & Stalk, supra note 80, at 169.

84. Id. at 184.

85. "Free cash flow" basically refers to income after debt service and the acceptance of investment projects having a positive net present value (using the firm's cost of capital as the discount rate). See Michael C. Jensen, Agency Costs of Free Cash-Flow, Corporate Finance, and Takeovers, 76 Am. Econ. Rev. 323 (1986). When a firm undertakes an investment project that has a negative net present value (that is, an expected rate of return below its cost of capital), it will reduce the market price of its shares. In short, proceeds for which the firm lacks an attractive investment use should be paid out to shareholders as dividends, but a firm that seeks to maximize growth, rather than shareholder value, will hoard such cash flow. Professor Jensen argues that the excessive retention of free cash flow was a major cause of the takeover and LBO waves in the United States of the 1980s. See id. at 328–29.

86. See Ramseyer, supra note 62, at 97 n.16 (ratio of new capital borrowed from financial intermediaries fell from 74.3% in 1960s to 60.4% in 1980s).
hostile takeover (at least until recently), because unused borrowing capacity can fund shareholder distributions or can finance a takeover. But hostile raids are virtually unknown in Japan, where, after all, the majority of the stock is locked up in friendly hands. Nonetheless, dissatisfaction among Japanese institutional investors with low dividend yields has recently become open and public, as Japanese insurance companies in particular have criticized corporations with low dividend payouts.\(^{87}\)

In this light, the Japanese model of financial monitoring is less clearly a more efficient organizational form and may represent a mechanism for managerial entrenchment. The foregoing description suggests an industrial structure in which agency costs are high, as above-market wages are prevalent and substantial insurance payments are made to protect against an insolvency risk that concerns managers more than investors. Indeed, the very structure of the *keiretsu* seems designed to ensure weak monitoring. Because the main bank holds an ownership level that is below five percent by definition, it must secure the consent of its fellow *keiretsu* members before it can take disciplinary action or remove senior management. Yet these other members share a common interest in restricting main bank interventions in the internal affairs of each member to occasions in which the demonstrated delinquency of a member firm threatens the *keiretsu* as a whole.

The evidence on the *keiretsu*, however, is not clear-cut. Rational economic motives can also explain why the main bank that dominates the *keiretsu* tolerates managerial slack in its member firms. From an efficiency-oriented perspective, one can hypothesize that the deliberate use of minority public ownership permits some capital market discipline. The advantage of minority ownership is that the members of the *keiretsu* are not all lumped together on an aggregate basis. Instead, if one firm has better prospects or a superior track record, the market can price its publicly traded shares at a premium. Such market signaling may affect the allocation of capital within the group or indicate the need for outside intervention. Alternatively, Professor Masahiko Aoki, a noted Japanese economist, has argued that the relatively weak control exercised by banks over industrial corporations in Japan is efficient because it complements the internal organizational character of the Japanese firm.\(^{88}\)

One hard fact supports either theory: At least prior to Japan's 1989 stock market decline, Japanese shareholders enjoyed a

\(^{87}\) See Chiharu Okajima & John Taylor, Tokyo Stock Slide Triggers Shareholder Rebellion, IRRC Global Shareholder, Autumn 1990, at 5. The veiled threat made by some of these insurance companies was that unless payouts increased they might sell their holdings in the lowest paying firms. Such concentrated selling might collapse the firm's stock price. Insurance companies appear to be the one institution in the Japanese markets that parallels an American institutional investor.

\(^{88}\) See Masahiko Aoki, Toward an Economic Model of the Japanese Firm, 28 J. Econ. Lit. 1, 14–18 (1990).
very high annual after-tax market rate of return. Nonetheless, one may well ask whether the keiretsu system was responsible for this rate of return or, rather, whether the rate of return was responsible for shareholder tolerance for the keiretsu system. In any event, the irony is that if the Japanese keiretsu system is efficient, it seems to work well only within its special context and, according to Aoki, largely because it relies on a relatively passive and deferential style of monitoring.

Still, even if accepted, these arguments do not necessarily imply that the main bank is an efficient corporate monitor. Because the bank's position as a debtholder may outweigh its position as an equity holder, which cannot exceed five percent, it may be risk averse and want cash hoarded within the firm paid out as dividends. Or, it may use its controlling position to exact above-market interest rates on the loans it makes to member firms in its keiretsu, and may tolerate a managerial preference for empire-building in return. Clearly, this hypothesis suggests not optimal monitoring but a conflict between the interests of the main bank and the minority shareholders in the firm. For this Article's purposes, the basic point is that a substantial investor's willingness to incur significant monitoring expenses does not necessarily imply that it will act in the interest of the minority shareholders. Rather, it may behave opportunistically, such as by charging above-market interest rates. In short, a system that relies on institutional investors as monitors could simply substitute a new set of agency cost problems for the traditional problem of managerial opportunism.

Some observers believe that the keiretsu mode of organization is gradually disappearing in Japan. They report that few of the most successful Japanese multinational corporations over the last several decades have been members of traditional keiretsu. More importantly,
these observers note that the period of tightest control of Japanese corporations by financial institutions was during the 1950s and 1960s when Japan was still recovering from World War II and capital was scarce. By the mid-1980s, they note, the roles had reversed:

With greatly increased liquidity in the Japanese economy, and with stronger company balance sheets, this system has changed. Banks must now solicit attractive borrowers, and find themselves providing funds to the weaker companies, in which their powers remain considerable. The most successful of Japan's companies . . . are hardly under bank control. The leading companies have little debt, and they can choose their bank sources.

In short, the control of financial institutions is strong in times of capital scarcity, but weak otherwise. As discussed later, the same characterization can be applied to the relationship between Germany's "universal banks" and its industrial corporations. The rise of an international capital market may spell the end for financial monitors in internal capital markets.

C. Germany

Even more than in Japan, German corporations depend upon their banking system for access to all forms of external finance. The German stock markets are used by relatively few German corporations (402 as of 1988), and even these firms obtain only a small proportion of their capital by issuing exchange-listed securities. Of the German firms that do trade in the public market, fewer than one hundred lack a con-

93. Abegglen & Stalk, supra note 80, at 188–89.
94. Id. at 189.
95. See infra notes 108–116 and accompanying text.
96. See John Cable, Capital Market Information and Industrial Performance: The Role of West German Banks, 95 Econ. J. 118, 119 (1985). Bank borrowing is the largest single external source of capital (20% of total enterprise funds), and banks also handle most new issues of marketable securities, placing substantial proportions of them with their customers. See id.
97. A 1989 study conducted by Coopers & Lybrand for the British Department of Trade and Industry provides the best comparative data on the size of the European stock markets and the role of institutional investors in them. It found: "Germany's stock markets have never been a significant factor in the equity raising process as companies have traditionally relied upon long term loans from their primary banks as the major source of finance." See 2 Department of Trade and Industry, Barriers To Takeovers in The European Community 16 (1989) [hereinafter, Coopers & Lybrand Report]. Whereas the U.K. had 1804 publicly traded domestic corporations listed on its stock exchanges as of the end of 1988, Germany had only 402. 2 id. at 26. Another revealing statistic is that the total capitalization of the London Stock Market in 1988 was 587.6 billion (in European Currency Units), as compared to 205.8 billion for Germany, 190.4
trolling shareholder or shareholder group. In short, investors who pursue liquidity have little chance at participating in control.

Unlike the Japanese banks, German banks are merchant banks that handle both commercial banking and securities underwriting. Yet, bank domination of German industrial corporations does not result from outright ownership, because German banks in fact own under 5% of the stock of the largest one hundred German corporations. Rather, control is effectively held by the major German banks because they provide the country's stockbrokerage services, and shares in German corporations are generally deposited by their owners with the banks, which can vote the shares on behalf of their owners. As a practical matter, the German proxy voting system produces a functional analogue to the Japanese keiretsu. Because of it, German banks exercise nearly 34% of the total voting power in the top one hundred German corporations and over 50% of the total voting power in the ten largest companies. Once again, we encounter a puzzle: despite the absence of legal restrictions, German banks own no more stock on a percentage basis than do Japanese banks—or than U.S. bank holding companies billion for France, and 115.6 billion for Italy. Thus, the U.K. market capitalization exceeds the total of the next three largest markets.

Institutional investors other than banks appear to play a relatively insignificant role in corporate finance in Germany, and fund managers are particularly unimportant. The Coopers & Lybrand Report sets forth the following breakdown of funds under discretionary management as of 1986: U.K. (580 billion pounds); France (148 billion pounds); the Netherlands (147 billion pounds); West Germany (142 billion pounds). See Hopt, supra note 27, at 4. The Coopers & Lybrand Report estimates that the combined holdings of the two largest classes of institutional investors in Germany (banks and insurance companies) accounted for 21% of the ownership of publicly held German corporations as of the end of 1988. See 2 Coopers & Lybrand Report, supra note 97, at 26. No other class of institutional investor had significant holdings. Hence the overall level of institutional ownership of German corporations is around half that in the United States.

99. Cable, supra note 96, at 120. No legal restriction requires German banks to hold ownership to this level. Recently, this percentage has fallen to around 3.2% in the case of exchange listed firms. See infra note 112 and accompanying text.

Interestingly, German banks do not appear to provide much new equity finance for their corporate clients. The Coopers & Lybrand Report finds that in 1987 financial institutions across Europe provided new equity finance according to the following breakdown: France ($15 billion); Italy ($2.8 billion); the Netherlands ($0.7 billion); United Kingdom ($21.6 billion); West Germany ($5.5 billion). 2 Coopers & Lybrand Report, supra note 97, at 13. In short, British banks (at least in 1987) provided nearly four times as much equity finance as did their much larger German rivals. Instead, German banks appear to provide primarily debt finance to their clients. Possibly, this is a consequence of the limited liquidity available to banks in the German economy or of the desire of those holding control not to dilute their control position.

100. See 2 Coopers & Lybrand Report, supra note 97, at 13-14.

101. See Cable, supra note 96, at 120. Based on this voting power, German banks hold 9.8% (through their officers and agents) of the total seats on the supervisory boards of the one hundred largest German companies. 1 id. at 119.
Bank supervision of corporate managements in Germany has been described as close and intensive. One observer reports that:

Through the exercise of voting rights the big banks greatly influence hirings and firings in West German corporations' executive bodies, the supervisory boards; as well as on managing boards. They have a voice in all fundamental business decisions. ¹⁰³

This greater interest in "voice" seems easily explainable in terms of this Article's framework of analysis: because German banks lack liquidity, as a result of the relatively undeveloped state of the German stock markets, they are compelled to exercise "voice." Commentators characterize the relationships between the three major German banks and their corporate clientele as "very close and stable" and note that the problem of "[s]hort-termism" does not arise. ¹⁰⁴

How effective is the German system of monitoring? The available empirical evidence indeed suggests that it does benefit minority shareholders. One recent statistical study of the largest German corporations finds a "significant, positive relationship between the degree of bank involvement in leading industrial companies and their financial performance." ¹⁰⁵ Regression analysis suggests that these results are not explainable simply in terms of the market power or credit advantages that these corporations obtain from their banking associations. ¹⁰⁶ Rather, the explanation that works best to explain the German data is that bank monitoring reduces agency and information costs applicable to these corporations and results in their exhibiting "greater conformity to cost-minimising, profit-oriented goals." ¹⁰⁷

Still, even if the German system works well, it may be rapidly changing. The balance of power between German financial institutions and German industrial corporations seems to be shifting in the latter's favor. During the 1970s and 1980s, large German corporations (the Aktiengesellschaften) appear to have escaped their former dependence on the universal banks as a source of debt capital. ¹⁰⁸ Debt/equity ratios shifted correspondingly, but, even more importantly, the development

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¹⁰² See supra note 63 and accompanying text.
¹⁰⁴ Id. at 790. See also 2 Coopers & Lybrand Report, supra note 97, at 14 ("banks' representatives [on the board] are not viewed suspiciously... but are gladly welcomed").
¹⁰⁵ Cable, supra note 96, at 130 (study of 48 leading German corporations).
¹⁰⁶ See id. at 129–30.
¹⁰⁷ Id. at 121.
¹⁰⁸ The share of bank credits and loans in the overall capital position of the Aktiengesellschaften fell from 16.9% in 1974 to 6.6% in 1984. In the chemical sector, it fell from 18.4% to 4.0%, and in the electronics sector from 16.3% to 2.8%. See Josef Esser, Bank Power in West Germany Revised, 15 W. Eur. Pol. 17, 23 (1990).
of international capital markets allowed German industrial corporations to select their creditors and hence escape their traditional monitors.\textsuperscript{109} Between 1976 and 1986, the number of German corporations in which the universal banks jointly held a 10\% or greater equity stake fell from 129 to 86,\textsuperscript{110} and by the end of 1986, this aggregate ownership amounted to only 0.7\% of the capital of all German non-banking firms (down from 1.3\% ten years earlier).\textsuperscript{111} Among German firms having a stock exchange listing, the average equity stake held by German banks similarly fell from 4.5\% to 3.2\%.\textsuperscript{112} Furthermore, the representation of German banks on the supervisory boards of the hundred largest firms fell to 7\% of the board members by 1989.\textsuperscript{113} At least one close observer reports that management had succeeded "in usurping the controlling function of the supervisory boards."\textsuperscript{114}

Even more striking has been the behavior of Germany’s leading universal bank, Deutsche Bank, which has voluntarily begun to relinquish its chairmanships on the supervisory boards of German corporations.\textsuperscript{115} Why should it abandon the chairmanship of these boards, when by all accounts the chairman wields the greatest influence and performs the principal monitoring role on the supervisory board? A partial answer is that the Deutsche Bank repeatedly found itself caught in conflicts of interest. With the appearance of an incipient merger and acquisition movement in Germany, some have speculated that Deutsche Bank wanted to avoid entanglements with corporations that might prevent it from financing, or engaging in, such takeovers.\textsuperscript{116} Still, a more general explanation is possible that focuses on the declining profitability to Deutsche Bank from monitoring: Deutsche Bank’s
disengagement from the supervisory boards it formerly chaired may be a direct consequence of the greater reliance of German corporations on international capital markets. Monitoring is often costly, including both the direct costs of supervision and the indirect opportunity costs of lost business which conflicts of interest required the Deutsche Bank to forgo. In the past, the German universal banks may have been compensated for their monitoring services by virtue of the near monopoly position they held as the sole or primary provider of capital market services to German corporations. As an international capital market brought competition and a lower cost of capital to German corporations, however, it also made monitoring less profitable for the German universal banks. In short, unless shareholders can compensate an institutional monitor (either through above-market interest rates or some other means), the amount of monitoring provided may decline.

D. Intermediate Cases: Sweden and Canada

Sweden and Canada provide interesting case studies because each reveals the adaptive responses to which corporations can resort when they are exposed to direct monitoring by institutional investors in a developed external capital market. The Swedish economy has both a well-developed stock market and a high level of takeover activity. As in the United States, there has been a dramatic recent increase in the level of institutional ownership. Between the 1960s and 1988, individual ownership of stock in Sweden fell from roughly 70% to 23%. The balance of the stock in Swedish corporations is held by a diverse group of institutional investors, with investment companies and insurance companies constituting the largest categories.

Yet another trend is equally noticeable in Sweden: over the same period that institutional ownership has risen, stock has become concentrated in the hands of small control groups assembled by management or the firm’s founders. In 1978, the largest single owner of a Swedish

117. In 1985, the Swedish Government authorized the Minister of Industry to appoint a parliamentary commission to study stock ownership and control. The Commission on Stock Ownership and Efficiency submitted its report in 1988. An English-language summary of that report has been prepared. See Rolf Skog & Mats Isaksson, Ownership and Control in the Swedish Business Sector (Institutional Investor Project, Columbia University School of Law, 1989). It reports that, of the 200 “major” companies in the private sector in Sweden, approximately half were listed on the Stockholm Stock Exchange. Id. at 3. These companies “accounted for about 90% of the total number of employees in the 200 private sector companies.” Id.

118. Of the 90 major companies listed on the Stockholm Stock Exchange in 1978, 40 were taken over by other companies by August, 1988, with three-fourths of these transactions occurring after 1983. See id. at 16. Skog and Isaksson do not indicate whether these takeovers were “friendly” or “hostile”; however, they do note that in 29 cases a change in company control occurred.

119. Id. at 5.

120. As of year-end 1985, Swedish stockholders fell into the following categories:
"major" company accounted on average for 20% of the equity; by 1985, this figure had risen to 29%. The five largest shareholders together held 41% of the equity in 1978, but 56% by 1985.\footnote{121}

These figures actually understate the degree to which control of Swedish corporations has been locked up in a very small group of controlling shareholders. Under Swedish law, corporations may issue two classes of common stock with different voting rights.\footnote{122} Thus, ownership of equity does not imply equivalent voting rights. When one looks instead at the concentration of the voting stock, one finds that in 1978 the largest single holder averaged 27% of the voting stock, but this figure had risen to 39% by 1985.\footnote{123} Similarly, the top five shareholders combined averaged 48% of the voting power in 1978, but 66% by 1985.\footnote{124} Once an additional adjustment is made for stock held by affiliated companies, the largest owner's share of the voting power rose from 34% in 1978 to 47% in 1985, and the top five owners' voting power together rose from 51% in 1978 to 69% in 1985.\footnote{125}

In short, the typical Swedish firm has either a single shareholder or a closely affiliated group which clearly holds control. More importantly, this trend toward consolidation of control occurred concomitantly with the rise of institutional ownership. Thus, at least viewed from a distance, Swedish institutional investors may have liquidity, but apparently not control.

A closer look at the transition in Sweden reveals that control has been insulated from capital market discipline by a variety of less visible measures as well. First, Sweden has developed a system of cross-ownership and circular ownership of stock that closely resembles the

<table>
<thead>
<tr>
<th>Category of Owner</th>
<th>Percentage of Total Stock Market Value</th>
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<tbody>
<tr>
<td>Individuals</td>
<td>25%</td>
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<tr>
<td>Mutual funds</td>
<td>1%</td>
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<tr>
<td>Payroll investment and national investment funds</td>
<td>5%</td>
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<tr>
<td>Listed investment and holding companies</td>
<td>16%</td>
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<tr>
<td>Non-listed investment and holding companies</td>
<td>3%</td>
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<tr>
<td>Insurance companies</td>
<td>11%</td>
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<tr>
<td>Pension and employee investment funds</td>
<td>4%</td>
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<tr>
<td>Listed non-financial companies</td>
<td>9%</td>
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<tr>
<td>Non-listed nonfinancial companies</td>
<td>2%</td>
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<tr>
<td>Foundations</td>
<td>9%</td>
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<tr>
<td>National and local governments</td>
<td>2%</td>
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<tr>
<td>Other institutional owners</td>
<td>5%</td>
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<tr>
<td>Foreign owners</td>
<td>8%</td>
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\[100\%\]

\footnote{121}{See id. at 13.}
\footnote{122}{See id.}
\footnote{123}{Id.}
\footnote{124}{Id.}
\footnote{125}{Id. at 13–14.}
Frequently, Company A owns stock in Company B, which owns stock in Company C, which owns stock in Company A. A Swedish Parliamentary Commission found the levels of such reciprocal ownership varied from 2% to almost 50% and averaged 14%. Second, dual-class voting schemes have come into increasing use over the last decade. By 1985, 75% of major companies had adopted such a scheme. Obviously, both devices—cross-ownership and dual-class voting stock—are means by which management or a controlling family can entrench itself. Finally, Sweden restricts the voting power that investment funds, insurance companies, and pension funds may possess in any single company.

In terms of this Article's analysis, Sweden's significance lies in the separation it has effected between liquidity and control. Institutional investors appear to dominate the stock market in Sweden, but they do not control individual companies. The high rate of takeover activity in Sweden shows that control can pass to other nonfinancial corporations, but institutional investors appear to have accepted liquidity in lieu of control.

The Canadian experience resembles Sweden's. Much like the United States and Great Britain, Canada has an active stock market and takeovers are common. But, unlike either country, Canada has experienced a recent and rapid concentration of stock ownership in the hands of controlling shareholders. A Royal Commission on Corporate Concentration reported in 1978 that of Canada's 100 largest non-financial corporations, 48% were either wholly owned (usually by a foreign corporation) or were controlled by a majority stockholder. This breakdown appears to have understated the level of control because it overlooked those firms subject to minority control through a de facto controlling shareholder. A later 1985 study found that nine Cana-
dian families held control over 46% of the top 300 companies traded on the Toronto Stock Exchange. Even more recent data shows that only 20 of Canada's 400 largest public corporations are widely held, and some 380 have a single shareholder with at least a 15% holding (and in 374 of these, a conglomerate or family holds between 25% and 30% of the stock). The Canadian experience thus resembles the Swedish, but with the difference that the vehicle holding control is not typically another non-financial corporation, but a family dynasty.

E. United Kingdom

The British capital markets match those of the United States in being extremely active and well-developed. Institutional ownership is increasing, and has long been higher in the U.K. than in the U.S. Thus, the United Kingdom comes closest to an economy that offers investors both liquidity and control. Still, there are other significant differences between the U.K. and the U.S. that militate against the uniting of liquidity and control in British markets. First, it is estimated that the major pension funds hold 60% of the equity in U.K. corporations, whereas the corresponding U.S. figure is only 20.4%. Although British pension funds can be active and substantial shareholders, and indeed in one recent case have even launched a successful takeover, observers report that they are in general long-term holders who do not need "the overnight liquidity of the stock market." This is logical because, unlike mutual funds, pension funds do not face shareholder redemptions; nor are they engaged in an active competition for investors' funds. Moreover, there are structural differences between the type.
ical U.K. pension fund and its U.S. equivalent. U.K. funds typically invest more heavily in long-term, illiquid assets, including real estate and foreign stocks.¹⁴¹ British funds also tend to do most of their investing through "in-house staffs,"¹⁴² while the normal U.S. practice is for the funds to allocate the management of their assets among several investment advisers, thereby effectively staging a competition among them. Arguably, the use of internal money managers and the absence of competition in the U.K. may reduce the pressure for short-term performance.

Another fact about British institutional investors is more striking: although unrestricted by legal constraints, individual institutional investors seldom hold more than one to two percent of the stock of any corporation.¹⁴³ Why not? The most plausible explanation for this self-imposed limitation is that larger-sized blocks would render them illiquid. Institutional investors often share the same views and thus trade in a herd-like manner.¹⁴⁴ Because British pension funds make up a disproportionate amount of the British financial markets, a fund that held a large block of stock might find it necessary to accept a substantial block discount. In this light, a decision to limit holdings to a low percentage of each issuer's outstanding stock reflects the preference of British institutions for liquidity over control.

Because Britain has long had a level of institutional ownership that exceeds the current U.S. level,¹⁴⁵ its experience with the growth of institutional ownership may foreshadow future changes and trends within the U.S. corporate environment. British institutional investors tend to act collectively through umbrella institutions when dealing with corporate managements. Four "Industry Associations"—covering pension funds, insurance companies, unit trusts, and investment companies, respectively—have developed, in part to share the expenses and political burden of confronting and opposing individual corporate managements.¹⁴⁶ When an emergency situation arises—such as a takeover de-

¹⁴¹. See Barry B. Burr, British Lead In Investing Abroad, Pensions & Investments, July 23, 1990, at 14. Some 81.4% of the assets in the typical British pension fund are allocated to stocks, as contrasted to 45.1% for the 200 largest U.S. pension funds. See id.

¹⁴². Id.


¹⁴⁴. Thomas concludes that because institutional investors in Britain tend to hold an "identity of view" (that is, they tend to trade the same way at the same time) the liquidity of the British equity market has been diminished. See id. at 18. This could, in turn, explain why institutions restrict themselves to small stakes of under 2%.

¹⁴⁵. In 1975, British institutions owned 45% of all British equities, which is about equal to the current U.S. level of institutional ownership. Today, British institutions own over 63%. See supra note 136.

fense—the four associations will form a “case committee” to deal with the particular corporate management. In addition, the Bank of England plays a behind-the-scenes mediating role when tensions arise between dissatisfied institutional investors and corporate managements that appear to have been underperforming. This collective strategy is in sharp contrast to the classic Wall Street Rule, under which dissatisfied institutions dump their shares into the market and move on. Arguably, this pattern shows that (1) institutional investors will exercise greater “voice” when their ability to “exit” is diminished, and (2) to exercise “voice,” some protective mechanism must evolve that spares them from head-on, one-to-one confrontations with corporate managements.

F. An Initial Summary

Three fundamentally different kinds of relationships between institutional investors and corporate managements can be posited based on the foregoing survey. The first is the internal capital market. For the present at least, the external capital markets that typify the United States and the United Kingdom remain unique. In other major economies—most notably Japan and Germany—the allocation of capital to corporate users is determined principally by internal capital markets. These internal capital markets maximize the monitoring power of financial institutions, but the monitoring process remains relatively consensual, not hostile, and the trip wire for external intervention tends to be the approach of insolvency, not the failure to maximize stock price. Moreover, financial institutions undertake external intervention gradually and generally as a last resort. Even when it occurs, disruption is carefully minimized, and control eventually returns to internal management, after, perhaps, the replacement of the most senior level of the incumbent management. By contrast, monitoring in external capital markets often involves hostile contests for corporate control that are

147. See id. Further research is needed on the role played by these industry associations. They may also serve to dissuade individual members from liquidating their holdings.
148. See Taylor, supra note 41, at 80.
149. As Professor Aoki observes, within the Japanese firm, bank monitoring follows a gradual progression from first raising questions to later intervening as a shareholder, to, finally, removing the senior executives, but even then, typically replacing them from within the firm:

   If the profit of a company starts to decline, the main bank is able to detect the problem at a rather early stage through information gained from the management of commercial accounts, short-term credits, long-term personal contacts with top management of the company and its business partners, and so on, because of its special position. Tacit and explicit pressure for the internal overhaul of management would be initiated in exchange for various types of rescue operations as noted before. If bad states continue, the main bank may decide to take over management through the governance structure of the company. . . . Recent experiences indicate, however, that banks do not change the
triggered simply by a share discount. Typically, such discipline results in the substitution of an entire external management team for the incumbent senior management.

The second form of relationship begins with the deterioration of the first. Reliance on internal capital markets is diminishing with the growth of a single international capital market. In both Japan and Germany, there is evidence that corporate managers are gradually escaping the control of a single financial monitor by moving to diversify their credit sources. As this happens, the independence of financial monitors is increasingly compromised because they must begin to market their services to corporate managements against active competition. In turn, as profits erode, financial monitors may begin to cut back on those monitoring services for which they feel inadequately compensated. From this perspective, the days of internal capital markets may be numbered. Unless special means can be found to compensate them for their monitoring services, financial monitors, such as the German universal banks, may survive only under circumstances of capital scarcity—such as post-war Europe and Japan—where they hold control over access to capital.

The third relationship is less stable: as financial monitors—such as the German universal banks or the Japanese main banks—face increasing competition, they may begin to strike new alliances. If they cannot offer their clients lower cost capital than can the international markets, they can provide management with other services that may justify special compensation, such as protection from hostile takeovers. To describe this scenario is also to recognize that financial monitors need not ally inherently with minority shareholders.

The rise of the institutional investor to a controlling position is by no means inevitable. Defensive alliances are also possible between corporate managements and other shareholders. As the Canadian and Swedish experiences show, even in economies with external capital markets, structural defenses can evolve that insulate managements from the full impact of capital market discipline. In other major economies, the level of public ownership remains simply too small to enable institutional investors to discipline corporate management.

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150. For a detailed discussion of the view that takeovers are motivated by a margin (or "share discount") between a firm's liquidation value and its stock market value, see Reinier Kraakman, Taking Discounts Seriously: The Implications of 'Discounted' Share Prices as an Acquisition Motive, 88 Colum. L. Rev. 891 (1988).

151. On the general subject of shifting alliances within the public corporation and defections among allies unable to reach enforceable agreements, see John C. Coffee, Jr., Unstable Coalitions: Corporate Governance as a Multi-Player Game, 78 Geo. L.J. 1495 (1990).

152. The Coopers & Lybrand Report finds that of over 200 listed companies in
LIQUIDITY VERSUS CONTROL

The foregoing survey places us in a position to evaluate the historic passivity of American institutional investors. Although the new critics attribute this passivity to overregulation, this brief survey casts substantial doubt on the overregulation thesis. At least five fundamental objections can be made to the overregulation story as the primary explanation for shareholder passivity.

First, the claim that American banks were uniquely subject to regulation seems puzzling given that Japanese banks are subject to effectively the same five percent limitation on voting stock ownership.153 Italy, only seven have over 50% of their shares in public hands. 1 Coopers & Lybrand Report, supra note 97, at 22. It estimates that in France over half of the 200 largest companies are "family controlled." Id. In addition, government shareholdings and cross-shareholdings also minimize the possibility of takeovers and institutional investor influence in France. Others provide a similar assessment of the thinness of the French capital markets. See Gareth P. Dyas & Heinz T. Thanheiser, The Emerging European Enterprise: Strategy and Structure in French and German Industry 169–71 (1976). According to Dyas and Thanheiser, the financial markets in France "are described by all observers as extremely 'narrow.'" Id. at 170. They conclude that "this is ascribable, in part, to the preponderance of the state as lender and borrower of available funds." Id. Only around 460 French corporations trade on the Paris Stock Exchange (out of some 135,000 stock corporations incorporated in France), and the remainder would appear to be financed largely through internal capital markets. See Hopt, supra note 27, at 4. See also Franks & Mayer, supra note 113, at 208–09 (noting government involvement as a shareholder in French corporations as a barrier to takeovers and control changes).

153. The National Bank Act does not authorize banks to own stocks directly. See 12 U.S.C. § 24 (1988). However, until the Glass-Steagall Act of 1933, banks could easily outflank this prohibition by investing through securities affiliates. See Roe, Political Theory, supra note 3, at 17. While the Glass-Steagall Act precluded commercial banks from having an affiliation with firms "dealing" in securities, it did not directly prohibit banks from being owned by a parent company that simply owned securities, either directly or through an affiliate. See supra note 59. For a variety of reasons, bank holding companies appeared during the 1950s, and because they were not covered by the National Bank Act, they were effectively unregulated. In response, Congress enacted the Bank Holding Company Act of 1956, which generally precluded a bank holding company from owning more than 5% of the voting stock of a nonbanking company. See 12 U.S.C. §§ 1843(c)(6)–(7) (1988). Effectively, this means that virtually any major bank may legally acquire up to 5% of the voting stock of an industrial corporation through a parent or securities affiliate. See supra note 63. In addition, bank trust departments, which are not restricted in stock ownership by the prohibition on bank ownership, may invest up to 10% of their funds in the stock of a single corporation. See 12 C.F.R. § 9.18(b)(9)(ii) (1991). Alone, this provision would allow a bank with a large trust department to exercise control over corporations of substantial size (although fiduciary requirements would necessitate diversification). Finally, the Bank Holding Company Act permits banks to acquire businesses whose activities are "so closely related to banking... as to be a proper incident thereto." 12 U.S.C. § 1843(c)(8) (1988). Recently, bank regulators have expanded the category of activities falling within this exception. See American Land Title Ass'n v. Board of Governors of the Fed. Reserve Sys., 892 F.2d 1059 (D.C. Cir. 1989).

One commentator observes that the "most dramatic shift in bank regulation over the last decade has been the extent to which banks have been permitted to diversify their activities and investments." Helen A. Garten, Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age, 57 Fordham L. Rev. 501, 529 (1989).
Similar limitations on stock ownership exist in other countries as well.154

Second, in other economies—for example, Germany and Great Britain—in which substantive limitations on bank ownership of equity securities have not existed, financial institutions still have not exceeded this same five percent level.155 Perhaps the need to diversify investments limits banks in these countries, or perhaps other factors—such as the need for liquidity, possible conflicts of interest, or fear of business or political reprisals—cause them to halt ownership of voting stock at this low level. Alternatively, banks may just not view equity ownership as a business at which they have a comparative advantage.

Third, even within the United States, banks generally have not exploited the statutory powers they do possess to own and hold equity securities—possibly because they have not found such ownership to be particularly profitable.156 Although nonbanking activities of bank holding companies were virtually unregulated until the passage of the Bank Holding Company Act of 1956, banks made little use of these powers.157 After the Act's passage, real constraints were placed on the ability of bank holding companies to make acquisitions, but even the combination, these exceptions to the general prohibition on bank ownership of corporate stock potentially overwhelm the rule and permit a single bank to exercise a significant influence over most corporations. But extra-legal factors seem to prevent this from happening. See infra note 156.

154. In Sweden, for example, insurance companies may not own more than 5% of the voting stock of any company. The largest Swedish insurance company owns 2% of more than 100 listed Swedish companies. See Skog & Isaksson, supra note 117, at 9. In contrast, American banks have not utilized their legal capacity to buy stocks.

155. German banks today own 3.2% of the voting stock of the 100 largest major German corporations. See supra notes 99, 112. British banks own even less of the stock of British industrial companies. See E. Gerald Corrigan, Reforming the U.S. Financial System: An International Perspective, FRBNY Quarterly Review, Spring, 1990, at 1, 2 (noting that “bank holding of shares of commercial firms is far less common” in Britain than in Germany). British institutional investors tend to hold in the 1%-2% range. See Thomas, supra note 143, at 18.

156. As noted earlier, see supra note 153, although national banks may not directly own equity securities for their own account, bank holding companies may hold up to 5% of the voting stock of a non-banking corporation. One explanation for why banks have failed to exploit this power (and why they did not diversify before 1956 when the Bank Holding Company Act was passed) is that they have found diversification to be only marginally profitable. See Garten, supra note 153, at 519, 557. Professor Garten concludes: “[T]he evidence suggests that bank holding company management of nonbanking subsidiaries has not been very successful . . . .” Id. at 557. If so, perhaps banks do not make particularly efficient monitors either.

157. Professor Garten notes that the “relative importance of [bank] holding companies actually declined between 1936 and 1956.” Id. at 519 (footnote omitted). Indeed, between 1930 and 1939, only 34 nonbank subsidiaries were formed or acquired by bank holding companies, and between 1950 and 1959 only 290 nonbank subsidiaries were formed or acquired. Id. at 519 n.85. As Garten notes, a logical explanation for this reluctance to diversify into nonbanking activities is that bank holding companies found such acquisitions to be less profitable than their traditional activities. See id. at 519.
substantial powers that remain are not exploited. Today, Citicorp, the largest U.S. banking institution with total assets of over $200 billion, holds only about $1 billion in equities.\textsuperscript{158} Even when U.S. banks do take equity stakes in U.S. corporations, they do so indirectly, for example, through leveraged buyout ("LBO") funds.\textsuperscript{159} Perhaps the use of a buyout fund vehicle enables the banks to obtain greater diversification, and thus reduces the risk of equity ownership, or perhaps, as some observers have suggested, the motive for the equity investment was not the investment itself, but the lucrative fees received by the banks for financing the LBO.\textsuperscript{160} Whatever the reason, it is difficult to assign a causal relationship to legal restrictions on ownership when American financial institutions historically have not used, and today continue not to use, the considerable discretion that the law gives them.

A fourth problem with the claim that U.S. institutional investors were regulated into passivity is that this explanation lacks a meaningful benchmark for comparison. From a comparative perspective, one can point to countervailing examples in which U.S. law is more protective of institutional investors' freedom of action. For example, the German co-determination law gives half the seats on the supervisory board to labor and employee representatives, thereby effectively precluding takeovers and limiting shareholder control.\textsuperscript{161} Another example is ERISA's requirement that pension funds be adequately funded and structured as free-standing legal entities.\textsuperscript{162} In many European countries, there is no such requirement, and often there is no separate pension fund, only a legal claim held by the pensioner against the general

\textsuperscript{158} See, e.g., Black, supra note 12, at 552. Other U.S. banks own considerably less. See Robert Guenther, Bankers Trust Leads Way for Major Banks in Investment Banking, Wall St. J., Dec. 5, 1989 at A1, A14. Again, this limited ownership may reflect the limited profitability of such activities. See supra note 156.

\textsuperscript{159} See Anise C. Wallace, Banks With Stakes in Borrowers Are in Spotlight, N.Y. Times, July 4, 1990, at 47 (discussing equity investments by major banks in buyout fund run by Kohlberg, Kravis & Roberts). The key fact about an LBO fund, however, is that the general partner (such as KKR) and not the bank investor plays the principal monitoring role.

\textsuperscript{160} See id. (estimating that banks have collected $350 million in fees for financing buyouts arranged by Kohlberg, Kravis & Roberts and $150 million in such fees during 1988 alone). Under this interpretation, the banks invested in buyout funds as a form of "relationship-building" (as one bank official acknowledged) in order to "win some of the lucrative lending business generated by" these transactions. Id.

\textsuperscript{161} For a discussion of the impact of this requirement, see Franks & Mayer, supra note 113, at 205-07.

\textsuperscript{162} Section 402(a) of ERISA requires that every employee benefit plan be established and maintained pursuant to a written instrument. 29 U.S.C. § 1102(a)(1) (1988). This trust requirement is supplemented by section 403(a) of ERISA, which requires that all assets of an employee benefit plan be held in trust by one or more trustees. 29 U.S.C. § 1103(a) (1988). In effect, the corporate sponsor may not hold the assets out of whose earnings the pension is to be paid. Such a "funded" scheme is in contrast to "pay-as-you-go" pension systems, which do not require a separate fund. See John Creedy, State Pensions in Britain 13-14 (1982).
assets of the employing corporation. This arrangement effectively eliminates the pension fund as an entire class of institutional investor and over the long run necessarily reduces the level of institutional ownership of corporate stock. A third example is the legal rule in Britain and Canada that may require a person acquiring a controlling position in a corporation to offer to buy out all the remaining minority shareholders. Such a rule may chill institutional activism far more than the basically disclosure-oriented rules imposed on institutional investors who seek to exercise control in the United States. In short, legal restrictions on financial institutions and other institutional investors exist in most industrial economies that could support the thesis that political coalitions in those countries had conspired to hobble those institutions. For overregulation to be meaningful as an explanation of institutional passivity, it must be shown at a minimum that U.S. institutional investors suffer from more overregulation than similar institutions elsewhere. This showing has not yet been made.

A fifth problem with the overregulation story is historical. A premise of this story is that the Glass-Steagall Act, and the consequent separation of commercial and investment banking, precluded financial institutions within the United States from evolving into corporate monitors in a manner that would have paralleled the German universal banks or the Japanese main banks. However, the historical evidence suggests that well before the Glass-Steagall Act, the largest, most powerful American financial institutions had already begun to retreat from an active monitoring role. In his monumental history of the Morgan Bank, Ron Chernow reports on developments within the Morgan Bank during the 1920s:

Gradually, if imperceptibly, the banker was becoming less a corporate partner and more a professional, a disinterested intermediary . . . . In [Pierpont Morgan's] day, weak companies needed to lean on strong bankers. But by the 1920s, a Standard Oil of New Jersey or a U.S. Steel had a stability compara-

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163. Indeed, in most European countries, private pension plans are a rarity, with "the vast majority of an individual's pension [coming] through the social security system." Eric Short, First Steps on a Very Long Journey Towards a Single Market, Fin. Times, May 3, 1990, Pension Fund Investment Section, at 5. While separate pension funds are common in the United Kingdom, both Germany and France currently rely on alternative systems that do not give rise to pension funds as institutional investors. See Margaret Price, EC Funds Get Ready: New Rules to Liberalize Pension Investing, Pens. & Investments, Aug. 20, 1990, at 1, 38.

164. British takeover law discourages partial bids and under some circumstances requires a corporation that has assembled a substantial (but still a minority) percentage of a firm's stock to make a mandatory bid for all the remaining shares. Such a mandatory bid requirement obviously increases the costs of acquiring control. See DeMott, supra note 132, at 408–09 (City Takeover Code requires persons acting in concert who assemble 30% or more of voting securities to make mandatory buyout bid for remaining shares at highest price paid by them within last twelve months).
As Chernow observes, the bankers' power was at its zenith "when capital markets were limited, with few financial intermediaries to tap them." Yet, as capital markets developed and became "globally integrated," competition reduced the power of the Wall Street banker. Much this same process—of gradual "emancipation" of industrial corporations from bank influence—seems to be occurring in Germany and Japan today. Their slower development may be the product of the longer survival of internal capital markets in those countries or the result of the instability and chaos following World War II, which may have made association with a bank more important to financially strained corporations in a war-ravaged economy. The irony here is that, rather than Germany and Japan serving as a model for future industrial development in the United States, the reverse may be gradually happening, as international capital markets gradually supersede internal capital markets. Predictions are speculative, but the internationalization of the capital markets does seem to weaken banker control.

II. THE EXTRA-LEGAL CAUSES OF SHAREHOLDER PASSIVITY

Without denying that the overregulation of institutional investors may partially account for shareholder passivity, this Article suggests that extra-legal causes contribute more to an explanation of why insti-


166. Id. at 486. It is far from clear that even during this era Morgan bankers were monitoring the corporations on whose boards they sat to assure that management maximized value for shareholders. Rather, because the basic business of the Morgan Bank was bond sales, its own rational incentives were to protect its creditor clients by encouraging the retention of free cash flow within the corporation. Also, a seat on the client’s board is an obvious way for an investment bank to protect its business from the competitive efforts of rival investment banking firms and to market its own services.

167. Id. ("Gradually Wall Street bankers would lose their unique place in world finance.").

168. See supra notes 92–95, 108–116 and accompanying text.

169. One last possibility should be noted. Arguably, the impact of the legal differences to which institutional investors in different countries are subject can be overemphasized. Thus, an alternative standard might be to compare the percentages of listed companies in different countries that have majority or controlling shareholders. Such a comparison clearly suggests that the U.S. economy has comparatively fewer such shareholders who might make effective monitors. Of the 5240 firms on national stock exchanges in the United States in 1984, 663 (or 12.7%) had majority shareholders. See, e.g., Clifford G. Holderness & Dennis P. Sheehan, The Role of Majority Shareholders in Publicly Held Corporations, 20 J. Fin. Econ. 317, 321 (1988). In contrast, over 48% of Canadian firms had majority shareholders. See DeMott, supra note 132, at 425 n.12; supra note 130 and accompanying text. A comparable level of Swedish firms had such shareholders. See Skog & Isaksson, supra note 117, at 14. But what does this comparison ultimately show? Does it imply that U.S. investors were somehow deterred by legal or other forces from acquiring control or simply that they preferred liquidity to control? This is the basic chicken-or-egg question that confounds the overregulation thesis.
tutional investors have not yet exerted a greater "voice" in corporate governance. From this perspective, institutional investors cannot be characterized as a Gulliver tied down by Lilliputian bureaucrats; if anything, they more resemble spectators at the Roman Colosseum, content with bread and circuses and unwilling to organize for political reform as long as the game continues.

Neither metaphor, however, captures adequately the nature of the extra-legal barriers to institutional activism. These barriers are diverse and have little in common, except that they would remain even if deregulation reduced the legal barriers to collective shareholder action.

A. Liquidity and Thin Equity

Some institutions need liquidity more than others. For institutions requiring liquidity, taking a large control position is unacceptable if such a stake would be illiquid. Mutual funds, banks, and insurance companies fall into this class of institutions, chiefly because their shareholders, depositors, or policyholders can withdraw their funds on short notice. Not surprisingly, the latter two have been characterized as the institutions most unlikely to oppose corporate managements.

This problem is most acute in the case of "open end" mutual funds, which must stand ready to redeem on a daily basis the shares of customers who wish to sell. Thus, most mutual funds are active traders and would hesitate to make any investment the liquidation of which would require a significant block discount. In addition, because mutual funds compete for customers' funds based on their asserted ability to

170. The term "extra-legal" requires a word of definition. This Article uses it to refer to practices, norms, or conventions that have not historically been considered unlawful (even though potentially such practices could be made unlawful). Thus, if institutional money managers wish to avoid acquiring a reputation as "activist" shareholders for fear that it will cost them future pension fund accounts, this factor would be considered an extra-legal one (even if a visionary might imagine a legal regime under which such reputations could not be considered).

171. Traditionally, insurance companies have not been grouped with mutual funds, because their payout to customers is actuarially predictable. However, they are also subject to panic surges in policyholder redemptions and withdrawals. Recently, three insurance companies—Mutual Benefit Life Insurance Co., Monarch Life Insurance Company, and First Capital Life Insurance Company—were taken over by state regulators in the wake of policyholder panics about their firm's solvency. See Eric N. Berg, Rater to Add Policyholder Panic Factor, N.Y. Times, Aug. 2, 1991, at D1. Hence, the need to assure policyholders of their solvency may inhibit insurance companies as well from investing in illiquid investments.

172. This is the view of professional proxy solicitors. See Could Girard Have Won the Proxy Fight?, Corp. Control Alert, Sept. 1990, at 11 (Joseph Morrow of proxy solicitor Morrow & Co. describing insurers and bank affiliated positions as "the two groups most likely to support management").
outperform their competitors, they need to be able to report the current market value of their investments. The resulting focus on short-term performance is inconsistent with holding a collection of illiquid blocks. As a result, so long as mutual funds face a market in which investors will continually, and with little notice, shift their funds from one fund to another or will withdraw their funds to purchase other non-capital market investments, preservation of maximum liquidity must remain a high priority for the rational mutual fund manager.

Banks and, to a lesser extent, insurance companies face a more important obstacle: Structurally, they have very thin equity compared with that of industrial corporations. For example, among the largest commercial banks, the proportion of equity capital to total assets has steadily fallen from 60% during the early nineteenth century, to 20% at the turn of this century, to below 10% since the early 1950s, and to under 5% since the mid-1970s. The significance of this point comes into clearer focus when we consider the balance sheet of a hypothetical bank with $1 billion in assets and equity of under $50 million. If it held even 20% of its assets (or $200 million) in the form of equity securities and the stock market declined by 25% over a period of, say, two months, the bank's equity would be wiped out, and the bank would be, at least technically, insolvent. In short, highly leveraged but regulated entities, such as banks or insurance companies, lack the capacity to hold

173. Whether in fact they can outperform the market or their competitors is an entirely different question. See infra note 192 and accompanying text.

The foregoing analysis does not consider the "indexed" mutual fund, which is not an active trader and which is discussed at infra notes 236–244 and accompanying text.

174. See Yair E. Orgler & Benjamin Wolkowitz, Bank Capital 3 (1976). For all national banks as a group, the ratio of shareholders' equity to total assets was 5.8% in 1983. See Federal Deposit Insurance Corporation, Bank Operating Statistics: 1983, Table 1, at 2. This definition of equity includes both undistributed earned surplus and reserves for contingencies and other capital reserves.

For the ten largest banks in the United States in 1988, the ratios of total equity capital to total assets were as follows:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Total Assets (In Millions)</th>
<th>Total Equity Capital</th>
<th>Total Equity Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citibank</td>
<td>150,241.0</td>
<td>8,168.0</td>
<td>5.4</td>
</tr>
<tr>
<td>Bank of America</td>
<td>82,912.0</td>
<td>3,611.0</td>
<td>4.4</td>
</tr>
<tr>
<td>Chase Manhattan</td>
<td>77,542.5</td>
<td>4,372.9</td>
<td>5.6</td>
</tr>
<tr>
<td>Morgan Guaranty</td>
<td>71,227.8</td>
<td>4,020.1</td>
<td>5.6</td>
</tr>
<tr>
<td>Bankers Trust Co.</td>
<td>55,349.9</td>
<td>2,889.1</td>
<td>5.2</td>
</tr>
<tr>
<td>Manufacturer's Hanover</td>
<td>54,210.0</td>
<td>2,546.0</td>
<td>4.7</td>
</tr>
<tr>
<td>Chemical Bank</td>
<td>50,933.0</td>
<td>2,488.0</td>
<td>4.9</td>
</tr>
<tr>
<td>Security Pacific National Bank</td>
<td>48,920.5</td>
<td>2,216.6</td>
<td>4.5</td>
</tr>
<tr>
<td>Wells Fargo Bank</td>
<td>43,732.1</td>
<td>2,576.5</td>
<td>5.9</td>
</tr>
<tr>
<td>First National Bank of Chicago</td>
<td>35,172.7</td>
<td>1,302.2</td>
<td>3.7</td>
</tr>
</tbody>
</table>

This table was derived from data on total assets and equity capital obtained from Sheshunoff Information Services Inc., 1000 Largest U.S. Banks: 1989, at II.1 (1989).
volatile investments, such as equity securities, as a significant portion of their investment portfolios. While this volatility problem may explain why bank holding companies appear not to hold equity securities up to the ceiling now permitted by the Bank Holding Company Act, it also undermines the claim that regulatory constraints are the decisive factor in the passivity of these financial institutions. Further complicating the volatility problem is the prevailing practice among financial regulators to write down the value of marketable securities in determining a regulated firm's legal capital. Thus, if banks could directly own equity securities, regulators would predictably apply more or less the same "haircuts" to these investments as they now apply to the securities portfolios of broker-dealers.

The need for liquidity is based on more than simply the necessity of assuring customers that their investments can be repaid or redeemed on request. In fact, some institutions do not promise their customers ready liquidity, and thus they potentially could hold more illiquid equity stakes. But these firms—closed-end mutual funds, holding companies, and natural resource companies—typically trade at significant discounts below their asset liquidation value. Thus, for some institutions, the real risk in holding illiquid assets for the long-term is that they thereby incur a substantial discount in their share value, which could in turn invite a hostile takeover by those investors seeking to arbitrage the difference between the firm's market value and its underlying...
ing asset value. Obviously, this danger poses no threat to pension funds (which have a uniquely low need for liquidity), but it would present a substantial barrier for other institutions, such as merchant banks, if deregulation were to permit commercial and investment banking activities to be combined.

B. Conflicts of Interest

Because conflicts of interest have been fully and ably discussed by others, they will only be briefly treated here. Generally, commentators report that banks and insurance companies are the institutions least willing to oppose corporate managements. Usually, the reason given for their reluctance is fear that their firm will lose business—either of the specific firm whose management they have opposed or of the corporate community generally if the investor is perceived as an "activist." Private pension funds are subject to a related form of pressure in that corporate managements can, and do, instruct the professional investment management firms, to which voting and investment discretion usually are delegated, as to how to vote in a proxy contest. Moreover, trustees of private pension funds often are corporate employees or agents who report to senior management and predictably share their attitudes toward institutional activism.

Even if regulations adopted under ERISA prohibited such influence, their efficacy is doubtful for two reasons. First, corporate managements have the legal power to reclaim voting discretion over the portfolio's assets. To some extent, this power is now being exercised; and, once reclaimed, corporate managements predictably will

179. The leading works are James E. Heard & Howard D. Sherman, Conflicts of Interest in The Proxy Voting System (IRRC 1987) and John Brooks, Corporate Pension Fund Asset Management, in Abuse on Wall Street: Conflicts of Interest in the Securities Markets 224 (Twentieth Century Fund ed., 1980). See also Black, supra note 12, at 595-608 (arguing that conflicts of interest may prevent significant monitoring by institutional investors); Rock, supra note 9, at 469-72 (same).

180. See supra note 53 and accompanying text; infra notes 181-191 and accompanying text.

181. A 1987 survey by the magazine Institutional Investor found that half of all corporate pension officers considered it "appropriate" to advise pension money managers how to vote and that money managers almost uniformly followed any such advice that was given; only 6.8% of them claimed to have resisted. See Pensionforum: Taking the Offensive, Institutional Investor, Dec. 1987, at 101. More recently, the Department of Labor has begun to question such pressure, but low visibility practices are extremely hard to detect or discourage. See Black, supra note 12, at 555-56.


183. Professor Black reports that as the Labor Department has begun to scrutinize corporate pressure on professional pension money managers, more companies are choosing to retain (or reclaim) voting discretion, while delegating to the professional
support each other in the expectation that a Golden Rule of Deference may someday benefit them. Only public pension funds and mutual funds are relatively free from such pressure and, not surprisingly, they are the most likely to oppose management's proposals. Second, even if active retaliation were forbidden so that corporate managements could not terminate or withdraw voting discretion from an institutional money manager who supported dissidents, there would remain the problem of reputation. Money managers are in active competition for new pension accounts. If a reputation as an "activist" inhibits one's ability to obtain new accounts, then money managers will predictably shun behavior that could give them that reputation—even if reprisals by existing pension accounts could somehow be strictly forbidden.\footnote{Based on a series of interviews with pension fund managers, two anthropologists working with Columbia University's Institutional Investor Project report that fund managers "are reluctant to do anything which attracts any sort of attention." See John M. Conley & William M. O'Barr, The Culture of Capital: An Anthropological Investigation of Institutional Investment 31 (1991) (unpublished manuscript, on file with the Columbia Law Review).}

Real as the problem of conflicts of interest is, its magnitude can be debated. For institutional investors that are substantial shareholders in a company, the gains to be made from improved corporate performance seem likely to exceed the potential losses from business that moves elsewhere. Thus, as the scale of institutional holdings grows, the expected gains from activism should increasingly outweigh the losses. Still, "exit" remains a rational strategy to the extent that reputational damage could follow from active involvement in a proxy fight or similar contest. It may be difficult ex ante, to estimate the likelihood or severity of the reputational injury that a specific corporate contest could threaten. Moreover, even if the gains from improved corporate governance were large, these gains should be available at many firms, while specific conflicts are likely to exist only with respect to a few firms for any individual investor. Hence, it may make sense for an institutional investor to flee proxy or other control fights when the corporation can credibly threaten retaliation. So long as the "exit" option is available, the rational institutional investor can make its decision on an ex post basis—in effect, casting its vote with the dissidents only after it has first evaluated the potential downside in terms of the threats management can make. In turn, this gives corporate managements a greater incentive to use threats of business retaliation. Once again, however, the bottom line is that the "exit" option weakens institutional "voice."

C. Political Retaliation

Institutional activism may trigger political repercussions. The manager, only investment discretion over the portfolio's assets. See Black, supra note 12, at 598 ("Often, the conscious purpose is to ensure promanager votes.").
1989 report of the New York State Task Force on Pension Fund Investment, which recommended restrictive legislation barring pension fund involvement in takeovers, was one ominous signal.\textsuperscript{185} The recent attempt by California Governor Pete Wilson to oust the CalPERS board and take direct control over that particularly active pension fund may be a similar signal, or it may just reflect the covetous desire with which public officials battling deficits eye cash-rich pension funds.\textsuperscript{186} At a minimum, however, it suggests that the traditional independence and insularity of pension funds is not inevitable.

 Probably the clearest example of legislative pressure aimed at institutional investors is the recent Pennsylvania antigreenmail statute.\textsuperscript{187} This statute requires institutions to disgorge any profits if they acquire, either individually or as a group, a twenty percent stake in a Pennsylvania-chartered company and sell their shares at a profit within eighteen months thereafter.\textsuperscript{188} Even more chilling to institutional activism, the Pennsylvania statute apparently also would be triggered if investors formed a "control" group to elect directors. Although such statutes are clearly "legal" restraints, the extra-legal threat is that continued activism could bring additional restrictions. For institutions, the real object lesson is supplied by the success of corporate managements in securing the passage of antitakeover legislation in over forty-two states during the 1980s.\textsuperscript{189} Whether corporate managements would be as successful in challenging pension funds as corporate raiders is debatable, but the risk may be substantial enough to discourage some institutional investors.

\section*{D. Soft Information}

Institutional investors who oppose management risk cutting themselves off from the flow of soft information that management provides to "friendly" securities analysts and institutions.\textsuperscript{190} The magnitude of this problem is difficult to assess, but there is anecdotal evidence that securities analysts who issue negative reports about a company may be

\begin{itemize}
  \item 185. See supra note 16 and accompanying text.
  \item 186. See Robert J. McCartney & Kathleen Day, California Governor Seeks Control of Pension Fund; Plan Would Cut Benefits of State's Retirees, Wash. Post, June 18, 1991, at C1, C3. Although Governor Wilson partially backed down in the face of an outcry from pensioners who did not want to subsidize the state's deficit, other governors and legislatures have recently hinted at similar plans. See Michelle Osborn, Politicians Coveting Pension Funds, USA Today, July 3, 1991, at 4B.
  \item 188. The disgorgement rule does not apply to shares bought more than two years prior to the acquisition of a 20% stake. See id. § 2575(2).
  \item 190. This threat has been acknowledged by many commentators. See, e.g., Black, supra note 12, at 602. Mutual funds are thought to be the most susceptible to it because they are very active traders.
\end{itemize}
denied further information. 191

In terms of this Article's framework, the trade-off between "exit" and "voice" is once again posed here. Soft information is desired by institutions that trade actively in order to outperform the market—in effect by dumping shares if the information provided to it suggests a downturn in earnings that the market has not yet anticipated. To be sure, the ability of institutions to outperform the market is questionable—although those in possession of truly material, nonpublic information have certainly been able to profit even in an efficient market. 192 In any event, institutions in a highly competitive market, such as mutual funds, fear less that they will underperform the market than that by passing up such information they may underperform the other institutions with whom they are in direct competition. In contrast, for long-term holders, such as indexed funds and some pension funds, the value of soft information is minimal because it benefits only active traders, not those who effectively hold the market in their portfolios. For these larger holders, the probable block discounts they might suffer on the disposition of their substantial holdings are likely to be greater than the gains or losses from active trading.

E. "Short-Termism"

The benefits of improved corporate governance do not immediately translate into enhanced share value. The election of a few independent directors or the granting of greater "voice" to institutional investors will seldom, if ever, make an unprofitable company profitable in the short-run. 193 Indeed, the introduction of dissident directors

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192. Considerable doubt exists that mutual funds can outperform the market (at the same level of risk). See Michael C. Jensen, The Performance of Mutual Funds in the Period 1945-1964, 23 J. Fin. 389 (1968) (finding mutual fund returns to be no better than that of a passive investor holding a market portfolio). More recent research, however, has found that mutual funds earned significant abnormal returns (although transaction costs largely consumed these gains). See Norman E. Mains, Risk, The Pricing of Capital Assets, and the Evaluation of Investment Portfolios: Comment, 50 J. Bus. 371, 384 (1977); see also Jeffrey N. Gordon & Lewis A. Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. Rev. 761, 839-41 (1985) (questioning the relevance of performance comparisons between mutual funds and the Capital Asset Pricing Model). It should be emphasized that a finding that mutual funds do outperform the market is not inconsistent with the standard "semi-strong" version of the Efficient Capital Market Hypothesis, because mutual funds may have access to nonpublic information through the medium of securities analysts. See id. at 839 n.209.

193. Some may question whether institutional ownership and monitoring has any observable impact on share value. Obviously, investors that are skeptical about the financial payoff from reforms will not support them, and frankly the available evidence is scanty. Some studies have found that the market responds positively to the appointment of outside directors. See Stuart Rosenstein & Jeffrey G. Wyatt, Outside Directors, Board of Independence and Shareholder Wealth, 26 J. Fin. Econ. 175 (1990). Yet, because management usually selects outside directors, this finding does not imply that mecha-
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onto a board may even result in an interim period of disruption, uncertainty, and decreased profitability. Thus, for the short-term trader who expects to hold a stock only for a few months, the long-term benefits of improved governance and increased accountability mean little, while the costs of financing shareholder opposition remain real.

Reliance on the timing differences between long-term benefits and short-term costs to account for passivity is incomplete, however, in the absence of some explanation of why institutional money managers need to focus on the short-term. The most plausible answer focuses on agency costs at the institutional level. Many institutional investors are in head-to-head competition for investor funds, mutual funds being the most obvious example. If their profitability lags even for a quarter, some investors may withdraw their funds and move them to a competing firm.194 Other institutions, such as pension funds, are not subject to this same pressure, but other internal pressures for performance may be equally intense. For example, pension funds use a variety of external money managers and regularly replace those whose market performance lags behind that of their peers.195 Thus, so long as pro-
nisms for the appointment of outside directors selected by institutional investors, see Gilson & Kraakman, supra note 13, would have a similar impact. Some inferential evidence is available that firms with a concentrated institutional ownership are less subject to managerial retention of free cash flow. See John J. McConnell & Henri Servaes, Additional Evidence on Equity Ownership and Corporate Value, 27 J. Fin. Econ. 595 (1990) (finding that firms with high institutional ownership have a higher Tobin’s Q, the ratio of stock market value to the replacement cost of tangible assets). Still, as Professor Rock has pointed out to me, this relationship may imply that institutional investors invest in such firms, not that their presence causes the firm to have a higher Tobin’s Q. Moreover, no correlation has yet been found between firm profitability (according to reported accounting profits) and institutional ownership. See Harold Demsetz & Kenneth Lehn, The Structure of Corporate Ownership: Causes and Consequences, 93 J. Pol. Econ. 1155 (1985). In contrast, studies of the correlation between the board of director’s ownership and firm Tobin’s Q have suggested a positive relationship between board ownership and profitability. See Randall Morck, et al., Management Ownership and Market Valuation: An Empirical Analysis, 20 J. Fin. Econ. 293 (1988). In short, managerial and individual owner control may matter, but the evidence that institutional control relates to profitability has not yet been presented. Absent such evidence, some sophisticated observers may believe that corporate governance issues have little impact on share value, unless they foreshadow a takeover bid.

194. Numerous commentators have raised the same point that the competition among money managers leads each to seek “a short-term premium for a portfolio stock,” even though they recognize that stockholders would profit more from a buy and hold policy. See Lipton & Rosenblum, supra note 14, at 207 (citing other authorities); see also Michael L. Dertouzos et al., Made in America: Regaining the Productive Edge 62 (1989) (main criterion for evaluating fund managers is current value of portfolio).

195. A recent survey of pension funds and other money managers found that over 90% reviewed the performance of the outside money managers they employed at least quarterly. Only 5.6% relied on semiannual review, and only 3% on annual review. See Pensionforum: Dismay Over Short-termism, Institutional Investor, Mar. 1991, at 139. Although underperforming managers were not replaced immediately (three years being the typical period before replacement for below-market performance was likely), the pressure of such constant reviews is the critical variable.
professional money managers are held accountable in terms of their monthly or quarterly performance and the benefits of improved corporate governance do not accrue over this same period, they obviously will be reluctant to expend funds or incur costs that do not affect their current competitive standing vis-a-vis their peers. Moreover, in any competition, there are inevitably laggards. For example, if a pension fund uses four external money managers, the one whose performance has most lagged can expect replacement unless it catches up. In such an environment, short-term performance matters greatly for the money manager, as agent, even if it is a secondary concern for the pension fund, as principal. In essence, this is a moral hazard problem, because the laggard manager has an incentive both to gamble and cut costs recklessly. As a result, agency problems at the institutional level can frustrate efforts to correct agency cost problems at the corporate level, even if institutional shareholders own sufficiently large blocks to be able to resolve their collective action problems.

F. Agent Apathy

Even if institutional investors have an interest in corporate governance issues, it does not necessarily follow that their agents will share their concerns. What could explain such a disparity in attitudes? The short answer is a combination of a lack of incentives for the agent to monitor plus an inability on the part of the principal to detect such shirking by the agent. This explanation becomes more plausible when one learns that the federal securities laws greatly restrict the ability of an investment adviser to receive incentive compensation based on capital appreciation in the fund it manages. If an investment manager is compensated simply on the basis of an annual fee equal to a declining percentage of the fund it manages (that is, \( \frac{1}{3} \) of 1% of the first $500 million, \( \frac{1}{4} \) of 1% of the next $250 million, etc.), it may have insufficient incentive to engage in monitoring so long as it bears the monitoring costs, while the fund's beneficiaries receive the benefit. Yet, exactly this structure prevails in mutual funds and, to a lesser extent, in pension funds. Of course, successful monitoring may attract new clients and


197. Typically, the investment adviser bears the fund's administrative costs and charges an annual fee based on the fund's assets under its management to compensate it. For examples of such a fee structure, see Krinsk v. Fund Asset Management, 875 F.2d 404, 407 (2d Cir. 1989); Gartenberg v. Merrill Lynch Asset Management, 694 F.2d 923, 926 (2d Cir. 1982); Galfand v. Chestnut Corp., 545 F.2d 807, 810 (2d Cir. 1976). Obviously, such a fee structure gives the investment manager a strong incentive to economize on the administrative and operating costs that it bears.

198. The largest indexed money manager charges its clients, including many pension funds, an annual service charge of two basis points a year. See infra note 244 and accompanying text. Clearly, this will not cover much monitoring.
increased assets into the fund, thus partially solving the problem. But this depends on whether the difference between real versus merely formalistic monitoring by the agent is immediately observable by the principal. If it is not, even successful monitoring will not necessarily attract new business in the form of increased funds for the agent to manage. The bottom line is that, in the absence of incentive compensation, agents may be rationally indifferent about monitoring and will thus do only the minimum required of them by the law.

G. Managerial Manipulation of Agenda

Management’s most effective tactic in securing shareholder approval of an antitakeover proposal has been its ability to link a disfavored proposal to a “sweetener,” such as a recapitalization with a large dividend or a stock buyback.\(^{199}\) For those investors who are focused on the short-term, the gain from the “sweetener” exceeds the loss on the other linked transaction, and so they vote in favor of both. Although the “sweetener” may leave the shareholder better off than if no inducement for its acquiescence were paid, this tactic still reduces the expected payoff from shareholder activism. It thus aggravates the traditional collective action problem.\(^{200}\)

Obviously, agenda manipulation is a problem that only regulation, and not deregulation, can address.\(^{201}\) Still, this tactic of “bundling” issues again implicates the trade-off between “exit” and “voice.” Shareholders who rely on the “exit” option seem more likely to vote approval in such a case, expecting to receive the sweetener and then sell their shares. However, for longer-term investors, who effectively hold the market in their portfolios, such linkages are distasteful because in effect management is “bribing” shareholders into passivity with corporate funds that already belong to the shareholders. Thus, if share-

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199. For a fuller discussion of this theme, see Black, supra note 12, at 592–94. Black gives as an example the 1987 proxy statement of Holiday Corporation, which asked shareholders to vote on a single proposal to (i) declare a massive special dividend, (ii) grant very large stock options to management, and (iii) adopt a “capped voting” antitakeover charter amendment that prevented new shareholders from voting more than 10% of the corporation’s stock. Id. at 593. On the general theory of agenda manipulation, see Michael E. Levine & Charles R. Plott, Agenda Influence and its Implications, 63 Va. L. Rev. 561 (1977).

200. See supra note 23. The inevitable existence of free riders (i.e., shareholders who will not contribute to the costs of collective coordination and resistance) implies that the expected payoff from the proposed course of action must exceed its aggregate costs by a corresponding margin. The more the payoff is reduced, the less likely it becomes that large shareholders will fund the costs of coordination (such as by financing a proxy solicitation).

201. SEC Rule 14a-4(a) does contain a potential limitation on linking unrelated matters by seemingly requiring a separate vote on “each matter or group of related matters.” See 17 C.F.R. § 240.14a-4(a) (1991). CalPERS has proposed tightening this vague limitation to prevent some forms of agenda manipulation. See CalPERS Letter, supra note 56, at 11. The feasibility of these proposals is beyond this Article’s scope.
holders perceive themselves as long-term holders who are locked into the market, the rational course of action may more often be to reject the bribe and seek eventually to secure the distribution of the excess corporate funds, or "free cash flow," by exercising "voice."

H. Summary

Some institutional investors need liquidity. Whether this need derives from "thin equity," the need to meet potential redemptions, a fear of their own stock being discounted, or other factors, it seems to be the common denominator that also explains why even unregulated British and German banks actually acquire only modest to intermediate stakes in their clients.202

If we also assume that for the foreseeable future some institutions will remain active traders with a high turnover in their portfolios, these two factors—the inability to take large positions and an active trading style—explain why they will show only a limited interest in corporate governance issues, except possibly those related to takeovers. Put simply, money managers are rationally apathetic because the expected gains from most such governance issues are small, deferred, and received by investors, while the costs are potentially large, immediate, and borne by money managers. This problem is compounded because the competitive pressures on institutional money managers give them little reason to focus on the long-term. To address this imbalance one must either induce institutional investors to hold larger stakes or to hold even modest stakes for a longer term, over which the expected gains from improved governance would materialize. Additionally, the compensation formulas used to reward money managers ought to create incentives for monitoring. In the absence of these conditions, however, the reasons for shareholder passivity would remain, even if the current legal obstacles to the exercise of shareholder "voice" were greatly reduced.

Where does this analysis lead? It is by no means intended to justify existing legal rules that chill shareholder "voice," but to take us back to the essential trade-off between liquidity and control. The more significant these legal and extra-legal obstacles are judged to be, the more likely it becomes that institutional investors will stand and fight only if their "exit" option is made less available or less attractive.

III. THE POTENTIAL COSTS OF UNITING LIQUIDITY AND CONTROL

To this point, this Article has argued only that a trade-off between liquidity and control characterizes most major industrial economies. Thus, the famous generalization of Berle and Means that the modern

202. As noted earlier, German banks own less than 5% of the top one hundred German corporations and British institutional investors seldom exceed 2% ownership in any individual corporation. See supra notes 99, 143 and accompanying text.
LIQUIDITY VERSUS CONTROL

public corporation produced the separation of ownership and control can be translated into the deeper and more accurate statement that public shareholders in the modern corporation purchased liquidity at the cost of control.\textsuperscript{203} Still, the state of the world described by Berle and Means may already be in flux. With institutional ownership of corporate equity nearing the fifty percent level and some of the largest U.S. corporations already having over three quarters of their stock owned by institutions, it is easily imaginable that, absent legal restrictions, a dozen or so institutional investors could form a group overnight that would hold effective control of a giant U.S. corporation.

To be sure, today there are substantial legal obstacles to the formation of such a control group, and commentators have begun to debate the scope and purpose of existing regulations.\textsuperscript{204} However, such a debate cannot sensibly begin with the regulations themselves; rather, it should start by identifying the potential harms that regulation should address. This Part will assess five potential problems with relying on institutional monitoring to end the separation of ownership and control. In each case, it will suggest that the problem lies less in institutional monitoring itself than in its combination with easy liquidity.

A. The Exiting Monitor

The first and most obvious problem with institutions as monitors is that they are watchdogs whose every incentive is to flee at the first sign of trouble. This is where the liquidity/control trade-off is the most acute. A traditional controlling shareholder, owning perhaps thirty percent or more of a corporation's voting stock, necessarily realizes that its investment is illiquid, even though a deep and active market exists. Any attempt by it to dispose of a substantial portion of its stock in the market is likely to be perceived by the market as a bail-out and to be greeted by a collapse in the stock price, as sophisticated market professionals infer from this disposition that the controlling shareholder has received nonpublic, but material, adverse information.\textsuperscript{205}

The same is not necessarily true for a loose association of institutional investors, numbering perhaps between ten and twenty, who

\textsuperscript{203} For a similar observation, see Walter Werner, Corporation Law in Search of its Future, 81 Colum. L. Rev. 1611, 1662–63 (1981). Martin Lipton has more recently argued that stockholders “view the corporation more as the holder of a betting slip views a racehorse.” See Lipton & Rosenblum, supra note 14, at 194 (citation omitted).

\textsuperscript{204} For a partial review of these obstacles, see infra notes 246–287 and accompanying text. Some commentators have expressed doubt that these obstacles are substantial enough to deter institutional monitoring. See Gilson & Kraakman, supra note 13, at 894–905. This Article does not directly analyze that debate, although it does suggest that extra-legal forces may be more important to some institutional investors.

\textsuperscript{205} For the finding that the market does distinguish between block sales by insiders and block sales by institutional investors and penalizes the former more heavily, see Myron S. Scholes, The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices, 45 J. Bus. 179 (1972).
might collectively own a controlling block. Because they own smaller blocks on an individual basis—say, one to three percent each—and because they have lesser visibility, they may be able to liquidate their positions on learning of adverse developments, without alerting the market. For such investors, the choice is between seeking to reverse the company’s decline in fortune and seeking to beat the market’s recognition of that decline. Of course, this use of material, nonpublic information by a controlling investor may violate the insider trading laws. Yet, while this may be formally true, institutional investors are in a marginally safer position under these laws than the traditional controlling shareholder. Typically, they will have no employee on the board; nor will they necessarily be in direct contact with corporate officers. Confidential information will reach them through indirect leakages, usually through security analysts. Moreover, the information on which they act typically will be soft information; not hard, specific data, but looser general impressions and a premonitory feel for future trends. In short, bail-outs seem both relatively more feasible and marginally less vulnerable as a legal matter when institutional investors constitute the control group.

Even if institutional investors cannot exit before the market’s perception of the problem, there are other reasons why they might prefer to flee than fight. Conflicts of interest or fear of reputational loss (either at the institutional level or, more likely, at the level of their money manager agents) could motivate such a decision. Put simply, while the ten percent stakeholder can be expected to fight, the one percent holder is apt to be a “sunshine patriot” unwilling to remain on duty during the corporation’s winter of discontent.

B. The Market-Dominated Monitor

In all likelihood, the principal impact of institutional investors as large shareholders will be to make corporate management more sensitive to the market’s judgment. This development will yield greater efficiency only to the extent that the market can make a better informed or less biased judgment than can the corporation’s own management. Often, the market can. Yet, because management inherently has access to nonpublic information that the market lacks, it is impossible to conclude that the market’s judgment will always be superior. Even in an efficient market, those possessing “inside” information are capable of outperforming the market.206 Thus, institutional investors may tend to

206. Under the standard “semi-strong” version of the Efficient Capital Markets Hypothesis, one assumes only that the market has incorporated all publicly available information into the share price, not that nonpublic information is reflected. Thus, those in possession of such information, as management typically is, can make a better judgment of the firm’s value than can the market. For a fuller explanation of efficient market theory, see Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 554–92 (1984).
follow the herd, enforcing the generic judgments and conventional wisdom of the market, but thereby chilling entrepreneurial managers who believe they perceive opportunities that the market has missed.207

One answer to this claim is that if a management team truly knows more than the market, it has every incentive to explain and defend its judgment by persuading the consensus of securities analysts on whom the market, and institutional investors, rely. Still, there is a problem with this answer: Such an explanation may release confidential, proprietary information. Suppose, for example, that at a time when the market believes that American companies should cease to produce a particular technology because they cannot outcompete Japanese firms that seemingly have a comparative advantage, one lone American firm bucks the market's judgment and seeks to expand its activities in this area. If this firm is heavily owned by institutions, this deviant behavior likely will encounter institutional resistance.

What happens next? Possibly, the corporation's management can explain to the market why its new technology can outperform all existing products made by the competition. But to be credible, this claim must be corroborated. At this point, if the corporation reveals to its institutional investors, or to the market generally, its basis for believing its new technology to be superior, it may effectively release—directly or indirectly—proprietary information, thereby benefitting its competitors. Conversely, if it just asserts the superiority of its new technology, its position may not be credible to market-sensitive institutional investors. The paradox is a familiar one: it is often difficult to value proprietary information without revealing it and thereby sacrificing its proprietary value.

Although corporate management has long faced the prospect that an unsympathetic market would discount its share price if it bucked the conventional wisdom, management could withstand this pressure in the past, either because public shareholders were too disorganized to mount effective opposition or because the controlling shareholders, such as a family group, would have participated in the decision, or at least could have it explained and justified to them in confidence. Again, the difference between a traditional controlling shareholder and a loose association of institutional investors is significant here. It is one thing to disclose confidential plans and data to a single majority shareholder or a close-knit family group, and quite another to explain the same information to the community of securities analysts on whom institutional investors rely. In the latter case, information leakage is likely.

This problem is not insurmountable. Institutional investors could

207. For the hypothesis that institutional shareholders are susceptible to herd behavior, see David S. Scharfstein & Jeremy C. Stein, Herd Behavior and Investment, Am. Econ. Rev., June 1990, at 465.
rely on professional directors selected by them to evaluate management’s plans and projections, without proprietary information leaking to the public.208 Yet, this course would require institutional investors to accept some market penalty during the period when the market was skeptical of management’s plans. Many institutional investors might be willing to pay this price, but others would not because of their need for liquidity. For this latter group, the ideal position is to be a low-profile member of a loose investors’ association that has access to nonpublic information and projections, and to choose “exit” when that information suggests a future market decline in the firm’s stock price. In short, such actively trading investors make poor monitors because they are unwilling to pursue long-run policies that may elicit a short-run market discount.

C. The Risk-Preferring Monitor

Standard finance theory recognizes that the shareholder in a highly leveraged firm will prefer a higher-risk course of action than would the same shareholder in a less leveraged firm.209 Because in such a firm most of the loss will be borne by creditors, while most of the gain will go to the shareholders, shareholders might rationally prefer a high-risk investment with a low probability of success to another investment with a projected lower return but a much higher probability of success—even though these shareholders would have the opposite preference if they were the suppliers of all the capital for the project. Based on this analysis, some commentators have contended that the Japanese/German model, under which the same banking institution provides both debt and equity capital to the firm, has significant efficiency advantages.210 Monitors who hold both debt and equity need not be “excessively risk-prone” because their attitude will reflect their weighted average position as both creditors and shareholders.211

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208. Such an institutional arrangement has been carefully spelled out by other recent commentators. See Gilson & Kraakman, supra note 13. They assume (as do I) that institutional investors must delegate to outside professionals the actual responsibility for monitoring.

209. This has been a central insight of standard finance theory. See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 334 (1976) (noting that managers in a leveraged firm will have an incentive to accept projects having a high payoff but low risk of success because the shareholders capture the gain and creditors suffer the loss). While Jensen and Meckling ignore that managers may have firm-specific human capital at risk that may dissuade them from accepting such risks, their analysis works well for institutional investors.

Of course, this problem is mitigated if institutional investors also hold the debt securities of the firms in whose equity securities they invest. See Prowse, supra note 66, at 46-48 (discussing Japanese pattern). Still, no reason is apparent why U.S. institutions would undertake on their own to diversify on such a matched basis.

210. See Prowse, supra note 66, at 51-52.

211. See Aoki, supra note 88, at 16 (citing Phillipe Aghion & Patrick Bolton, An
Prowse has reasoned that allowing financial institutions to serve as both creditors and shareholders should minimize agency costs.212

The immediate point, however, is that the legal restrictions in the United States that inhibit banks and insurance companies from owning stock should logically produce monitoring by other institutional investors of a very different character than prevails in Japan or Germany. Rather than being neutral monitors, American institutional investors have a logical incentive, at least in the case of leveraged companies, to prefer risky strategies that may transfer wealth from debtholders to shareholders. To be sure, managers may have the opposing tendency to be excessively risk averse because they have undiversifiable human capital and other wealth locked into the firm.213 Ultimately, it is hard to determine how this tension between risk-averse managers and potentially risk-preferring institutions will be resolved. However, it stands in sharp contrast to an earlier era when the incentives of the controlling shareholders tended to match those of management because the bulk of their wealth was typically invested in the firm so that they could not be risk neutral.

D. The Disruptive Monitor

A substantial economic literature has described contracting within the firm as based on "implicit contracts."214 Because managers and other employees should be risk averse, while diversified shareholders should be risk neutral, this literature argues that the two sides maximize their respective interests by entering into employment contracts under which employees trade off some portion of the wages they could demand in return for employment stability. One aspect of this system of implicit contracting is that it defers a considerable portion of the managers' expected aggregate compensation until the end of their careers.215 But, such implicit contracts are vulnerable if there is a hostile change of control because the new owners can in effect renege on this implicit agreement and withhold the deferred compensation.216


212. See Prowse, supra note 66.
213. See Coffee, supra note 178 at 17–19.
215. Deferred compensation is a protection against both shirking and managerial departures. This theory assumes that the manager's value to the firm is often difficult to estimate until a subsequent period; thus, deferred compensation acts as a bonding device to reduce the need for costly monitoring.
This same point can be made in more overtly political terms. Professor William Simon has argued that a tradition of "economic republicanism" in the United States has long been hostile to "speculators and intermediaries" because "they introduce a community-threatening liquidity to investments."\textsuperscript{217} Fear of such destabilizing changes may well explain the recent wildfire-like passage of antitakeover statutes in the majority of states.\textsuperscript{218}

From either an implicit contract standpoint or this community-oriented perspective, liquidity is disquieting because it implies instability. Thus, the future power of institutional investors presents many of the same issues as did the hostile takeover. Potentially, pools of institutional investors could form and re-form. Particularly because they arrive on the scene at an interim point in the corporation's existence, they are unlikely to feel bound by prior implicit wage and employment arrangements between the corporation and its employees and managers. Thus, they may disrupt the implicit contract by pressuring senior management to reduce employment and compensation levels. Some empirical support exists for this proposition, with one study finding the level of deferred compensation to be higher in firms with low shareholder concentration.\textsuperscript{219} Arguably, managers may be less willing to rely on implicit contracts as institutional ownership increases.

E. The Opportunistic Monitor

Institutional investors should not be mistaken for financial saints. Their representatives on a board will not automatically represent all shareholders; to the extent that conflicts among shareholders exist, board members who are institutional employees or agents may favor the interests of their employers.\textsuperscript{220} For example, because mutual funds are often affiliated with investment banking firms, it is not unimaginable that mutual fund representatives on boards might pursue the interests of their investment banking firm sponsors, favoring transactions that generated fees for them. Pension funds have less obvious conflicts, but to the extent that they are dominated by their own corporate management, they could logically pursue a policy of reciprocal deference to their host management. Individuals may also act opportunistically, using their influence to obtain corporate office or perquisites. Indeed,
although public pension funds probably have the fewest potential conflicts, their own employees are also probably the least monitored, giving them a vast range for discretionary decision-making.

Finally, there is the overriding danger of market manipulation. Unlike risk averse corporate managers, who tend to favor steady earnings and stock price growth, institutional investors who possess de facto control can benefit from volatile swings in stock price and could manipulate corporate affairs to create profitable trading opportunities. The enactment of the Securities Exchange Act of 1934 was motivated to a considerable degree by Congressional dissatisfaction with the behavior of “notorious market pools,” which were essentially trading syndicates formed by large investors to manipulate stock prices. Absent restrictions on liquidity, the growth of institutional ownership creates the preconditions under which such pools could reappear.

F. The Unaccountable Monitor

Public pension funds have been the most active of institutional investors, but they may also be the least accountable to their own beneficiaries. A state or municipal pension fund covers an enormous number of employees, and therefore substantial collective action problems would be obvious, even if the beneficiary had some recourse other than litigation. But unlike the corporate pension fund, there is no corporate sponsor looking over the public pension fund trustee’s shoulder and seeking to economize on its own contribution. Instead, the public pension fund offers an attractive vehicle by which political leaders, or would-be candidates, can present themselves to the public. The more prominent the role of public pension funds becomes, the greater will be the political allure of such office. The result is a special agency problem: political leaders as pension fund trustees are subject to strong constituency pressures that can conflict with their obligation to maximize value for their beneficiaries. In fairness, this problem has not yet materialized in the United States, but its eventual appearance seems

221. See Steve Thel, The Genius of Section 16: Regulating the Management of Publicly Held Companies, 42 Hastings L.J. 391, 399 (1991) (arguing that the Congressional purpose underlying § 16(b) of the Securities Exchange Act of 1934 was not to prevent insider trading, but to eliminate the incentive for the manipulation of corporate affairs to produce stock price fluctuations).

222. Id. at 439–40.

223. Recently adopted rules under § 16(b) may reduce this danger, but do not eliminate it. See infra notes 256–258 and accompanying text.

certain.

G. Summary

This Article does not contend that institutional monitoring is undesirable. To the contrary, the benefits seem likely to outweigh the costs by a substantial margin. The point here, however, is that monitoring is not a neutral phenomenon; all monitors have characteristic biases. The substitution of institutional investors for previous monitors, such as family groups, carries with it the risks that new agency costs will be substituted for old ones. Chief among these risks are the following: (1) the new monitors will be more prone to bail out when crises loom; (2) a volatile market will interfere with long-term planning; (3) under some circumstances, the new monitors will have a higher tolerance for risk than society as a whole deems desirable; and (4) implicit contracts will be disrupted. These risks are simply that: Risks, not certainties. Part IV will next discuss how they can be mitigated and, in that light, how the “unleashing” of the institutional investor should proceed.

IV. SHAPING THE INSTITUTIONAL MONITOR: THE ROLE OF REGULATION

If one sought to define the optimal corporate monitor, what criteria would one select? Three factors seem to stand out: (1) the institutional monitor should be reasonably free from conflicts of interest so that its evaluation of corporate management will not be biased by the opportunity to earn fees or income not equally available to other shareholders; (2) its stake in the corporation should be large enough to justify the expenditure of significant monitoring costs; and (3) its preferred investment horizon should be sufficiently long so that it has an interest in improved corporate governance, even when no immediate value-maximizing transaction, such as a takeover or LBO, is in the offing. Based on these three criteria—the absence of conflicts of interest, a substantial stake, and a long-term horizon—the relative superiority of the pension fund over other institutional investors seems clear. First, unlike banks or insurance companies, the pension fund has no other opportunities to earn fees or income from the corporation.225

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225. For a recent instance in which fee income may have driven decisions by banks to invest in corporate equity, see Wallace, supra note 159 (discussing fee income received by banks from LBO lending and its influence on their decision to invest in...
Second, it is increasingly likely to hold a substantial stake in the corporations in which it invests; but because it cannot make a takeover bid, there is less prospect for a conflict arising between its interests and those of smaller shareholders.\(^{226}\) Third, it characteristically has a lower turnover rate on its stock portfolio than most other institutional investors and so has a relatively longer investment horizon.\(^{227}\)

Because pension funds represent the largest, and still growing, category of institutional investor, their relative superiority to other institutions in terms of these criteria may seem fortunate. However, pension funds are hardly immune from pressure,\(^{228}\) and some commentators believe there is an unresolvable fundamental tension between the legal responsibilities of pension managers to their beneficiaries and their actual subservience to senior corporate officials.\(^{229}\) At a minimum, most commentators recognize that senior corporate management wants its pension managers to vote for management and against insurgent shareholders.\(^{230}\) While overt pressure on pension managers may no longer be permissible,\(^ {231}\) only obtuse money managers will fail to detect their client’s or superior’s sympathies and the corresponding impact on their self-interest.

Although the conflict of interest problem has been duly noted by a number of commentators, two more serious obstacles to active institutional monitoring have received less attention. First, many institutions—pension funds in particular—are so widely diversified, holding literally a thousand or more stocks, that it is simply beyond their realis-

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\(^{226}\) No U.S. pension fund has ever made a takeover bid, and such a substantial investment would probably run afoul of ERISA’s diversification requirement. See 29 C.F.R. § 2550.404a-1 (1990). See also Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982) (in a takeover bid, trustees who are also corporate officers have a duty to resign when their positions as trustees conflict with their positions as corporate officers).

\(^{227}\) One recent study of turnover rates found the annual turnover rate for pension funds to be 61%, while it was 76% for mutual funds and 51% for college and university endowments. See Stephen A. Berkowitz & Dennis E. Logue, The Portfolio Turnover Explosion Explained, J. of Portfolio Mgmt., Spring 1987, at 38, 40.

\(^{228}\) For examples of such pressure, see Joe Kolman, The Proxy Pressure on Pension Managers, Institutional Investor, July 1985, at 145–47; Minow, supra note 172, at 1105, 1126–28 (1988).


\(^{230}\) Beginning in 1988, the U.S. Labor Department has campaigned to reform pension voting practices and has issued a series of interpretations requiring plan fiduciaries to vote shares held by the plan or supervise those with voting discretion. See Black, supra note 12, at 597 (noting that subtler pressures still remain possible); Rock, supra note 9, at 476–78.
tic monitoring capacity to make any meaningful evaluation of the competence of the management at individual firms or of the likely impact of proposals raised by other shareholders of those firms. Second, institutional money managers are typically compensated based on formulas that leave them rationally indifferent to shareholder voting decisions.

It is debatable whether these problems can be overcome, and the trend toward global diversification suggests that both will be aggravated. Without expressing either optimism or pessimism, this Part will chart the structural changes that would be necessary to achieve effective monitoring through institutional investors.

Three basic proposals will be considered: (1) an unbundling strategy which would shift proxy voting decisions from institutional money managers to specialized proxy advisers, who would be encouraged to develop and sell their expertise to institutional investors; pension fiduciaries would be required either to use these services or to demonstrate a sufficient in-house capacity to internalize voting decisions; (2) a restricted diversification strategy which would discourage institutional investors from diversifying beyond the limits of their monitoring capacity; and (3) an incentive compensation strategy which would reward money managers for voting decisions that increased their portfolio's value. The first strategy addresses the informational overload on the institution, while the second and third increase the expected payoff from monitoring to the institution and its agents, respectively. As discussed below, these strategies can also be linked.

Such a combined strategy would require some deregulation, but not a broad "unleashing" of institutional investors that freed them from all existing constraints under the federal securities laws. Rather, because "voice" and "exit" are competing options for the investor, reforms that increase the availability of "exit" by enhancing the liquidity of institutional investors could chill "voice," namely, their willingness to participate in corporate governance. Thus, relaxation of "exit" regulations should selectively focus on both: (1) whether the investors thus aided will still have an incentive to exercise an increasingly costly "voice" in corporate governance, and (2) whether relaxed "exit" will

232. The problem is most acute with respect to "indexed" funds that follow a passive investment strategy. See infra notes 236-245 and accompanying text. The problem is not, however, limited to the indexed funds. For a similar, if more pessimistic, view, see Lipton & Rosenblum, supra note 14, at 206.

233. See infra notes 336-347 and accompanying text.

234. By "costly," I mean to cover both financial and nonfinancial costs. Current estimates place the direct financial cost of a proxy campaign in opposition to management at between $2 million and $15 million, depending upon the size of the corporation and the specific proposal. See Proxy Contests: Oasis for Dissidents—or a Mirage? Corp. Control Alert, May 1990, at 1, 10 [hereinafter Proxy Contests]. Undoubtedly, legal reforms can reduce these costs, but any campaign to elect directors or dismantle antitakeover charter provisions is likely to encounter managerial resistance and entail
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give the wrong investors an incentive to participate in control groups in order to manipulate corporate affairs to benefit from stock volatility.235

A. The Decline of “Exit”

Although commentary about institutional investors customarily distinguishes among them in terms of their legal status (e.g., pension funds, mutual funds, or insurance companies), a more important distinction may lie in their differing investment philosophies. Today, it is estimated that nearly one-third of all equity investments held by institutional funds are “indexed”—that is, they are invested in a portfolio of securities that is intended to represent an accurate proxy for the stock market as a whole. Such passive investing seeks not to beat the market, but to duplicate its movements, and, as a result, such investors tend to hold for the long-term.237 In this Article’s terminology, such indexed investors have essentially abandoned their “exit” option and have become long-term holders. This decision was motivated by their perception that an active trading strategy did not enable them to outperform the market, but only increased the brokerage and other costs they bore.238

Demographic forces indicate that pension funds will hold a progressively larger percentage of all equity securities and may account for forty percent of the equity ownership of U.S. corporations by the year

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235. See supra notes 221–223 and accompanying text.

236. A survey by Financial Executives Institute of pension plans found 34% of the equity investments held by the surveyed plans were indexed. See David M. Walker, The Increasing Role of Pension Plans in the Capital Markets and in Corporate Governance Matters, in Institutional Investing: The Challenges and Responsibilities of the 21st Century 34, 36 (Arnold W. Sametz ed., 1991). The New York Stock Exchange has reported that “analysts estimate that between $200 billion and $300 billion—or about 30 percent—of institutional assets are held in portfolios that replicate or mirror a market index.” NYSE Press Release, Panel Recommends Initiatives Aimed at Reducing Volatility, Enhancing Investor Confidence, June 12, 1990. Public pension funds are particularly “indexed.” For example, it has been estimated that of the $40 billion in equities held by the three principal New York pension funds covering state and local employees, “$30 billion are in indexed portfolios.” Taylor, supra note 41, at 72.

237. For example, CalPERS has an average holding period of between six and ten years for each security in its portfolio and an annual turnover rate of approximately 10%. See Gilson & Kraakman, supra note 13, at 863. CalPERS is apparently moving to the point where it will be 85% indexed during 1991. See Stephen Clark, Why Dale Hanson Won’t Go Away, Institutional Investor, Apr. 1990, at 80. A recent survey by the Financial Executives Institute found that the average turnover rates for pension funds are falling. For actively managed equity portfolios, the average turnover rate declined from 66% in 1987 to 47% in 1989, and for passively managed portfolios, the turnover rate declined from 24% in 1987 to 13% in 1989. See Walker, supra note 236, at 36.

238. As Professors Gilson and Kraakman accurately observe, these institutional investors have essentially accepted the Efficient Capital Market Hypothesis. See Gilson & Kraakman, supra note 13, at 865–67.
2000. As both pension funds and mutual funds switch to an indexed strategy, indexed investing eventually will account for a significant fraction of all equity investment. Necessarily, however, a ceiling will be reached on the percentage of the total market for which indexed investors account. If all, or nearly all, institutional investors were to adopt passive trading strategies, there would simply be no market—or at least not an efficient one. Economic theory suggests that if indexed investing were to become the predominant strategy for institutions, other investors would be enabled to pursue more profitable trading strategies. Thus, there seems considerable reason to believe that institutional investors will divide along a continuum whose poles are represented by (1) indexed investors and others who follow basically long-term trading strategies and (2) active traders who may find that the growth of indexed trading increases the opportunities available for profitable short-term trading.

Among fund managers, there is already a wide divergence in trading styles, as shown by their different turnover rates. Recognition of this diversity should be the starting point for a sensible public policy analysis of the institutional investor, because different institutions are likely to behave very differently as corporate monitors. Having abandoned “exit,” indexed investors present little risk of bail-outs or the misuse of inside information. Sharing a long-term perspective, they have less reason to be interested in obtaining short-term gains by disrupting implicit contracts. In contrast, active traders seem more likely to exert pressure for management decisions and strategies that will in-

239. For this estimate by the Pension and Welfare Benefits Administration, see Pension and Welfare Benefits Admin., U.S. Dep’t of Labor, Proxy Project Report, Mar. 2, 1989, at 1.

240. See Sanford J. Grossman & Joseph E. Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 393 (1980) (concluding that there will be an equilibrium level of disequilibrium because the market cannot stay efficient without some incentive to search for new information).

241. See Walker, supra note 236, at 36 (noting that in 1989 actively managed equity portfolios of pension plans had an average turnover rate of 47%, while passively managed portfolios of the same institutions averaged only 13%). Another recent survey of turnover rates by Institutional Investor reported the following range of rates among responding fund managers:

<table>
<thead>
<tr>
<th>Turnover Rate</th>
<th>Percentage of Funds</th>
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<tbody>
<tr>
<td>25% or below</td>
<td>26.3%</td>
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<tr>
<td>26 to 50%</td>
<td>41.6%</td>
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<tr>
<td>51 to 75%</td>
<td>21.8%</td>
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<tr>
<td>76 to 100%</td>
<td>8.2%</td>
</tr>
<tr>
<td>101 to 150%</td>
<td>1.7%</td>
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<tr>
<td>151 to 200%</td>
<td>0.3%</td>
</tr>
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</table>

See Pensionforum: Dismay Over Short-Termism, Institutional Investor, Mar. 1991, at 139. Fifty-six percent of the surveyed funds also reported that their turnover rates were unchanged as compared to five years ago, but of the 24% that did have a lower turnover rate, the majority attributed the decline to “a shift in assets into index funds.” Id. at 139.
crease the volatility of the corporation's securities, which, to a degree, they can anticipate because of their privileged position as quasi-insiders. Accordingly, as a normative matter, deregulation of the restrictions on institutional ownership, and particularly those regulating "exit," should go further and faster in the case of the indexed investor.

Although indexed investors are typically long-term and substantial holders, it does not follow from this that they will be active monitors. The problem is that indexed funds are typically managed by external money managers who have little incentive to monitor. Rather, having abandoned any attempt to outperform the market, they compete by reducing their costs in order to be the lowest-cost provider of "indexing" services. Obviously, a money manager intent on radical cost economizing has little interest in undertaking costly monitoring activities. The extent of this problem is revealed by a question aptly posed by my colleague, Professor Louis Lowenstein. He reports that Wells Fargo Institutional Trust, the leading index fund manager, has nearly $60 billion invested in indexed equity funds for its clients, of which $40 billion is in its S&P 500 index, and that it holds perhaps 5000 different stocks in these funds. Yet, because of the competitive nature of the indexing industry, it charges fees as low as two basis points a year. Thus, he asks: "How much monitoring do we get for two basis points?"

The only logical answer is that one gets very little monitoring for such a price. But if capital markets are competitive, why do not other competitors offer more meaningful monitoring services and charge a higher fee? The most likely answer involves a combination of the corporate manager's desire for an implicit and reciprocal system of self-protective passivity, under which corporate sponsors dissuade their money managers from supporting shareholder activism and the fear of money managers that if they acquire a reputation for activism they will be less able to attract additional pension fund accounts. Under this combination of factors, even if all corporate sponsors do not seek to chill active monitoring by money managers, the latter still fear acquiring an adverse reputation and so seek a low profile. The result resembles an implicit contract: money managers are free to use their own discretion in making investment decisions, but not in the case of voting decisions, because the latter more clearly threaten executive job stability.

242. This point has been well made by Professor Rock. See Rock, supra note 9, at 474.
243. Lowenstein, supra note 45, at 33–34.
244. Id. at 33. A basis point is 1% of 1%. Thus, two basis points charged annually on a $1,000,000 fund would amount to $200 a year. The director of proxy voting at Wells Fargo described their voting practices to Professor Lowenstein as follows: "[S]ince we invest by formula, we vote by formula." Id. at 34. In my view, use of such a formula reflects simply an attempt to minimize costs while achieving minimal compliance with the Department of Labor's guidelines.
Finally, there is a third factor: Most pension funds have only a skeleton in-house staff, which then hires several external money managers. Both investment and voting decisions are then delegated to the external managers, and the function of the in-house staff is basically to evaluate the performance of these fund managers. To such an in-house staff, a manager who expends funds or time on proxy voting may seem to be overcharging, particularly given the likely delay between voting and any resulting increase in share value.

What then is the answer? Clearly, a small in-house staff is even less able to monitor the managements of the 500 firms in the S&P 500 or to follow other corporations on a world-wide basis as pension funds increasingly diversify their holdings on a global basis. Inevitably, a serious reform program must consider whether some level of portfolio diversification is "excessive" because it is inconsistent with a capacity to monitor even minimally the firms held in the portfolio. Because such a reform would undoubtedly be controversial, it seems best to consider first several less drastic measures.

B. The Regulation of "Exit"

What gains could be realized simply by relaxing existing regulatory barriers to institutional activism? Much of the federal securities laws and many state statutes can be grouped into two categories: (1) legal rules that regulate "voice," and (2) legal rules that regulate "exit." In the former category, for example, are those rules that apply to shareholder communications or that require disclosure of plans and intentions once certain ownership thresholds are crossed. Much commentary has recently recommended revision of the federal proxy rules and state corporate law to reduce the costs of proxy contests to insurgents. Recently, the SEC has proposed relaxing significantly the proxy rules as they would apply to shareholder communications among institutional investors. Highly desirable as the SEC's proposed reforms are, this Article doubts that either they or the reforms proposed by academic commentators would, if adopted, "unleash" in-

245. See Black, supra note 12, at 596 (describing this relationship as "the most common pattern").
246. The proxy rules are contained in Rules 14a-1 to 14b-2, 17 C.F.R. §§ 240.14a-1 to 14b-2 (1991). For a discussion of their impact on the organization of shareholder groups seeking to oppose management, see Black, supra note 12, at 536–42. But see infra note 249 and accompanying text (discussing proposed relaxation of proxy rules).
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stitional investors. In contrast, "exit" regulation, which focuses on the disposition of securities by persons holding control, has received less attention but may be more effective in inducing institutional investors to join and participate in control groups. Among the legal rules that fall into this category are the following:

I. The Securities Act of 1933. — An individual or a group that possesses control of a company is deemed an "affiliate" and is therefore restricted in its ability to resell any of its shares and may resell only pursuant to a registration statement or an exemption from registration. As a practical matter, the only feasible means by which an affiliate can dispose of shares in a publicly held company at the market price is pursuant to Rule 144, which imposes both volume and sometimes holding period restrictions on affiliates. Thus, the acquisition of "control" by an institutional investor, or a group of them, implies at least some restrictions on liquidity before resale is likely to be economically feasible.

2. Section 16(b) of the Securities Exchange Act of 1934. — Any gain that an officer, director, or ten percent beneficial holder of any class of an equity security of a "reporting" company receives on purchases or sales that occur within six months of any earlier sale or purchase must be disgorged to the corporation. Although long thought of as a prohibition on insider trading, the better, and original, rationale for this extraordinarily prophylactic rule against "short-swing" trading profits is that it is necessary to deter manipulative behavior by corporate insiders. Effectively, this threat of a six-month period of illiquidity deters most institutional holders from crossing the ten percent threshold.

The potential reach of section 16(b) as it applies to institutional

250. See supra notes 10–14, 153–169 and accompanying text.
251. Under § 2(11) of the Securities Act of 1933, 15 U.S.C. § 77(b)(11) (1988), a person who acquires shares from a "control" person becomes an "underwriter" who also cannot sell shares in the issuer without registering the shares with the SEC or obtaining an exemption from registration. "Control" is defined very broadly in Rule 405 to mean the "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person . . . ." 17 C.F.R. § 230.405 (1991). Rule 144 does provide a practical exemption from the registration requirement for affiliates, but under Rule 144(a)(1), an affiliate of an issuer is defined as one who "controls . . . or is under common control with, such issuer." 17 C.F.R. § 230.144(a)(1) (1991). Thus, if an institutional investor joins a control group, its ability to resell even the shares acquired in the open market is significantly restricted.
252. See 17 C.F.R. § 230.144(c)(1) (1991). A controlling shareholder may also make a "private sale" to another sophisticated person or institution, but typically such a sale will be at a significant discount to reflect the fact that the shares remain "restricted." In the future, Rule 144A may liberalize these restrictions, but at present it does not apply to publicly traded securities.
254. See Thel, supra note 221, at 393–401. Professor Thel distinguishes this rationale from the frequently stated rationale that § 16(b) prevents the misuse of nonpublic information, a function that § 16(b) accomplishes only imperfectly.
255. See Black, supra note 12, at 568.
investors is uncertain because current law is conspicuously imprecise as about when members of a loose association of institutional investors become subject to it. For example, assume such a group seeks to elect a slate of directors to a corporate board. Potentially, this group either (1) could be deemed to be "constructive" directors if any candidate on their slate is elected, under a legal doctrine based on "deputization theory," or (2) could have their individual holdings aggregated and thus be considered a single beneficial ten percent holder for purposes of section 16(b). To date, the SEC has declined to define when support of, or solicitation for, a directorial candidate will trigger this "deputization theory" under which an institution, or group of institutions, becomes a constructive director for section 16(b) purposes. The SEC has, however, indicated that if investors form a "voting group" that requires disclosure under the Williams Act and if this group collectively controls ten percent or more of a class of equity securities, then it will be deemed subject to section 16(a). As a result, an institution that solicits proxies may be deemed the beneficial owner of the shares corresponding to the proxies it receives. Alternatively, by participating in discussions with other institutions, the solicited institutions could be found to have entered into a voting group. Under either theory, insti-

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256. Some decisions suggest that an institution or group that has "deputized" an agent or employee to serve on a corporate board will be deemed to be a constructive director for purposes of § 16(b), regardless of whether its holdings exceed 10%. See Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969); Lowry v. Howmet Corp., 424 F. Supp. 461 (S.D.N.Y. 1977).


258. 15 U.S.C. § 78p(a) (1988). As part of its comprehensive revision of the rules under § 16(b) of the Exchange Act, the SEC adopted Rule 16a-1 in early 1991. This Rule defines the term "beneficial owner" for purposes of determining whether a person or group holds more than 10% of any class of equity securities to "mean any person who is deemed a beneficial holder pursuant to section 13(d) of the Act and the rules thereunder." See Rule 16a-1(a)(1), 17 C.F.R. § 240.16a-1(a)(1) (1991). However, Rule 16a-1 then exempts shares held by institutions that are eligible to file beneficial ownership reports on Form 13G that are held for clients in a fiduciary capacity in the ordinary course of business, "as long as such shares are acquired by such institutions or persons without the purpose or effect of changing or influencing control of the issuer. . . ." Id. Although this language does discourage institutional investor participation in a voting group (at least one intent on "influencing control" of the issuer), its overall impact is not great, because this definition applies only to § 16(a) and not § 16(b). For purposes of § 16(b), the term "beneficial ownership" is defined by Rule 16a-1(a) (2), 17 C.F.R. § 240.16a-1(a) (2) (1991), which requires that the investor "has or shares a direct or indirect pecuniary interest in the equity securities." The scope of the term "indirect pecuniary interest" is uncertain. Does it arise when a group of investors would be able to command a control premium for their shares that they could not expect to obtain on an individual basis? For the SEC release explaining the concept of "beneficial ownership" and "indirect pecuniary interest," see Ownership Reports and Trading by Officers, Directors and Principal Securities Holders, Exchange Act Release No. 28,869 [1990–1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,709 (Feb. 8, 1991).
tutions may become subject to section 16(a), even though they have agreed to pad their holdings and each holds well under the ten percent threshold. The consequence is at least a mild disincentive that may chill institutions from co-operating in solicitation support for a candidate for director.

3. Insider Trading Liability. — An institution with an employee or agent on a corporate board also becomes potentially liable if it trades while it is in constructive possession of material nonpublic information. In principle, the mere possession of such information within the corporate enterprise may be sufficient to create liability, even though those making the trading decision did not use it or have access to it. As a practical matter, this prospect of vicarious liability for information possessed by an employee or agent may force the institution to accept illiquidity if it allows an officer to sit on the corporate board of an issuer in which it holds an equity stake. Thus, to maintain liquidity, the institution must delegate its monitoring role to an outside agent, with whom it must have only limited contacts.

C. The Deregulation of “Exit”: What Rules Are Desirable?

Life would no doubt be simpler for the institutional investor if the foregoing rules were relaxed. But the cost of such relaxation might be to tolerate some low-visibility forms of insider trading and stock market manipulation. No reason is apparent why the antifraud purposes of the federal securities laws should be any less applicable to the behavior of institutional investors than that of any other group. In this light, what forms of “exit” deregulation could curb unnecessary over-

259. The institution could be liable for compensatory damages to contemporaneous traders and to the SEC for a civil penalty of up to three times its profit. See Securities Exchange Act of 1934, §§ 20(a), 21(a), 15 U.S.C. §§ 78t(a), 78u(a) (1988).

260. The SEC’s long-standing position has been that mere possession of material information is sufficient to create liability, and the plaintiff need not show that the information was actually used in the investment decision. See Louis Loss & Joel Seligman, Securities Regulation, at 3503–04 (3d ed. 1991). Where a “Chinese Wall” has been erected to bar the person making the trading decision from access to the information, a different result may follow, but the discussion in the text assumes that no such structural protection has been implemented. Indeed, it is generally infeasible if a senior officer of the institutional investor were to sit on the corporate board.

261. Again, this statement must be qualified to the extent that a “Chinese Wall” can be erected to cordon off the officer on the corporate board from investment decision-making at the institutional investor. However, most institutional investors have relatively “thin” in-house staffs, and most senior officers are involved in investment decision-making. Hence, the feasibility of this option seems doubtful.

262. In essence, this is the proposal for outside professional directors made by Gilson and Kraakman. See Gilson & Kraakman, supra note 13, at 884–88.

263. Other commentators believe the overreach of the § 13(d) rules could potentially pose an equally serious problem. See Gilson & Kraakman, supra note 13, at 896–901. I do not, because § 13(d) requires only disclosure, not illiquidity. Nonetheless, I acknowledge that the case they make for defining its scope more precisely is persuasive.
reach without imperiling important policies of the federal securities laws? The following very marginal changes could encourage those investors that this Article suggests have the greatest potential to become optimal monitors—namely, indexed investors—to participate in corporate governance. Collectively, they would encourage such investors to hold larger stakes and engage in more open discussions among themselves about corporate governance issues.

1. *A Section 16(b) Safe Harbor.* — Today, with the uncertainty that exists over when a “voting group” will be treated as a single beneficial owner, section 16(b) has newly emerged as an obstacle to institutional activism. Although indexed investors are basically passive investors, they still must engage in constant trading in order to adjust their portfolios. As a result, section 16(b) unnecessarily inhibits these investors who have no interest in manipulation or insider trading. Yet, the SEC has broad authority to create exemptions under section 16(b) and has regularly utilized this authority. In principle, a variety of solutions could work: (1) “deputization theory” could be curtailed so that it would not create liability for institutions where they neither employed nor paid the director alleged to be their “deputy” (but only solicited proxies for such person); (2) “deputization theory” could be clarified so that it would not apply to a campaign to elect only a minority of the directors; (3) trades made by indexed investors simply to adjust their portfolios in line with a stock index could be exempted from section 16(b); or (4) the concept of beneficial ownership could be redefined to exclude investors who have reached an understanding that amounts to a “voting group” for purposes of electing directors, but do not otherwise have control over, or an agency relationship with, those who are to be elected. The few decisions that have addressed what constitutes a “deputy” sufficient to trigger section 16(b) liability for its controlling principal have generally involved senior officers or directors of one corporation who were delegated the task of serving on the board of another. Thus, a court could still rule, consistent with prior

264. See supra notes 256–258 and accompanying text.

265. The last sentence of § 16(b) authorizes the Commission to adopt rules and regulations to exempt transactions “not comprehended within the purpose of this subsection.” 15 U.S.C. § 78p(b) (1988). See, e.g., Rules 16a-4 to 16a-11, 17 C.F.R. §§ 240.16a-4 to 16a-11 (1991) (exempting various classes of transactions).

266. This position has been advanced by Professors Gilson and Kraakman. See Gilson & Kraakman, supra note 13, at 902–03. As discussed in the text, I am not optimistic about its chances of adoption.

267. In Feder v. Martin Marietta Corp., 406 F.2d 260, 264–66 (2d Cir. 1969), the deputy was the president of one corporation who served on the other’s board at the direction of his own corporation. In Lowey v. Howmet Corp., 424 F. Supp. 461, 463–64 (S.D.N.Y. 1977), Felix Rohatyn, a director of Howmet, was allegedly deputized by Howmet to represent its interests on the board of Pfizer Incorporated. Finding the issue to require a detailed factual analysis, the court denied motions made by both sides for summary judgment. In contrast, institutional investors are unlikely to use either their own officers or directors as their representatives on the corporate boards of portfolio
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precedents, that merely favoring or even soliciting proxies for a candidate does not make such a candidate into one’s agent or “deputy.” Rather, some economic or other special relationship with the principal should be necessary.

In the absence of such a judicial statement, however, the simplest, narrowest reform would be administratively to exempt from section 16(b) trading transactions that are undertaken simply to maintain an indexed portfolio. At a stroke, this solves the section 16(b) problem for the indexed investor, who buys for the long-term, but recurrently needs to adjust its portfolio. The rationale for such an exemption is that the motive for such trading transactions is so clear and innocent that any presumption of misuse of inside information is rebutted. To implement such a rule, the indexed investor seeking to rely on it could be required to file in advance a description of its indexing strategy, and still would be required to report all trading transactions. Above all, however, such a rule creates a greater incentive for the long-term holder to play a monitoring role than it does for the active trader.

In contrast, a policy such as that proposed by Professors Gilson and Kraakman, which would exempt a transaction from section 16(b) companies, in part because of the need to maintain a “Chinese Wall” to protect against insider trading liability. In Exchange Act Release No. 28,869 [1990–1991 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 84,709 (Feb. 8, 1991), the Commission declined to adopt a rule expressly codifying or clarifying “deputization theory,” but instead indicated that that doctrine’s development “will be left to case law.” Id. at 81,251 n.27.

268. Such an exemption is far from fanciful. In its newly adopted Rule 16a-1, the SEC exempts from the definition of “derivative securities” “interests in broad-based index options, broad-based index futures and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority.” See 17 C.F.R. 240.16a-1(c)(4) (1991). See also Exchange Act Release No. 28,869, supra note 267, at 81,264 (streamlining the compliance requirements under § 16 of the Securities Exchange Act of 1934 with respect to derivative securities, employee benefit plans, and trusts administered by insider trustees). This exemption does help the institutional investors that own shares themselves rather than derivative securities (such as options, futures, or baskets), but conceptually the rationale that justifies exempting trading in indexes through derivative securities should also exempt transactions in the underlying securities. In both cases the underlying justification for the exemption is that transactions by indexed investors create little potential for abuse.

269. Indexed investors may need to trade for a variety of reasons. First, stocks are continually added to, and subtracted from, the S&P 500 and other indexes. Second, indexes differ, and under some (“equal weighted” indexes) the user invests equivalent dollar amounts in each stock in the index. In such a case, if an individual stock appreciates (or declines significantly), it will bear a disproportionate relationship to the portfolio as a whole, and the indexed investor would need to sell some shares (or buy more shares) to maintain a properly diversified portfolio. Third, investors may often decide to index only a portion of their portfolio (say, 50%) and, if they revise this percentage (up or down), sales or purchases will be necessary. Finally, the assets under the institutional investor’s control may change, necessitating sales or purchases. For example, a mutual fund may experience a significant number of redemptions during a market downturn. The key point about all these trading transactions is that the indexed investor is not making individual, firm-specific trading decisions.
simply because the investor group seeks to elect only a minority of the board, reflects a misunderstanding of the purpose of section 16(b). Section 16(b) is concerned not with control, but with the formation of "pools" and access to inside information. An investor group controlling a minority of the board clearly can amount to such a "pool" and can possess such access, even if it lacks control.

2. Redefining Control. — An investor or investor group that possesses "control" faces two problems: (1) it cannot sell its shares, absent registration or an exemption, and (2) a "controlling" shareholder is prima facie liable for federal securities law violations committed by the "controlled" corporation, unless an affirmative defense of non-negligence can be established. The term "control" is defined very broadly by SEC rules, and under this definition, the power to elect even a minority of the board could well constitute control. Indeed, the SEC's staff has taken the position that a ten percent holding creates "a rebuttable presumption of control, especially if such holdings are combined with... membership on the board." If so, institutional investors who join a "control" group potentially face the worst of all possible combinations: illiquidity and liability.

What exemptions from this definition of control make sense for the institutional investor? First, with respect to the illiquidity problem, it would sensibly parallel this Article's earlier suggestion that portfolio adjustments by an indexed investor should not be considered transactions within the scope of section 16(b) to exempt these same portfolio modifications from the concept of "distribution" under the Securities Act of 1933. The practical significance of this proposal is limited,
however, because Rule 144 already permits an affiliate to sell up to the greater of one percent of the class or the average weekly trading volume of the security every three months.\footnote{277} Nonetheless, Rule 144 could, and should, be extended expressly to permit indexed investors who have a "control" relationship to the corporation to sell, regardless of volume, provided that their disposition was undertaken as part of a portfolio modification consistent with an indexed strategy previously filed with the SEC.\footnote{278} Thus, the indexed investor would face no significant increase in illiquidity, even if it wished to dispose of more than one percent of the class and was a member of a control group.

"Controlling person" liability presents a more serious problem for institutional investors who are considering whether to join a collective effort to influence corporate management.\footnote{279} Here, the best answer is explicit rule-making by the SEC to tighten its overly expansive definition of "control." Some have argued that a group formed to elect only a minority of the board should not be considered a "control group."\footnote{280} Doctrinally, this argument faces an uphill battle, given a tradition of SEC interpretation to the contrary.\footnote{281} Moreover, it is not at all clear that directors who are representatives of institutional investors will necessarily be in the minority on any given decision. More typically, the board will act as a group and reach a consensus. Thus, a narrower and more doctrinally feasible route to the same protective safe harbor might be for the SEC to promulgate rules that indicate that merely agreeing on voting decisions without soliciting proxies does not make

\footnote{277. See Securities Act Rule 144(e), 17 C.F.R. § 230.144(e) (1991). This 1% volume limit assumes, however, that the securities are not "restricted securities" that were acquired in a private placing.}

\footnote{278. This proposal does not extend to "restricted securities," which are issued in a transaction or series of transactions not involving a public offering. See Rule 144(a)(3), 17 C.F.R. § 230.144(a)(3) (1991). "Restricted securities" must be held for a two-year holding period. See Rule 144(d)(1), 17 C.F.R. § 230.144(d)(1) (1991). This Article is concerned only with the impact of Rule 144 on "free" stock that has been purchased by a person having "control." Rule 144 subjects such "affiliates" to special volume restrictions regardless of their holding period. See Rule 144(e) and (k), 17 C.F.R. §§ 230.144(e), (k) (1991).

279. Professor Conard has argued that this is the principal regulatory barrier to active institutional participation in corporate governance. See Conard, supra note 43, at 158-59.

280. See Gilson & Kraakman, supra note 13, at 902.

281. See supra notes 274-275 and accompanying text.
one a "controlling person" where one would otherwise not possess control.\textsuperscript{282}

Similarly, SEC rules could also specifically extend and apply the affirmative defense that the federal securities laws provide to a controlling person so that it would clearly protect the institutional investor who lacks actual knowledge but does have a nonemployee representative on the corporate board.\textsuperscript{283} Under the Securities Act of 1933, a controlling person is not liable for securities law violations committed by the corporation that it nominally controls if it "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."\textsuperscript{284} The same principle, expressed in slightly different words, is also contained in the Securities Exchange Act of 1934.\textsuperscript{285} Yet, some decisions have held that a controlling person has a duty to supervise.\textsuperscript{286} Such a duty is simply beyond the monitoring capacity of the typical pension fund, with its usually small, in-house staff. Thus, a safe harbor exemption rule could be adopted by the SEC to protect institutional investors by establishing "bright line" standards for them. For example, such a rule might appropriately provide that shareholders should not be deemed to have "knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged" if the investor lacked actual knowledge, had no direct employee or paid agent on the board, and had taken reasonable precautions by establishing a "Chinese Wall" between itself and any

\textsuperscript{282} Where the agreement related to the election of directors, such a definition would need to indicate that there could be no agency relation between the institution and the director. It could add, however, that support for an unaffiliated candidate did not make that candidate an agent. Thus, this proposal is not inconsistent with the Gilson and Kraakman idea that directors should be dependent on institutions. See Gilson & Kraakman, supra note 13, at 880–82.

\textsuperscript{283} There are several precedents for such a safe harbor defense. Under § 11(b) of the Securities Act of 1933, see 15 U.S.C. § 77k(b) (1988), Rule 176 sets forth criteria to guide courts in interpreting the "due diligence" defense. See 17 C.F.R. § 230.176 (1991). See also Rule 175, 17 C.F.R. § 230.175 (1991) (statements on behalf of issuer not deemed fraudulent if made on a reasonable basis and in good faith).


\textsuperscript{285} Section 20(a) of the Securities Exchange Act of 1934 requires that "the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." See 15 U.S.C. § 78t (1988).

\textsuperscript{286} Compare SEC v. First Sec. Co., 507 F.2d 417, 421 (7th Cir. 1974) (brokerage firm liable for fraud committed by its officer on escrow investors) with Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir. 1975) (newspaper liable for "touting" columns written by one of its columnists). These decisions generally have involved corporations who were supervising their own employees. Courts have been more lenient with outside directors. See Burgess v. Premier Corp., 727 F.2d 826 (9th Cir. 1984) (where director was not involved in day-to-day operation of corporation, he was not a controlling person). A fortiori, courts should be even more lenient with an outside investor group holding less than a majority of the shares and electing less than a majority of the board.
implicit representative on the controlled corporation's board.287

There is a trade-off to such a defense; to invoke it, the institutional investor would have to delegate its monitoring role to a representative—i.e., the director it sponsored—with whom it could have only limited contacts. Yet, such a separation is probably made necessary in any event by the potential for insider trading liability, and thus there is little marginal cost to this standard.

In sum, what would be the net impact of the foregoing proposed reforms? It is difficult to predict more than a modest increase in activism if they were implemented alone. Thus, the real point here is that any program of deregulation that is consistent with the basic assumptions of securities regulation will not have much impact and will certainly not “unleash” institutional investors. At bottom, institutional passivity is primarily a product of: (1) a preference for liquidity over control, and (2) agency problems that leave money managers without sufficient incentives to be concerned about voting. The foregoing proposals deal only with the former problem, but the next section addresses the latter.

D. The Reregulation of “Voice”

Many recent commentators have proposed the relaxation of those SEC rules that limit institutional “voice.”288 In response to this criticism, and in particular to a series of detailed proposals made by CalPERS,289 the SEC has proposed a bold, sensible, and far-reaching program of deregulation in order that its proxy rules not inhibit intershareholder communication.290 The proposal most relevant to institutional holders would exempt solicitations by any “disinterested” person who is not seeking to obtain authority to vote proxies.291 Thus, institutional investors could freely communicate and recommend opposition to a management proposal (so long as they did not solicit proxies).

The SEC’s proposals would largely remove the chill on shareholder communications that the current proxy rules create.292 But,

287. The relevance of such a “Chinese Wall” here is not that it rebuts the possession of indirect control, but that it demonstrates the absence of “reasonable grounds” to know of the facts giving rise to the asserted liability.
288. See supra notes 10–14, 48 and accompanying text.
289. See CalPERS Letter, supra note 56.
291. Release No. 29,315 sets forth a proposed Rule 14a-2(b)(1) that would exempt a “disinterested” person’s communications from the obligation to file a proxy statement. The definition of “disinterested” requires that the person not have as “material economic interest” in the solicitation (other than as a securityholder) and not seek a proxy or related authority. No exemption is given from the anti-fraud rules relevant to proxy solicitations.
292. Under current rules, the term “solicitation” includes any request for, or any
they respond less adequately to the problem of rational apathy. The basic dilemma is that most institutional investors, and particularly those agents that run them, have insufficient interest in exercising "voice." This is true particularly for the indexed investors that this Article has argued have an unrecognized potential to serve as corporate monitors. Although these investors have less need for liquidity and are typically less affected by conflicts of interest, their interest in "voice" is limited by two basic constraints: First, investors following an indexed investment strategy typically hold a highly diversified portfolio in which no single stock is likely to amount to more than a small percentage of the portfolio.\(^2\) This fact implies both an informational overload problem and a low expected payoff from involvement with issues at any single corporation in the portfolio. Second, the competitive strategy of external money managers who provide indexing services is to cut costs and engage in price competition.\(^3\) As a result, the real policy challenge is not how to deregulate but, rather, how to motivate the rational institutional investor and its agents to engage in costly monitoring. The following proposals address this challenge.

1. **Making Monitoring Mandatory.** — As a starting point, let us assume that indexed investors are disinclined to be active monitors. After all, a primary purpose of indexing is to economize on transaction costs, and participating in proxy fights is certainly costly. Still, because institutions hold for the long-term, such investors are more likely to reap the benefits of improved corporate governance than are short-term traders whose portfolios turn over regularly. Also, because indexed investors hold shares in numerous companies, they seem more able to exploit economies of scale in reaching voting decisions and coordinating to oppose management, a factor that one commentator has argued should reduce the costs of active monitoring to an acceptable level.\(^4\) Finally, the largest institutional investors may hold a two or

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2. See Rule 14a-1(1), 17 C.F.R. § 240.14a-1(1)(iii) (1991). Rule 14a-2(b)(1) then exempts "solicitations" of ten or fewer persons. See 17 C.F.R. § 240.14a-2(b)(1) (1991). Thus, an institutional investor could contact up to ten other institutions today while staying within this safe harbor. But even in this case, it is not clear whether persons solicited in turn by the ten or fewer persons originally so solicited would count against this limit on the theory that it was a "group" conducting the solicitation.

3. See Lowenstein, supra note 45, at 33–34; see also text accompanying supra note 243 (noting that the largest indexed money manager supervises a portfolio of 5000 stocks for its clients). Also, as institutional investors increasingly diversify on a global basis, they will invest in multiple indexes (i.e., an S&P index for U.S. investments, and equivalent indexes for European and Asian investments).

4. See supra notes 243–244 and accompanying text; see also Rock, supra note 9, at 474 (arguing that since all indexed fund managers hypothetically produce the same gain or loss, the key to competition is to be the lowest cost producer, which provides disincentives for engaging in costly corporate governance activities).

5. See Black, supra note 12, at 588–91. Some corporate issues will recur regu-
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three percent stake in the corporations in their index. At this level of investment, any improvement in corporate governance that translates into improved financial performance can justify the expenditure of substantial costs. If monitoring is then rational for the institution but does not occur, the most logical diagnosis is that an agency problem exists.

If so, one answer might be regulatory initiatives that require the agent to engage in costly monitoring that it would prefer to avoid. Beginning in the mid-1980s, the U.S. Department of Labor tried this approach, warning ERISA fiduciaries that participation in corporate governance is not optional. Basically, the Labor Department has required that pension plans and their investment managers vote their shares in proxy contests, rather than abstain, and has mandated that they establish procedures to ensure that their vote is informed. The doctrinal basis for this position is the Labor Department's view that voting rights are a pension plan asset that must be exercised "solely in the interests of... and for the exclusive purpose of providing benefits to participants and beneficiaries." Finally, the Labor Department requires that, in voting, investment managers must act prudently and in the exclusive interest of plan participants. As a normative statement of fiduciary responsibilities, the Department of Labor's recent pronouncements on proxy voting by investment managers cannot be faulted. But the effect upon money managers, particularly money managers handling indexed accounts, may only be to require the creation of formalized procedures and voting guidelines that are largely window dressing.

What other steps could motivate pension plan fiduciaries to take monitoring more seriously? Put simply, for monitoring to work, some agent in the process must see monitoring as in its self-interest. One means to this end would be to create and make mandatory a new professional—the proxy adviser. Actually, such a professional already exists, and the market for its services is growing. Intelligently regulating

296. See Black, supra note 12, at 568.
297. For an overview, see Rock, supra note 9, at 477–78.
300. See Lowenstein, supra note 45, at 34 (comment of largest indexed money manager that it votes "by formula").
301. Among the groups specializing in providing voting advice are: Investor Re-
could further increase the demand for such services, both in terms of providing voting advice and monitoring those investment managers who hold voting discretion. Today, the Department of Labor's rulings require the pension plan's trustees to monitor "the activities of the investment manager" to whom voting discretion is delegated. Thus, there is both a duty to vote, which in the typical case of external investment management will fall on the investment manager to whom discretion over the portfolio is given, and a duty to monitor voting, which chiefly will fall on the pension plan's trustees. These standards however, do not adequately answer the important question: What steps must a pension plan take to ensure that voting decisions will be given adequate and disinterested attention by professional managers? In effect, there is a duty of care imposed on the pension plan's trustees to supervise the voting performance of its investment managers. Yet, not only is the content of this duty uncertain, but the internal staff of most pension plans is simply not equipped to undertake a detailed evaluation of hundreds, perhaps thousands, of individual voting decisions. Thus, professional assistance is required. The simplest way to fulfill this duty is to rely on a qualified expert—namely, the professional proxy adviser.

2. Creating a Market for Monitoring Services. — The problem with the foregoing proposal is not in showing that a need for such a professional exists but in demonstrating that a market for its services can be created. Three distinct steps seem appropriate:

a. "Unbundling" Prices. — Today, investment managers generally charge a single price for their services; in the case of index fund managers, this price is low because the investment management services provided are minimal. What then would be the impact of requiring these managers to unbundle their services and quote separate prices for investment management and proxy voting advice? In all likelihood, their charge for proxy voting advice would be low to nominal because these firms seem to follow simple voting formulas. Yet, it is also clear that one gets what one pays for, and a nominal charge thus reflects only nominal service. If nominal prices are charged, the bur-
den would then fall on the pension plan's fiduciaries to justify how they could expect to receive adequate service for a trivial charge. If higher prices are charged, true competition can develop.

In part, this strategy seeks to embarrass pension fiduciaries by highlighting the inadequacy of existing advice. Companies that did not hire such an advisor could be placed under special scrutiny and asked to justify how their skeletal, in-house staff expected to monitor all the voting decisions before them. Still, the larger point is that the first step toward the creation of an actual market for professional services is to prevent those services from being provided on a tie-in basis. Instead, ERISA regulations should require that they be specifically contracted for. This would allow new entrants to quote potentially competitive rates. The next step would be to specify through regulation what the minimum content of those services should include: for example, specific review of the proxy statements, record-keeping, and an articulated basis for the decision to vote for or against a specific proposal or slate of candidates. To be sure, such rule-making would be unpopular with corporate sponsors to the extent that it raises the administrative cost of the pension fund, but the inescapable fact is that monitoring is costly. In reality, most firms today are buying only investment advice and not voting advice.

b. Restricted Diversification. — An even more controversial and more important step toward implementing a serious system of institutional monitoring would be to restrict portfolio diversification, including indexing, to a level consistent with the institution's ability to monitor. In theory, a diversified portfolio can be assembled with as few as 15 stocks and 95% of the value of diversification can be achieved with a portfolio of only 20 stocks. Clearly, indexing does not require the purchase of all of the Standard & Poor's 500, and "excess" diversification is thus wasteful because it raises the transaction costs, both in terms of unnecessary securities transactions and unnecessary monitoring. Although it may be impossible for any investment manager to monitor 500 stocks, even a medium-sized institution could monitor 25 to 50. The impact of any rule restricting "excess" diversification would also increase the size of the stake that institutions would typically hold in individual companies because, other factors being held constant, the same total investment would be invested by the same institutions in fewer companies. Thus, the expected payoff from improved corporate

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307. See Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 156 (3d ed. 1988). In addition, 99% of the value of diversification can be achieved based on a 100 stock portfolio. Id.

308. One reason for "excess" diversification might be the excess brokerage commissions that integrated broker-dealer firms receive when the portfolios they handle diversify based on the S&P 500 index.
governance would be higher, and institutions would rationally spend more on researching and lobbying corporate governance issues.

Potentially, such a restricted diversification rule would also create an incentive for institutions to hire professional proxy advisers in order to help them justify that their monitoring capacity was consistent with their preference for a larger portfolio. The proposed rule would not prevent a pension fund from exceeding the 20 or 100 stock levels at which 95% or 99%, respectively, of the value of diversification can be achieved. Rather, it would only require such a fund to prove that its monitoring capacity enabled it to follow a larger portfolio adequately. In short, this strategy would have two goals: (1) by restricting "excess diversification," pension funds would be required to hold larger stakes in fewer companies, and (2) by recognizing the use of proxy advisers as a basis for demonstrating adequate monitoring capacity, the growth of a new and necessary industry would be encouraged.

Simple as this proposal sounds, it faces two serious obstacles, one structural and one legal. First, if one were seriously to insist that institutions limit their investments to stakes in some small number of companies (for example, 50 or 100), the result would be that large institutions, such as CalPERS, would be compelled to hold huge blocks, possibly 30% stakes or more, and only in very large companies, simply to invest that portion of their portfolios currently invested in the entire market. Because the net result would be to institutionalize the equivalent of the German universal banking system overnight, it is clearly unrealistic to think that such a sweeping change could be imposed on the corporate world in the absence of any strong political consensus for change. Thus, modifications are necessary. One possibility would be to place a safety valve on this proposal: for example, a 3–5% permissive cap could be incorporated, so that institutions would not be deemed to be "excessively" diversified as long as the stakes they held in corporations were within this range. The result still creates large enough holdings to justify close monitoring.

Another alternative would be to apply the restricted diversification standard in terms of individual fund managers. Thus, a large pension fund might have five fund managers handling different portfolios, each of which would be restricted to a maximum number of stocks consistent with effective monitoring. The net result is to give the individual fund manager (who might be limited to holding, say, 20 stocks) a strong incentive to monitor, because its impact could be far greater on the performance of such a limited portfolio.

The second obstacle is created by ERISA, which mandates a unique and economically unsophisticated form of diversification. Under section 1104a of the ERISA statute, a fiduciary must "diversify[... so as to minimize the risk of large losses, unless ... it is clearly
prudent not to do.”\textsuperscript{309} This language focuses the fiduciary’s attention not on the net losses to the portfolio, but on the risk of individual losses of sizable magnitude.\textsuperscript{310} As a result, concentrated ownership is dangerous in terms of the trustee’s exposure to liability.\textsuperscript{311} To be sure, a 100 stock portfolio, or even a 50 stock portfolio, may actually satisfy this special diversification standard, but a risk-averse trustee may think otherwise. Here then, a change in regulatory attitude does seem necessary in order to implement this proposal. Indeed, given the obvious controversy that mandating a “restricted diversification” policy would arouse, the most practical first step is to relax this unnecessary rule that today seems to require excessive diversification.

If investment managers were free to diversify on the basis of a smaller portfolio, then the final proposal that this Article will make—namely, that incentive compensation be more generally permitted\textsuperscript{312}—might itself be sufficient to cause investment managers to focus on monitoring as a means of creating value for their clients and themselves.

c. Retention of Voting Discretion. — The decision of a pension fund to delegate investment discretion, while retaining or reclaiming voting discretion, is inherently questionable, particularly in the case of an indexed investor. If a pension plan delegates investment decision-making, this decision should estop it from proclaiming itself competent to make voting decisions over the same portfolio assets that it has delegated to professional management. At a minimum, the Department of Labor should require special justification of such a step, which suggests that the corporate sponsor is seeking to gain control of the plan’s voting power.\textsuperscript{313}

Indirectly, such an initiative might also create an increased market for the services of professional proxy advisers in order to justify the pension fund’s ability to retain or reclaim voting discretion. Although corporate sponsors might desire to hire “tame” advisers whose advice would match their promanagement inclinations, one constraint could limit their ability to obtain cosmetic advice: Namely, professional advisers could be placed under a special obligation to report inconsistent advice given to different clients on the same issue. At least, this would


\textsuperscript{310} Labor Department regulations under ERISA require a “screen or filter process” even in the case of an index fund to exclude companies that have suffered “significant, adverse financial developments.” 44 Fed. Reg. 37,224 n.7, amending 29 C.F.R. § 2550.404a-1(b) (1990).

\textsuperscript{311} See Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52, 66–67 (1987); see also Black, supra note 12, at 553–54 for a similar conclusion.

\textsuperscript{312} See infra notes 336–347 and accompanying text.

\textsuperscript{313} Some evidence suggests that this practice is becoming more common and that its “conscious purpose is to ensure promanager votes.” Black, supra note 12, at 598.
inhibit specially tailored advice for each client in keeping with its corporate sponsor’s preexisting views.

3. **Deregulating the Proxy Adviser.** — The professional proxy adviser today operates in a legal limbo, because its activities are at the very edge of those permitted by law. Unlike earlier firms that played only a clearinghouse function, these new advisers expressly offer voting advice on proxy matters to their institutional clients. The best known of these new firms, Institutional Shareholder Services, Inc., not only gives voting advice, but is developing a database on outside directors and more technical issues, such as executive compensation.314

Potentially, these organizations could substantially reduce the collective action problem facing institutional investors. Both for financial and legal reasons, however, no institution will be eager to solicit proxies, particularly when it believes that other institutional investors are “free riding” on its efforts, and will benefit pro rata with it. As a result, collective action remains under-funded.315 Yet, because the costs of their services are equitably prorated among all their institutional users, proxy advisers provide a means for taxing the institutional free rider and reducing the costs that an insurgent must bear to conduct an effective proxy solicitation. Equally important, because the proxy adviser plays a critical coordinating role, no institutional investor would have to bear the full political heat of publicly opposing management and coordinating shareholder resistance. Rather, each can remain seemingly passive, on the surface only paying an annual fee to its proxy adviser, but in reality subscribing to the costs of collective action.

At present, the problem with this simple scenario is that it may run afoul of the SEC’s proxy rules. The legal issue is whether the provision of proxy advice amounts to a proxy “solicitation” under SEC Rule 14a-1.316 Clearly, the definition of solicitation reaches this far, but an exemption can be justified on any of several rationales. First, there is an existing exemption for the “furnishing of proxy voting advice by any person (the ‘advisor’) to any other person with whom the advisor has a business relationship, if . . . the advisor renders financial advice in the

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314. Founded in 1985 by Robert Monks, the former administrator of the Department of Labor’s Pension and Welfare Benefits Administration, Institutional Shareholder Services was the first firm openly to offer voting advice to its clients on corporate governance matters. See Peter Riddell, A Crusader Takes on Corporate America, Fin. Times, June 6, 1990, at 7; see also Marcia Parker, New Tactics in Governance Wars, Pension & Investment Age, Nov. 12, 1990, at 1 (describing an affiliated company, Institutional Shareholder Partners, which seeks partners in the form of large individual corporate investors to engage in corporate governance activities).

315. For a discussion of collective action and “free-riding,” see supra note 23 and accompanying text.

316. See 17 C.F.R. § 240.14a-1(l) (1991). This rule defines solicitation to include any “communication to security holders under circumstances reasonably calculated to result in the procurement, withholding, or revocation of a proxy.” Id. at § 240.14a-1(l)(iii).
ordinary course of his business." On its face, this exemption would seem to cover the new professional proxy advisor, except for the ambiguity in the requirement that the advisor render "financial advice in the ordinary course of his business." Unfortunately, the SEC has historically given a narrow interpretation to this exemption, and in 1988 it refused to grant a "no action" letter exemption to Institutional Shareholder Services, ruling that only an advisor who provides "separate and distinct" financial advice could utilize the exemption. More recently however, the SEC has proposed an even broader exemption for proxy advice furnished by a "disinterested" person so long as the adviser does not seek to obtain a proxy. This proposed exemption would expressly cover the new proxy advisory firms that have recently entered this field. Either approach is adequate, but whether either will be actually adopted may test the validity of the overregulation thesis.

E. Delegation to Professional Directors

As earlier noted, direct monitoring of corporate managements by institutional investors quickly encounters a major logistical problem: Most institutional investors own too many stocks and have too small an in-house staff to be able to evaluate the quality or performance of the corporate managements in whose securities they have invested. Delegating shareholder voting decisions to professional investment managers is a partial answer to this problem. Still, it is directors, not shareholders, who hold the real power in corporate governance. Here, the same overload problems re-appear, but they can potentially be solved by delegating the task of monitoring to outside directors. Yet, as most serious proponents of this approach acknowledge, there is considerable reason to doubt that, absent a crisis, outside directors today

318. See Institutional Shareholder Services, Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 17, (Jan. 2, 1991). In this no-action letter, the SEC staff advised Institutional Shareholder Services that: "Rule 14a(b)(2) seems to contemplate that the voting advisor will be rendering voting advice in the context of a relationship in which his role is primarily that of an advisor on financial matters separate and distinct from that of proxy voting." As a result, a bank trustee or a registered investment advisor can provide voting advice, but a specialized firm, such as Institutional Shareholder Services, Inc., apparently cannot.
319. See Release No. 29,315, supra note 290, at 28,990–92 (proposing Rule 14a-2(b)(1) to exempt proxy advice from a "disinterested" person).
320. Release No. 29,315 specifically refers to "organizations or associations comprised of securityholders or issuers that exchange information with members regarding such matters of common concern as proxy voting positions or views on corporate governance policy. Another category would be providers of shareholder advisory services, including organizations offering proxy voting information or recommendations . . . ." Id. at 28,991 (footnote omitted). The Release then names the principal existing proxy advisers and indicates that they would generally be covered by the proposed rule.
321. See supra notes 243–244 and accompanying text.
play an adequate monitoring role in the public corporation. Critics point out that the vast majority of outside directors at Fortune 1000 firms are chief executives of other corporations, who thus are subject to severe time constraints and other commitments. Such directors, they argue, may also share a group loyalty or "club ethos" that assumes that directors, like house guests, should not question or criticize the host. Finally, outside directors are part time visitors to the corporation, who lack any permanent staff, depend on management for their factual information, and on average devote only fourteen days a year to each board on which they serve.

Beyond these logistical, ideological, and social obstacles to effective monitoring, the greater problem again involves incentives. Even if the law could define independence in a meaningful way, there is no assurance that an independent director would be an effective director. The outside director still has few incentives to challenge or criticize the incumbent management, particularly when the economic payoff from such conduct to the director will be minimal—and may get the director removed from office. Thus, for the outside director to be effective, incentives must be used to increase the director's willingness to monitor.

Recognizing the need for enhanced incentives to monitor, Professors Ronald Gilson and Reinier Kraakman have recently proposed a novel and provocative solution: Make the outside director economically dependent on the institutional investors that the director is expected to serve. Under their proposal, institutional investors would identify a cadre of professional outside directors who would become specialists in monitoring. Each such director would serve on a full-time basis as the representative of institutional investors on the boards of a number of corporations in these institutions' portfolios. They suggest that a professional director could serve on, hypothetically, six boards and that, as a class, they would constitute a minority—probably a third—of the entire board. Through such multiple board memberships, the professional director could earn compensation equivalent to that of a partner in a law or an accounting firm, but, unlike most current

323. Lorsch finds 63% of outside directors at such firms to be other chief executives. Id. at 18.
324. Lorsch reports that many directors “still feel they are serving at the pleasure of the CEO-Chairman.” Id. at 17. For the view that there is a “club ethos,” see Elmer W. Johnson, An Insider's Call for Outside Directors, 68 Harv. Bus. Rev., Mar.-Apr. 1990, at 46, 47.
326. As Professor Brudney has noted, the law cannot assess the social and personal relationships that may exist between directors and those they are expected to monitor. See Victor Brudney, The Independent Director—Heavenly City of Potemkin Village, 95 Harv. L. Rev. 597, 613 (1982).
327. See Gilson & Kraakman, supra note 13, at 883–92.
outside directors, they would have no other major time commitments and would be dependent upon institutional investors for their continued service in that capacity. In effect, Professors Gilson and Kraakman discard the models of the outside director as an independent referee in favor of one under which the director becomes a full-time agent of an identifiable class of shareholders.\footnote{328. For precisely this reason the Gilson and Kraakman proposal presents the earlier noted legal issues surrounding deputization theory and controlling person liability in their least favorable light. See supra notes 253–262 and accompanying text.}

In principle, such an idea could work because it solves the logistical and incentive problems that have long made monitoring by outside directors more an ideal than a reality. But the real problem is how to get there from here. From this Article's perspective, the Gilson and Kraakman proposal for institutional investors to elect a minority slate of professional directors is not feasible without (a) some deregulation and (b) enhanced incentives for institutional money managers to monitor. The problem is not with what Professors Gilson and Kraakman say, but with what they leave out. Their solution works to align the interests of principal and agent only at the directorial level, not at the institutional level. At the institutional level, there is considerable reason to believe that professional money managers would remain rationally apathetic about minority directors, because they would incur short-run costs to benefit free-riding shareholders but would not expect to share in the long-run benefits.\footnote{329. See supra notes 194–198 and accompanying text. For a similar analysis, see Rock, supra note 9, at 474–75.}

This conclusion does not deny that a variety of legal obstacles should be reduced by the SEC through the deregulation of rules that curb the overreach of the proxy rules and reduce the prospect of section 16(b) and controlling person liability.\footnote{330. See supra notes 264–287 and accompanying text.} Still, even if these reforms were implemented, it remains doubtful that institutional investors would respond to the "voice" that the Gilson and Kraakman proposals would give them. The implicit premise to the Gilson and Kraakman proposals appears to be that if legal restrictions, particularly those on "exit," are eased, institutional investors will participate actively in corporate governance. Yet, from this Article's perspective, easy "exit" may mean diminished "voice"; and deregulation is not a cure for rational apathy.

To date, there is little evidence that institutional investors who rely on "exit" will participate in corporate governance, except on a short-term basis in connection with takeovers. Although sometimes institutional investors have successfully organized themselves to take collective action in favor of proposals that seek to unblock the market for corporate control, there are few instances in which they have success-
fully organized to pursue other goals. Only in corporate control battles have the short-term gains to investors been sufficiently high—because success may be followed by a lucrative takeover bid—to outweigh the uncertain direct and indirect costs of opposing corporate management. Even in these cases, institutional activism has been on balance largely unsuccessful. In 1987–88, the Council of Institutional Investors organized a campaign to adopt shareholder proposals opposing the poison pill; thirty-two corporations were chosen as candidates for such proposals because they had particularly high levels of institutional ownership (averaging 56.6%). Regardless, the average vote for the proposals was only 29.4%, implying that institutional investors only voted a little over half of their stock for the proposal.

Holding aside the special case of public pension funds, a pessimistic evaluation thus seems necessary: The costs of opposing management are still perceived by many, perhaps most, institutional investors as too high. Many fear the unknown evil represented by insurgents more than they fear the known evil of incumbent management. Still, over the next decade, pension funds will come to own approximately forty percent of the equity in American corporations. The future of corporate governance will depend less on what the SEC does about the overreach of the securities laws and more on what the Department of Labor does about creating incentives through compensation systems, diversification restrictions, and the pricing of money management services to encourage long-term monitoring.

F. The Case for Incentive Compensation

The hardest problem has been saved for last. Repeatedly, this Article has suggested that even if institutional investors have a rational

331. According to the Investor Responsibility Research Center, there were twenty-six proxy contests for full or partial control of the board in 1989, of which only three were successful. As of mid-1990, there had been twenty actual or threatened proxy contests, of which only one had been successful. See Proxy Contests, supra note 234, at 1, 10. There has also recently been a decline in the number of proxy contests. See supra note 47.

332. See Gilson & Kraakman, supra note 13, at 868, 893 n.91.

333. Id. By 1988, this average increased to 89.5%. Id. Still, this data suggests that a substantial portion of institutional investors will not even support a provision that seeks to unblock the market for corporate control (in which they make very high short-term returns). Contests over directorial elections are even more controversial and offer no immediate returns.

334. See Proxy Contests, supra note 234, at 11 (institutional investors have "conservative" bias and tend to back only candidates they know). The Gilson and Kraakman proposals are intended to respond to this problem by seeking to elect only a minority of the board. Still, investors may fear that a divided board implies disharmony and conflict. This fear was always the justification offered by corporations for their opposition to cumulative voting, and the Gilson and Kraakman proposals may produce an equivalent end result.

335. See supra note 239 and accompanying text.
interest in corporate governance, their investment managers may not. Why? Both in the mutual fund and pension contexts, investment advisers tend to be compensated under mechanical formulas that pay them a small annual percentage of the assets under their control. Clearly, such an unsophisticated flat formula does little to align incentives between the manager and the fund it serves, and incentive compensation based on capital appreciation would work far better.

Why isn't incentive compensation used? In the mutual fund context, the short answer is a legal one: The Investment Advisers Act of 1940 prohibits the use of any formula that “provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client.” Although this prohibition has been marginally relaxed in the case of an investment adviser to a mutual fund, index funds are, as a practical matter, unable to use the narrow authorization for incentive compensation. Moreover, even if a broader exemption specifically tailored to the index fund could be adopted, a further problem still remains: Directors of mutual funds have little incentive to adopt...
novel or potentially excessive fee formulas, because, under the Investment Company Act of 1940, they are subject to private suit for permitting investment advisers to receive excessive or unreasonable compensation.\textsuperscript{340} Derivative actions regularly raise such claims against mutual fund directors.\textsuperscript{341}

In the case of pension plans, there is similar fiduciary liability for unreasonable compensation, whether the plan is subject to ERISA or not.\textsuperscript{342} Moreover, incentive compensation contracts are strictly forbidden when the adviser is also a registered investment adviser under the Investment Advisers Act of 1940.\textsuperscript{343} Possibly some means of circumventing these prohibitions can be devised, but pension and mutual fund trustees have little reason to take risks or to experiment. Rather, both are likely to follow the herd and avoid original but potentially litigable compensation arrangements.

How great an impact do these limitations on incentive compensation actually have? In the case of mutual funds, the answer is debatable, because superior performance by a fund manager will attract new money into the fund, thus increasing the adviser’s compensation even though it is measured on the basis of a declining percentage of total assets. In short, the market may still work. In the case of a pension fund, however, the problem is more complicated. The corporate sponsor of a defined benefits plan, which includes most pension plans, does have an incentive to monitor its investment manager’s performance, because the better the manager does, the less the sponsor has to contribute to the pension fund. Still, this incentive weakens to the extent that investment managers begin to become involved in proxy contests or show other indicia of shareholder activism. Here, all the evidence suggests that corporate managers resist such involvement and may

\textsuperscript{340} Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (1988), creates fiduciary liability and gives a private cause of action to shareholders against both the fund’s directors and the investment adviser for “breach of fiduciary duty in respect of . . . compensation or payments paid by such registered investment company . . . to such investment adviser.”

\textsuperscript{341} See cases cited supra note 197. For a more recent case, see Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222 (S.D.N.Y. 1990).

\textsuperscript{342} Under § 1104(a)(1) of ERISA, a fiduciary “shall discharge his duties with respect to a plan solely in the interests of the participants and beneficiaries and . . . for the exclusive purpose of . . . defraying reasonable expenses of administering the plan.” 29 U.S.C. § 1104(a)(1) (1988) (emphasis added). For a decision imposing civil liability, see Leigh v. Engle, 858 F.2d 361 (7th Cir. 1988). Criminal and civil penalties are also authorized for breach of this duty. Non-ERISA trustees are subject to virtually identical standards under the law of trusts. See Black, supra note 12, at 553–56.

\textsuperscript{343} Many pension advisers in fact are registered investment advisers. Where the investment adviser represents a pension fund, the exemption in § 205(b)(2) of the Investment Advisers Act of 1940 for an adviser to a mutual fund is made expressly inapplicable by § 205(b)(2)(B). 15 U.S.C. § 80b-5 (1988). Thus, incentive compensation seems to be strictly forbidden in this case.
withdraw voting discretion. Put simply, corporate management's conflict of interest weakens its normal incentive to pressure its fund managers for performance in this area. Moreover, the investment manager may fear that aggressive monitoring will give it a reputation as an "activist" that will cost it additional pension fund accounts. In short, in the absence of incentive compensation that rewards it for successful monitoring, a pension fund investment manager probably has more reasons to avoid active monitoring than to engage in it.

So stated, the compensation problem seems to require regulatory intervention to encourage the use of incentive fee formulas that better align the investment manager's incentives with those of the fund. But here the real difficulty of the problem comes into view: In the case of the indexed fund manager, incentive compensation is difficult to devise because it is impossible to calculate how an index fund's performance exceeded that of the market when, by definition, it sought to match the market. In short, by choosing as its goal the matching of the market's performance, there is no yardstick for comparison or an obvious basis for measuring superior performance. Even if its monitoring improved the firms in its portfolio, a broadly diversified index fund will have thereby improved the entire market.

One answer to this "Catch-22" is possible and has already been discussed: Restricted diversification. A diversified portfolio of, say, 50 stocks can outperform a similar market index (i.e., the Standard & Poor 500)—largely to the extent that the firms in the smaller portfolio are better monitored. Indeed, the margin by which the smaller portfolio outperforms the larger, similarly selected portfolio is probably an approximate measure of the success, or failure, of monitoring. Ultimately, then, answers dovetail: a restricted diversification policy combined with incentive compensation to fund managers can raise the payoff from monitoring to both the institutional investor and its manager. Indeed, if prudent incentive compensation plans could be adopted, it might not be necessary to mandate restricted diversification, but only to relax the current rules that require a special level of diversification beyond that suggested by economic theory. Money managers who saw an opportunity to profit would have a rational self-interest in assembling smaller portfolios based upon their perceptions of the potential for monitoring gains in these stocks. Finally, the traditional reason for avoiding incentive compensation—namely, that it will lead managers to accept excessive risk—seems inapplicable here. ERISA's diversification requirements would continue to apply, and the

344. See supra note 18 and accompanying text.
345. See supra notes 309-311 and accompanying text.
346. See supra note 338.
347. See 29 U.S.C. § 1104(a) (1988); supra notes 309-311 and accompanying text. While the phrasing of this standard should be revised, the continuation of a diversification rule for pension funds is a certainty.
pension fund's trustees would be under a duty to monitor the fund manager to ensure that it not accept excessive risk. Put simply, the pension investment manager's strategy under such a compensation formula should be to increase portfolio value through active monitoring; and nothing suggests that this requires it to accept additional portfolio risk.

G. Summary

Investors who rely on "exit" are likely to show little interest in "voice." As a result, actively trading institutional investors are apt to make poor corporate monitors. In contrast, indexed investors have largely abandoned "exit" and might therefore be induced to exercise "voice." For them, participation in corporate governance can be rational, because they are locked into the market. Yet, even if it is rational for the institutional investor to be interested in corporate governance, it need not be for its agent, the professional money manager. Here, deregulation will have little impact, and the critical steps are for the Labor Department and the SEC to increase the incentives to monitor, by restricting diversification and/or by authorizing incentive compensation formulas that better align the interests of external money managers with those of the institutions they serve.348

Restricting diversification under ERISA to the level at which the pension fund could show that it was still capable of monitoring its portfolio would be a sensible means to this end. However, mandating such a rule may be infeasible. Although it would impose little cost on most institutions (because efficient diversification is achievable with relatively few stocks, and market indexes can be constructed using only a fraction of the Standard & Poor's 500),349 it does encroach on the sacred cow of the manager's investment discretion. Thus, if such a proposal is deemed politically infeasible, the second-best substitute would be to relax ERISA's diversification requirements to a level that is economically justifiable. Such a deregulatory step, if coupled with the authorization of incentive compensation, would give investment managers their own incentive to reduce their portfolio size so as to be able to outperform the market.

Still, if these steps were taken, how optimistic should we be that corporate governance would improve? It is difficult to make optimistic predictions, because adaptive responses by corporate managements are predictable. "Tame" proxy advisers would soon enter the market, and

348. As noted earlier, the Labor Department has begun to assert jurisdiction over pension voting decisions, but it has not gone much further than ruling that voting is mandatory. See supra notes 297–300 and accompanying text. The SEC has similar jurisdiction over mutual funds, but has taken no steps to date.

349. See supra notes 306–308 and accompanying text. Indeed, the net impact might be to reduce transaction and brokerage costs for institutions, as each would trade, monitor and focus on fewer stocks.
would characteristically counsel deference to the incumbent management. Assertive corporate managements can always find a variety of low-visibility means to induce their pension fund trustees to retain "safe" or "prudent" proxy advisers, if the law mandated their use. This does not mean that there would be no net gains because the foregoing proposals would likely activate public pension funds and indexed mutual funds. Still, the gains would be marginal. Only changes in the compensation formulas used for money managers promise significant short-term gains.

CONCLUSION

The trade-off between liquidity and control implies that overregulation is only one of the factors inhibiting institutional activism. More importantly, it also suggests that the reduction of agency costs cannot be the sole goal of corporate governance reform. Rather, monitors as well as managers can behave opportunistically. Indeed, the two can even collude to the disadvantage of minority shareholders (as may sometimes occur in the financial monitoring systems now in operation in Japan and Germany).

Once one recognizes the multilateral character of the relationships within the public corporation, the very concept of financial monitoring takes on a deeper ambiguity: (1) sometimes, the monitor may work on behalf of the minority shareholders to reduce agency costs (possibly in return for some benefit not made available on a pro-rata basis to all shareholders, such as above-market interest); (2) sometimes, the monitor may rebel against the tendency of minority shareholders to "free ride" on its efforts and instead align itself with management (again, possibly in return for some side payment); or (3) sometimes, the monitor may defect from one alliance to another and do so repeatedly. The result can be unstable and shifting coalitions.350

From this perspective, public policy should encourage some institutional investors more than others to assume a monitoring role. The profile of the optimal monitor seemingly includes the following elements: (1) an ability to hold large equity stakes; (2) an inclination to hold for the longer term over which improved monitoring can pay off; and (3) the absence of any substantial conflict of interest. On this basis, pension funds and closed-end mutual funds seem potentially superior to banks and other creditor-shareholders. Yet, what cannot be safely concluded is that monitoring will be adequately funded without the institutional investor occupying some other relationship to the corporation through which it can be compensated for the "excess" monitoring it provides the free-riding minority shareholders. Precisely this issue underlies, and confounds, any attempt to reach a bottom line evalua-

350. I have discussed this theme elsewhere. See John C. Coffee, Jr., Unstable Coalitions: Corporate Governance as a Multi-Player Game, 78 Geo. L.J. 1495 (1990).
tion of the efficiency of either the Japanese *keiretsu* or the German universal bank system of credit or/shareholder monitoring. The unwillingness of financial monitors to take and hold larger equity stakes that might justify greater expenditure on their part, even when legally permitted to do so, suggests that monitoring is costly and that these institutions do not consider themselves to have a major comparative advantage as equity investors.

The serious study of comparative corporate governance is still in its infancy. Yet, at least as a preliminary assessment, the liquidity/control trade-off seems readily discernible around the globe. Does this mean that it is unbridgeable? Not necessarily. This Article has focused on how to improve monitoring by those investors whose demand for liquidity is already limited. However, the longer term answer may lie in focusing on how public policy can reduce either the demand for liquidity or the demand for control. Much of the demand for liquidity may reflect managerial desires, rather than institutional needs.\(^{351}\) Similarly, the demand for control may be moderated to the extent that close substitutes for control can be developed.\(^ {352}\)

Ultimately, monitoring is not neutral. Different monitors will behave differently in terms of their respective needs for liquidity, their time horizons, or their attitudes toward risk. Society either chooses the monitors it wants or accepts those that emerge by default. In this sense, the new political theory of the corporation is correct: Politics does and will continue to count.

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351. The short-term trading of large portfolios, for example, produces brokerage commissions and justifies research fees, even though the large institutional investor may already be locked into the market and unable to outperform it.

352. This is essentially what the Gilson and Kraakman proposals would accomplish by allowing institutions to influence, but not directly control, corporate decision-making. See Gilson & Kraakman, supra note 13, at 883–905.