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THE FOLKLORE OF INVESTOR CAPITALISM

John C. Coffee, Jr.*

INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA. By *Michael Useem*. New York: BasicBooks. 1996. Pp. vii, 332. \$30.

Ideally, Thurman Arnold should review this book. In his *The Folklore of American Capitalism*,¹ Arnold dissected the ideology and rationalizations by which the business community of an earlier day defended its legitimacy and perquisites. Michael Useem, a sociologist at the Wharton School, also has an interest in the ideology of the business community: how corporate managers view the new institutional investors, how they justify resistance, and the tensions and inconsistencies between their critiques of money managers and their own behavior. This is an underutilized perspective (which law and economics inherently tends to overlook), and Useem is at his best when he compares the rival lenses through which corporate executives and money managers view each other.²

Useem is, however, neither Thurman Arnold nor even the first qualitative social scientist to focus on the relationship between institutional investors and corporate executives. Preceding him were William O'Barr and John M. Conley, cultural anthropologists at Duke University and the University of North Carolina, respectively, who earlier in this decade published a significant and ground-breaking work, which reported that the style of decision-making that they observed within pension funds was vastly different from the stereotypes reported in the popular press.³ Based on field work at nine large pension funds, these researchers found that

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1. THURMAN W. ARNOLD, *THE FOLKLORE OF AMERICAN CAPITALISM* (1937). Arnold was, of course, attacking what he saw as the mythology of the market system and the tired conceptualism that he believed underlay antitrust enforcement. In referencing Arnold, the skeptic of business ideologies, I do not mean to imply agreement with his hostility to antitrust enforcement.

2. Useem perceptively notes that "[a]t the core of the management culture is a rationale for resisting certain investor demands." P. 78. He detects three central claims: (1) investors have short time horizons; (2) investors lack the qualifications to speak on management issues; and (3) money managers do not truly represent the ultimate owners of the enterprise. Pp. 78-103. His analysis of these claims is well done and admirably concise.

3. See WILLIAM M. O'BARR & JOHN M. CONLEY, *FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING* (1992); see also John M. Conley & William M. O'Barr, *The Culture of Capital: An Anthropological Investigation of Institutional Investment*, 70 N.C. L. REV. 823 (1992).

money managers were not aggressive, performance-oriented, or preoccupied with short-term results, but rather were risk averse, extremely desirous of avoiding personal responsibility for their decisions, and generally eager to seek protection within the herd by adopting investment management strategies, such as indexing, that effectively minimized individual choice.⁴ Surprisingly, the pension fund managers that they studied gave highly personalized and idiosyncratic explanations for decisions that they had reached and seldom engaged in explicitly economic reasoning when asked to defend their decisions or their investment strategies.⁵ More to the point, Conley and O'Barr's pension fund managers were extremely reluctant to become involved in the corporate governance of their portfolio companies.⁶ Public fund managers, they did find, were somewhat more prepared to be activists, but even these fund managers also pleaded time and informational constraints as a justification for their passivity.

Possibly because their findings were so counterintuitive, the Conley and O'Barr study has encountered some sharp criticism, chiefly on the grounds that its authors were economically naive and brought much value-laden intellectual baggage with them.⁷ Still, given that they are Useem's immediate intellectual precursors, one naturally looks to him to confirm or rebut Conley and O'Barr — or at least to contrast his work with theirs.

Yet, Useem ignores Conley and O'Barr.⁸ This is especially surprising because both books were sponsored by the Institutional Investor Project of the Center for Law and Economic Studies of Columbia University. Although these two books thus sadly pass each other like ships in the night, Useem does have a perspective that contrasts sharply with that of Conley and O'Barr: subject to only marginal qualifications, he buys eagerly into the proposition

4. To a considerable extent, they also describe the avoidance of personal responsibility as often fostered by "the complexity and consequent impenetrability of the decisionmaking structure" within the large pension fund. Conley & O'Barr, *supra* note 3, at 834-37.

5. In a classic, if unintended, oxymoron, Conley and O'Barr generalize that, based on their observations, "[t]he work of Adam Smith's invisible hand was rarely in evidence." *Id.* at 827. Of course, were it evident, Adam Smith would have called it the visible hand. In fairness, Conley and O'Barr's point is that decisions seemed to be the product of "historical quirks, seemingly petty personal disputes, and bruising political battles" — but not economic criteria. *Id.* If public pension fund managers are more likely to be replaced as a result of political decisions by state legislatures than as the result of poor economic performance (as Conley and O'Barr also found), such behavior is exactly what economists would predict.

6. At least in the case of private pension funds, Conley and O'Barr find fund passivity to be explained by a "version of the Golden Rule: Do unto other corporations as you would want their pension funds to do unto yours." *Id.* at 842-43.

7. See Geoffrey P. Miller, *The Culture of Capital: Comments on Conley and O'Barr*, 71 N.C. L. Rev. 501 (1993).

8. I can find only one very modest reference to their study in Useem's footnotes. See p. 281 n.11. O'Barr and Conley are also listed in his references. P. 311.

that corporate managers are effectively constrained by institutional investors.

Different as their perspectives are, there is no necessary contradiction here. Their rival views may be partly explainable by the different populations that they are studying. Despite his title, Useem's real focus is on the corporate executives who now negotiate and interact with institutional money managers. To research this book, he interviewed senior executives at some twenty large public corporations (the identities of these corporations are kept secret and code names are used, but some seem clearly identifiable). In common, each of these firms had experienced institutional activism and was learning to cope with it. Useem's qualitative approach to the interaction of money managers and corporate executives offers genuine insights — principally as to the tactics and techniques by which senior corporate executives are learning to "manage" these relationships. Still, this technique has its obvious limitations. If one wants to understand fully the new institutional investor, this methodology of interviewing primarily the executive cadre of selected public corporations is roughly analogous to that of studying divorced husbands by interviewing principally their ex-wives. One will predictably hear that ex-husbands are a disagreeable and abusive group, but this may be only half the story. As a result, Useem inevitably tells much more about the thought processes and world view of senior corporate executives than about the money managers to which he refers in his title. This is not without value, but it makes his title a misnomer and also suggests who the audience is that he principally wishes to reach.

Logically, the differing focuses of these authors also raise the possibility that both studies could conceivably be right: that is, money managers could have only weak incentives to monitor, but corporate executives could feel threatened and therefore invest heavily in "managing" this new relationship. This observation will lead to some final remarks on which this review concludes.

One last prefatory observation: Useem brings an idiosyncratic perspective to his analysis of money managers that may distort his focus, in at least two respects. First, like many business school professors, he is very much the academic entrepreneur. Correspondingly, his voice and perspective waver: sometimes he is the disinterested scholar; other times, the street-smart, savvy practitioner. At its worst, this book occasionally reads like a how-to-do-it manual on the care and feeding of institutional investors: how to keep them docile and compliant.

Second, as a former student of the civil rights movement and grassroots community activism,⁹ Useem recurrently analogizes the more aggressive public pension funds to the liberal and radical activists who galvanized the 1960s civil rights movement and eventually mobilized the initially lethargic liberal wing of the American middle class.¹⁰ But the administrators of public pension funds are largely mid-level, underpaid public servants operating within state bureaucracies and subject to a variety of political and logistical constraints. Whether they should be viewed as the intellectual catalysts of this movement — in effect, the vanguard of the financial proletariat — seems doubtful. As later discussed, private money managers may prefer to let the public funds lead the initial assault in any battle with corporate managers in order to minimize their own costs and maintain their own financial camouflage. More generally, while Useem conceptualizes institutional investors as an awakening *political* movement, the logic of their collective action may be more determined by *economic* incentives than by political ideologies. In any event, the role played by the public funds may resemble more that of Don Quixote than that of Paul Revere: when they are supported by allies, they can win, but otherwise, they are tilting at windmills and destined to lose. Seldom can they awaken a more broadly based shareholder movement.

Useem's central thesis starts from the perception that we have moved from an era of managerial capitalism to one of "investor capitalism," in which institutional investors have substantially reduced the agency costs in corporate governance. This is, of course, the conventional wisdom. No one doubts that managements are much more constrained today by investor preferences than in a prior era when corporate stock was largely held by individual shareholders. But what does it mean to say that the era of investor capitalism has arrived? It sounds reassuring, even legiti-

9. See, e.g., Gary T. Marx & Michael Useem, *Majority Involvement in Minority Movements: Civil Rights, Abolition, Untouchability*, 27 J. Soc. ISSUES 81 (1971).

10. P. 39. For example, Useem asserts that:

[t]he activist funds play a role akin to that of political leadership in social movements. When a group of individuals or organizations faces distressed conditions, many may feel aggrieved but few are called to challenge. Leadership typically falls on the shoulders of a minority, a subgroup whose special conditions facilitate and inspire rebellion. Often this small cadre is composed of those who are most secure in their status and least subject to reprisal At the core of the investor movement leadership is a small set of public funds.

P. 54. Later, he adds, "Long-disenfranchised shareholders — or, more precisely, institutional investors — are doing what community organizers urge dispossessed communities to do anywhere." P. 254. Not only is the utility of this analogy doubtful, but it may even be misapplied within its own four corners. For example, public pension funds are subject to different forms of reprisal from different sources than are private pension funds, but are neither secure nor incentivized to act to the same degree as, for example, are mutual funds. The failure to consider the incentive problem in public pension funds is one of the more glaring omissions in this book.

mizing. But just how constrained are managements and how far can managements deviate from investor preferences (or the market's judgment) without incurring a shareholder revolt that ousts them? Useem focuses very little on this question, because his preoccupation is with how to "manage" this relationship.

Yet, the possibility that the relationship can be "managed" suggests, at least to a cold-eyed reader, that the agent can manipulate the principal. Useem in effect tells how, but not how much. Here, the principal problems with this book are, first, that it focuses very little on the costs of collective action by shareholders and, second, it never examines the underlying forces that generated the current structure of relationships between institutional investors and corporate managers or that may limit its future evolution. Nonetheless, this is a factually rich book, and it is useful to consider the evidence that it amasses, much of which points to conclusions that differ from those that it offers.

I. MANAGERIAL ACCOUNTABILITY TODAY: HOW CLOSE ARE WE TO INVESTOR CAPITALISM?

Early in this book, Useem paints the following word picture of CalPers, which he describes as the "premier activist shareholder" (p. 181), and its chief executive, Dale Hanson, at a 1993 conference between corporations and institutional investors:

When Calpers executives spoke, business listened. Their patience might allow a troubled chief executive some breathing room. Their impatience might bring the boot. . . . By midday . . . Calpers' commanding presence became evident even to the uninitiated. The chief executive, Dale Hanson, was introduced at a ballroom luncheon as a man who required no introduction, and once he finished . . . a dozen people pressed forward, pencils and notebooks at the ready.¹¹

This is, of course, exactly the sort of commentary that one reads every day in business page journalism. But if reporters who need to meet daily deadlines can be forgiven for always describing institutional investors as "powerful," investors as "skittish," and markets as "volatile," more should be expected of scholars. Indeed, Useem does know better. Elsewhere in this book, he notes some of the reasons why organizationally CalPers is more likely to be a passive than an active monitor: namely, it "employs only two inside managers to oversee its \$20 billion internally managed indexed funds" (p. 61). Given that it managed investments of over \$68 billion in 1992 (p. 31), such obviously thin staffing must result in an overload

11. P. 39. I should point out that I was the person introducing Mr. Hanson at this luncheon as a person who needed "no introduction," and I have a decidedly different impression as to what was occurring: namely, Mr. Hanson was being stroked by persons who wanted future access.

problem that disables any serious attempt at monitoring. Moreover, CalPers's ability to affect behavior at its portfolio companies is further constrained by its adherence to the common policy among institutional investors of limiting their individual holdings to a low percentage (typically one to two percent) of the voting stock in any individual company (p. 174). Indeed CalPers's portfolio is actually smaller in terms of the number of stocks owned than that of its leading peers. In 1991, Fidelity (the largest mutual fund family) spread its holdings over 2300 firms; Aetna held stock in over 2400 firms; and CalPers's colleague, the California State Teachers Retirement System, owned over 3500 stocks, despite a portfolio one quarter the size of that of CalPers.¹² While not all institutional investors manage portfolios of 500 or more stocks, the bulk of the total assets under institutional management appears to be in the hands of those that do (p. 177 fig. 6.1). Useem correctly implies that these portfolios are well beyond the institution's effective span of control.

What Useem misses, however, is that to the extent an institution such as CalPers does opt to be "activist," its targets are still necessarily constrained by its logistical inability to engage in meaningful individualized monitoring. Rather than push for divestitures, corporate restructurings, changes in management, or indirect board representation (all of which usually produce stock gains), CalPers tends to focus on "good government" issues, such as executive compensation, the elimination of staggered boards, or improved shareholder voting procedures. While critics have charged that CalPers's preoccupation with "Mickey Mouse" reforms results in only symbolic victories and has not "produced significant stock gains in targeted companies,"¹³ they ignore that this focus is necessitated by the size of the portfolio held by CalPers. Once an institution's portfolio reaches a thousand or more stocks, only standardized, recurring issues (such as the desirability of a shareholder vote on poison pills or the elimination of staggered boards) can be feasibly addressed, because the merits of such an issue do not change with the specific case.

Although many institutional investors do not follow CalPers's policy of extreme diversification, those that do not tend to be disabled as monitors for entirely different reasons. Private pension funds solve the logistical problems in monitoring by delegating investment (and, to a slightly lesser extent, voting) decisions to external money managers, who compete for the company's pension business. Thus, a large corporation may at any time have a number of outside pension managers handling its pension's assets, all in

12. Pp. 30, 176. The index fund managers (such as Wells Fargo) lead the pack with portfolios totaling over 4000 stocks.

13. Barry Rehfeld, *Low-cal CalPERS*, INSTITUTIONAL INVESTOR, Mar. 1997, at 41, 41.

active competition with one another. This probably results in superior monitoring, but it creates a coordination problem; that is, different fund managers can and do vote differently on the same issue and find it hard to cooperate when they are in competition for the client's business. For all these reasons, even holding aside the conflicts of interest that private money managers face because they are dependent on corporate clients, it may be shortsighted to assume that institutional investors are powerful simply because they are large. This assumption mistakenly equates an ox with a bull.

If we switch from the investor's perspective to the corporation's, this coordination problem comes into clearer focus. Exxon (to give an example used by Useem) does not face a unified phalanx of institutional investors, but a highly dispersed coalition of some 700 institutional investors (p. 176). As Useem repetitively explains, investor relations departments can manage such a field of dispersed institutional shareholders and can usually quell dissatisfaction before it fomented into mutiny. Thus, the real measure of the potential for institutional activism is less the aggregate percentage of stock held by institutions than the level of concentration within that institutional ownership: In short, how much stock do the top ten or twenty shareholders control?¹⁴ Whereas in Great Britain the evidence is that this group often controls more than fifty percent of the stock, the U.S. figure has been estimated at twenty-one percent.¹⁵ This percentage is significant because as a practical matter twenty may be near the maximum feasible number of shareholders that a single institution can contact under time-constrained circumstances.

Economists understand that collective action among a dispersed coalition will be costly. Those institutions who lead the fight must incur the often considerable expenses of proxy fights and litigation, but they have little way of taxing the free riders who may benefit from these expenses but do not wish to pay for them. Once we recognize that corporate governance is a form of what economists call a "public good," it is no surprise that investment in such a public good tends to be underfunded.¹⁶ From this perspective, then, the fact that public pension funds are activists may imply less that they are more sophisticated or the committed vanguard of a new

14. Useem does note that the top five shareholders at General Motors held only 6% of its stock in 1990, whereas a similar number of German investors held 74% of Daimler-Benz's stock. P. 174.

15. See John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 852-53 (1994) (citing data on largest 25 U.S. corporations). Note, however, that these twenty need not all be institutions or sympathetic to shareholder activism. Rather, this largest twenty could include the CEO or the founder's descendants, and hence it constitutes a ceiling on, rather than a likely estimate of, institutional concentration.

16. This was the central insight in Mancur Olson's classic work on collective action problems. See MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1971).

movement (as Useem tends to present them) than that they are either economically naive or politically motivated (or both) in their willingness to confer gratuitous benefits on the "private" institutional investors, who predictably accept these benefits but seldom offer to share the costs.

Like Sherlock Holmes's dog that did *not* bark in the night, there is something curiously missing from Useem's analysis (and also from Conley and Barr's): at no point is there any discussion or reference to institutional investors acting in concert to influence corporate management. This omission is not the product of faulty reporting; in fact, collective action by institutional investors is relatively rare. But why? To the extent institutions do not seek to unite around specific actions or agendas, they are inherently easy to "manage." "Divide and conquer" strategies have worked since well before the advent of the modern corporate governance wars. Alone, institutional investors will necessarily have somewhat idiosyncratic agendas, and each can be separately stroked and placated. Moreover, given the earlier noted overload problem caused by large portfolios and small staffs, institutional investors that do not act in concert are restricted to symbolic politics — such as CalPers's much publicized annual strategy of identifying a "dirty dozen" corporate managements with the worst governance records.¹⁷ To be sure, such a strategy works to a degree; a corporate management no more wants to be on CalPers's list (thereby grouped with Archer Daniels Midland and the other poster boys of poor corporate governance) than it wishes to be subject to a Mike Wallace-style exposé on *Sixty Minutes*. In short, only through coalitions can institutional investors maximize their political or economic clout.

So why do institutional investors not form coalitions? Hypotheses are easy. Legal restrictions, such as the William Act's over-expansive definition of "group," provide a partial explanation.¹⁸ Another cause is the fiduciary ideology that each institutional investor, when asked this question, inevitably articulates: they are responsible only to their own board and their own beneficiaries or shareholders. True enough, but there are seldom conflicts between the beneficiaries of the Wisconsin Investment Board and those of CalPers. Over the last decade, CalPers and Wisconsin have probably been the two most activist public pension funds, but they rarely

17. I do not mean to disparage this strategy, which undoubtedly has great public relations value. This year, CalPers's "home page" on the Internet identifies its worst corporate governance "underperformers." See John Wilcox, *Electronic Communications and Proxy Voting: The Governance Implications of Shareholders in Cyberspace*, INSIGHTS, March 1997, at 8.

18. See Coffee, *supra* note 15, at 877-82 (discussing the SEC's extension of Section 13(d) of the Securities Exchange Act of 1934's definition of "group" to include any "voting group," despite absence of statutory language to support this extension).

act in concert.¹⁹ The New York State Common Retirement Fund (the second largest after CalPers) is also notably aggressive and outspoken, but it limits itself to "social issues."²⁰ The Florida Board of Administration (the fourth largest public fund) is another occasional activist, but it also seldom acts with allies, preferring to "take it one case at a time."²¹ In short, each fund prefers to play "The Lone Ranger," with its own agenda and little willingness to engage in common action.

Why? At the risk of stating a tautology, the answer has to be that the incentives to take collective action do not exceed the costs (both political and economic). Because a pension fund holding the equity securities of a thousand or more issuers in its portfolio incurs relatively little gain from any single victory over a corporate management (and may suffer some political and economic costs), it may base its decisions about when to be an activist more on political, rather than economic, grounds. But, if so, the process resembles symbolic theater — much like student politics in the university. Indeed, if we view public pension funds as fundamentally political bodies, the problem with collective action is that it forces the individual fund, as a political body, to share credit with others. A strategy under which a public pension fund has a one-to-one confrontation with a particular corporate management may be relatively ineffective as a lever for economic change, but it is great politics. In contrast, behind-the-scenes negotiations and compromise, in which a group of funds are quietly represented by a common agent, may be effective economics but poor politics. Credit shared is credit diffused. Thus, the irony is that both corporate managements and public pension funds may prefer high profile face-offs to quiet bargaining between a coalition of investors and an individual corporate management. In this light, the possibility surfaces that public pension funds are "managed" (using Useem's phrase) at least in part because they like it that way.

But, if this seemingly cynical assessment has any validity — at least with regard to public pension funds — how does one explain the seeming evidence that institutional activism has had a marked impact? For example, Useem points to the spate of CEO firings in 1992 and 1993 to demonstrate the potency of institutional activism, but these firings may well have had a more basic cause: fierce international competition caused by the globalization of world markets.

19. See *The Loneliness of the Shareholder Activist*, INSTITUTIONAL INVESTOR, March 1997, at 46 (quoting general counsel of Wisconsin Investment Board as preferring a policy of "[t]alk softly and carry a big proxy"). Unfortunately, no single proxy is that big. Even a five percent holder — as Wisconsin often is — cannot realistically threaten a credible proxy contest without allies.

20. *Id.* (quoting Carl McCall, the New York State Comptroller and sole trustee).

21. *Id.* (quoting Peter Collins, communications manager for the Florida fund).

The firms that terminated their CEOs during this period — General Motors, IBM, Eastman Kodak, American Express, and others — had truly lost their way and were being outdistanced by their rivals. To be sure, institutions may have increased the pressure and hastened these executive transitions, but, to paraphrase Samuel Johnson, the prospect of extinction does wonders to focus the mind of the corporate board (even at the most hidebound corporate dinosaurs). In these cases, all affected corporate constituencies — creditors, suppliers, employees, and even lower management — could see the need for change, and in any event the ultimate decisionmaker was the board of directors, which no doubt heard the voices of institutional shareholders, but only as part of the general clamor for change.

Even if the increased turnover in CEOs is seen as an indication of enhanced stockholder power (and it may be in part), this evidence must be balanced against the contrary and more objective evidence that management has become steadily more entrenched in recent years. Here, Useem ably develops much of the available evidence. First, antitakeover devices have become more, not less, prevalent. Between 1989 and 1992, Useem notes, the fraction of the top 1000 U.S. corporations with staggered boards rose and a majority of such firms now have staggered boards — which deny stockholders the power to unseat the incumbent board in a single election.²² Only nine percent of such firms have adopted a confidential voting policy under which management does not learn how institutional shareholders voted their proxies (p. 160). If institutions held the dominant position that Useem attributes to them, one of their first acts logically would be to assure themselves of the same confidentiality that the ordinary citizen has when voting in a municipal election. In fact, institutions have tried to secure confidential voting and other governance reforms, but with only modest success.²³

The poison pill supplies another example. Of the 1000 largest market-value companies, 495 had adopted a pill in 1989 and 643 in 1992 (p. 64) — an approximately thirty percent rise over only a three-year period and precisely during the time period in which institutions were becoming more vocal. Although the impact and legitimacy of the poison pill can be debated at considerable length, the fact remains that institutions have long opposed its adoption

22. P. 160 (noting rise from 55% to 59% between 1989 and 1992).

23. Georgeson & Co., a major proxy soliciting firm, estimates that some 100 corporate governance proposals from shareholders were voted on during 1995, but only seven succeeded. See Paul Sweeney, *Clash By Proxy: Organized Labor and Shareholder Activism*, ACROSS THE BOARD, May 1996, at 21.

without a shareholder vote (and have been notably unsuccessful in so doing).

Next, as Useem clearly documents, the idea of institutional representation on the corporate board remains anathema to most corporate managements.²⁴ Looking at the composition of corporate boards, a cynic thus might conclude that it remains the government of the managers, by the managers, and for the managers. To be sure, this overstates, but neither the idea of professional directors nor that of shareholder-nominated board members has gained even a toehold level of acceptance. Even neutral "good government" reforms remain very unpopular. For example, a recent survey of more than 800 firms by the American Society of Corporate Secretaries found that: (1) more than 81% of respondents rejected limitations on multiple board memberships for directors; (2) 79.9% opposed creating shareholder advisory committees; (3) 79% opposed designating a "lead" outside director; (4) 76.6% rejected term limits for directors; (5) 73.6% opposed allowing directors to meet with investors or other stakeholders; and (6) 62.9% disfavored a policy whereby the outside directors would hold periodic meetings without the CEO or other managers being present.²⁵ The desirability of each of these reforms can again be debated, but the uniformity of corporate resistance to them suggests that constructive engagement between institutional investors and corporate executives is not yet fully at hand.

Indeed, from a legal perspective, it is not even clear that recent deregulatory initiatives by the SEC have significantly empowered institutional investors. Although the SEC did partially deregulate the proxy rules in 1992 (but still left substantial obstacles under the Williams Act to trip up institutional investors who arguably form a voting group),²⁶ developments at the state level have been largely adverse. The "Just Say No" defense has now been accepted in Delaware;²⁷ most states have enacted antitakeover statutes (and some of these statutes chill voting contests as well as tender offers); and proposed state legislation threatens further limits on shareholder rights. For example, the ability of shareholders to call a spe-

24. Pp. 223-27. In fact, only one in ten of the CEOs of 322 large companies participating in a 1993 survey indicated that (at least in principle) an institutional representative would be welcome on their board. P. 227. Useem does not discuss the many reasons (some compelling) why institutions do not seek board representation (in particular, federal securities law problems). This omission reflects the relatively one-sided nature of his inquiry into the executive perspective (but not the money manager's).

25. See *The IRR Monitor: Board Practices Survey*, CORP. GOVERNANCE ADVISOR, May/June 1996, at 25, 25-26.

26. For a review of the SEC's inconsistent record, see Coffee, *supra* note 15. Professor Useem has little specific to say about any of these legal developments.

27. See, e.g., *Moore Corp. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1554-64 (D. Del. 1995); *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1372 (Del. 1995).

cial meeting of shareholders would be significantly disfavored by recent legislation proposed by the American Bar Association's Committee on Corporate Laws.²⁸

In retrospect, it is now clear that the takeover wars of the 1980s are over. More importantly, management won. To be sure, hostile corporate control contests between large entities will persist, but the true insurgent of the 1980s, the financial entrepreneur (for example, Boone Pickens or Carl Icahn) who could launch a "bust-up" takeover with junk bonds, has now disappeared from the scene. Why, then, should we expect that, in the institutional wars of the 1990s, management is any less likely to prevail again? To ask this question is not to answer it. If ever there was an unlovable champion of shareholder welfare or economic efficiency, it was the 1980s-style takeover raider. To the public at large, the activities of the bust-up takeover raider seemed designed to do nothing more than enrich themselves and make a quick buck at the expense of employees, creditors, local communities, and long-term growth. Whether or not accurate, this perception made these takeover entrepreneurs highly vulnerable to antitakeover legislation and may have encouraged courts to uphold novel defensive tactics, such as the poison pill. In contrast, the institutional investor as activist is subject to none of these political liabilities. As the primary repository of the middle class's retirement savings, pension and mutual funds are the public writ large.

But while the institutional investor is a more credible opponent for management on the political level, it may be a far weaker economic antagonist. Fragmented among tens of thousands of pension and mutual funds, and lacking the lobbying resources of corporate managements, institutional investors are anything but an efficiently organized political or economic force. Coordination among them remains largely ad hoc and crisis-driven.

II. ROOT CAUSES: THE POSSIBLE EXPLANATIONS FOR INSTITUTIONAL IMPOTENCE

Useem clearly recognizes that institutional investors have large portfolios and limited attention spans, and hence make relatively ineffective monitors — except in the uncommon cases when they are outraged by high-profile incidents of corporate misfeasance and nonfeasance. But he stops here with these observations that only begin the analysis. Compared with institutional investors, corporate managements are just as overloaded with information, deci-

28. Under this pending revision to the Model Business Corporation Act, the shareholder vote necessary to call a special meeting of shareholders would be raised from 10% to 25%. See *The IRR Monitor: Shareholders' Rights to Call Special Meetings*, CORP. GOVERNANCE ADVISOR, May/June 1996, at 22.

sions, and day-to-day crises and have no more time for lobbying battles in Congress or the states on issues that are only of marginal importance to them as individual companies. As a result, trade associations long ago developed (for example, the Business Roundtable, the National Association of Manufacturers, the Chamber of Commerce) to assert vigorously business's collective interest and effectively economize on the costs of collective action by taxing the would-be free riders. In the case of institutional investors, there is really only one such group, the Council of Institutional Investors, and Useem devotes virtually no attention to it.²⁹ Yet, in principle, this organization of some 100 members could coordinate the activities of institutional investors holding over \$800 billion in assets (p. 65). More importantly, as the collective voice of many institutions, it is less subject to threats of retaliation or loss of business than is any individual institution.³⁰ Still, although the Council has at times targeted particular companies and published lists of underachieving firms whose corporate governance structure it deplors, it has never sought to be the active lobbying or fundraising vehicle that, for example, the Business Roundtable is.

Why not? This is precisely the type of question on which social scientists must focus in order to explore the potential of institutional activism. In fact, Useem gives it no attention. Possibly, the answer is that the community of institutional investors is too divided between its public and private sectors for the Council (or any similar body) to play a significant political or organizational role paralleling that of the Business Roundtable (or even that of environmental groups, such as the Sierra Club, which certainly coordinate even more dispersed environmentalists).³¹ Alternatively, the seeming inability of institutional investors to achieve a critical mass on the political scene illustrates Mancur Olson's arguments about which "latent groups" can organize effectively and which cannot.³² Because corporate managers are likely to incur

29. The index to *Investor Capitalism* shows only two references to the Council of Institutional Investors; both are very brief. P. 325.

30. See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992).

31. In 1996, in a closely contested election, the Council's membership elected for the first time a corporate executive to one of the Council's three co-chairs. See *The IRRC Monitor: Election at Council of Institutional Investors*, CORP. GOVERNANCE ADVISOR, May/June 1996, at 26. The election appears to have been heatedly contested by union pension officials. The result is that the three co-chairs of the Council are the New York City Comptroller, a Teamsters official, and the executive vice president of TRW — a triumvirate not likely to share a common perspective or world view on many issues.

32. See OLSON, *supra* note 16. Olson notes that when an action affects a large number of persons, the effect on any individual may be so small that it is less than the costs of joining in collective action. *Id.* at 43-52. Members of large groups may therefore have little incentive to organize effectively. In contrast, smaller interest groups in which the individual members have larger stakes are more likely to be effective. *Id.* at 125-28.

individual losses from institutional activism that are greater than the individual gains to shareholders, corporate managers may have greater incentives to take collective action, even though their aggregate losses are small in comparison to the aggregate gains to shareholders. In any event, managers have a critical transaction cost advantage, because they alone can expend corporate funds (while shareholders spend their own).

This issue of coordination costs is central and may in turn depend principally on the level of institutional concentration within the market. Although the U.S. equity market is heavily "institutionalized," with the current level of institutional ownership estimated at fifty percent or more, it is not heavily concentrated (that is, there are thousands of pension and mutual funds and no single institution plays a predominating role as the flagship for others). In contrast, the level of institutional activism appears to be higher in Great Britain than in the United States.³³ This could be the result of a variety of factors (including the higher level of institutional ownership of equity securities in Great Britain — close to sixty-five percent).³⁴ But the most striking difference between the U.S. and the U.K. markets may be the level of concentration in institutional ownership. In Great Britain, a relative handful of money managers dominate the market, and one firm (Prudential) is generally regarded as the standard bearer for the industry. This contrast between the U.K. market structure in which fifty-odd institutions (all in regular contact and generally having offices in close proximity within the financial district of London) control the bulk of the equity under institutional management versus the far more dispersed and dynamically expanding U.S. marketplace may go far to explain why a differential in coordination costs exists and why relatively greater institutional activism characterizes the British market. The strange, but symptomatic, fact about the U.S. capital markets is that we today have more mutual funds than publicly held companies.

Another aspect of this difference may shed even more light on why the level of institutional activism differs between the U.S. and the U.K. markets — and, in turn, may have predictive value for the prospect for greater activism by U.S. institutional investors. Inherently, a more concentrated market is also one with less liquidity. As a result, large investors cannot exit costlessly when they are dissatisfied with a particular management's performance.³⁵ Rather,

33. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2034-41 (1994).

34. See *id.* at 2002.

35. For a discussion of the special problems that exist in the U.K. market, see *id.* at 2040-60.

they are locked in — at least in the relative sense that the sale of a large block will come at a greater discount in a less liquid market. In turn, to the extent that investors find exit costly, they must turn to the alternative remedy of “voice” — and become more active shareholders.³⁶ Thus, institutional investors may be more active in the United Kingdom than in the United States because they have less ability to liquidate their blocks in the market without incurring a market penalty.

Although Useem makes little effort to survey the performance of institutional investors in other economic systems (other than for the standard cursory reference to Japan), he does supply some anecdotal evidence that supports this interpretation that liquidity concerns affect activism. The largest public pension funds and some mutual funds have recognized, he reports, that they cannot exit costlessly by selling into the market because their holdings in individual companies are too large.³⁷ Exit being thus less available, voice is becoming more attractive. Such data represent, however, an economic, rather than his preferred sociological, explanation for why the largest public pension funds are more activist than many private sector institutional investors. In short, the simplest explanation may be neither that public pension activists are culturally different nor an enlightened vanguard, but that, as investors who are highly indexed, they are both exposed to greater losses and do not wish to sacrifice the advantages of diversification through indexing by exiting. Being far more stable, buy-and-hold investors than the mutual funds (whose annual turnover often exceeds fifty percent), they must exercise voice within a community that they cannot easily escape.

This analysis that institutions exercise voice to the extent that they have grown too large to engage in stock picking or quick, in-and-out market maneuvers raises in turn a larger, deeper question that Useem also largely overlooks: Instead of holding 1% to 3% blocks in companies, institutional investors could seek real influence by holding more concentrated blocks of, say, 5% to 10%. Why don't they?³⁸ Such a policy would give them greater influence (although not true control), and it would not sacrifice the advantages of diversification. After all, full diversification is possible based on holding far less than the several thousand stocks that

36. This is the classic tradeoff first articulated by Albert Hirschman. See ALBERT O. HIRSCHMAN, *EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES* 3-5 (1970).

37. Pp. 30-31 (citing officials at CREF, CalPers, and the California State Teachers Retirement System).

38. A very few do. The best example is the Wisconsin Investment Board, which frequently holds 5% to 10% stakes in smaller companies. See *The Loneliness of the Shareholder Activist*, *supra* note 19.

some institutional investors today hold.³⁹ Similarly, if institutions are already locked in and hold blocks too large to easily liquidate at even the 1% to 2% ownership level, why do they not invest more in corporate governance activities, instead of continuing to limit themselves to very small internal staffs?

The seeming paradox is that institutions today have reached the boundary where their individual holdings are too large to assure them exit, but too small to give them effective voice. In this "no man's land" between exit and voice, they face the worst of both worlds. Yet, investors who acquire larger stakes without seeking to seize control from management — for example, Warren Buffett or Kohlberg, Kravis & Roberts — have done extremely well. Usually, success breeds imitation, but here it has not.

There are at least two major theories that attempt to answer this paradox, both of which Useem ignores. First, my colleague, Mark Roe, has argued that shareholder passivity was politically imposed on institutional investors by legislation, as corporate managers manipulated the regulatory system to protect their positions by constraining financial intermediaries.⁴⁰ From this perspective, the separation of ownership and control was never inevitable (as Berle and Means contended it was⁴¹), because, but for governmental interference, financial intermediaries would have assumed the same monitoring role in the U.S. capital markets that they have in Germany and Japan.

The rival perspective doubts that legal restraints are primarily responsible for shareholder passivity and similarly is skeptical of this claim that financial intermediaries would have evolved in the direction of the Japanese main bank or the German universal bank in the absence of politically imposed constraints intended to minimize their power.⁴² As one of the skeptics associated with this latter view, I have posited elsewhere that there exists a liquidity/control tradeoff: the cost of high liquidity is weak voice, and the cost of a strong voice is low liquidity. Given this tradeoff, it does not follow that financial intermediaries that originate in a economy characterized by liquid markets (such as the United States and the United Kingdom) would naturally evolve into financial institutions

39. See Meir Statman, *How Many Stocks Make a Diversified Portfolio*, 22 J. FIN. & QUANTITATIVE ANALYSIS 353, 353-62 (1987).

40. See MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); see also Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); Black, *supra* note 30; Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89 (1990).

41. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933).

42. See John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); see also Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

(such as the Japanese main bank or the German universal bank) that hold substantial power over their portfolio companies but that enjoy relatively little liquidity. The assertion here is not that liquidity is better than control, or vice versa, but that the world is path dependent. Institutions that evolve at one end of the liquidity/control continuum are not likely to move to the other end, absent strong destabilizing pressures or other exogenous developments. Instead, there is a trajectory to the evolution of economic institutions that is largely determined by their initial starting position.⁴³

Of course, neither of these two views is necessarily inconsistent with the other, and both can partially account for shareholder passivity among institutional shareholders. Deregulation might make institutions more inclined to participate in corporate governance, even if it could not induce them to hold large illiquid stakes. Had Useem written from the perspective of one familiar with this debate, he might have made a more useful contribution. For example, to what degree are money managers willing to consider proxy contests or to finance other forms of joint action now that there has been some deregulation under the proxy rules? What limits do they place on their holdings in individual companies and why (that is, legal barriers or liquidity concerns)? Regrettably, these are not topics that he addresses.

III. THE FUTURE EVOLUTION OF INSTITUTIONAL ACTIVISM

What will be the future course of investor-manager relations? Useem is uncertain as to whether more disruption or a new equilibrium lies ahead.⁴⁴ In his view, it all "depends considerably upon how well money managers and corporate managers work together in constructing their new world" (p. 275). Although caution in predicting the future is always prudent, this emphasis on how money managers and executives work and play together in the corporate sandbox illustrates the limitations (harsher critics would say the bankruptcy) of the sociological approach. Deeper forces and influences must be considered.

The future is undoubtedly contingent, but it is contingent on factors that can to a considerable extent be specified. Among these factors are the following:

1. *Will New Institutional Catalysts Emerge?* More than on any other single factor, the future of institutional activism hinges on coalition formation. Lone Rangers must learn to join the team. Yet, it is also clear that institutions are distrustful of long-term

43. See generally RICHARD R. NELSON & SIDNEY G. WINTER, *AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE* (1982).

44. P. 275 ("Whether the future is one of further expansion, a new equilibrium, or a reversal of this trend remains to be seen.").

political alliances (probably for good reason) and will not delegate power outside their organization, except on a very short-term, specific basis. Thus, potential bridging organizations, such as the Council of Institutional Investors, have remained weak by design. But can other institutions evolve to fill such a specific, coalition-building role on a case-by-case basis? Some logical candidates for this brokering role already exist. For example, Institutional Shareholder Services Inc. ("ISS") and the Investor Responsibility Research Center ("IRRC") are advisory firms that provide voting advice.⁴⁵ Because the same advice is given to most institutions, this can easily tend to build a "virtual coalition." But proxy advisory firms do not themselves start proxy contests or put issues on the corporation's agenda. Here, the more significant prototype may be a firm like LENS, an investment advisor that specifically targets underperforming firms and then seeks to improve their management through activist interventions.⁴⁶ This approach has promise, but encounters cultural resistance within the institutional investor community. Their success (or lack thereof) may thus prove to be the best measure of the maturity of institutional activism as an *economic* movement.

2. *Will the Institutionalization of the Market Increase or Wane?*

The growth of institutional investors has been fueled by demographics: retirement savings have flooded into pension and mutual funds, expanding them like accordions, as the baby boom generation of the 1950s has begun to near retirement age. Predictably, this dynamic will reverse itself in due course, as the smaller population in the next generation pumps less funds into these same financial institutions. This factor could be offset if small investors learn to prefer mutual funds to self-investing, but the net balance is cloudy.

3. *Will New Types of Institutional Investors or Retirement Savings Vehicles Appear?*

The future of the pension fund is not assured. Corporations may shift to 401(k) savings plans,⁴⁷ thereby avoiding risks and costs to themselves (including potential liability for underfunding), while shifting risk to the individual employee. A by-product of this transition could be shrinkage of the traditional pension plan and a resurgence in individual shareholdings through 401(k) plans. Again, the net impact on institutionalization is uncer-

45. For a brief discussion of proxy advisory firms, see Coffee, *supra* note 42, at 1354 n.301, 1358 n.314.

46. LENS was founded by Robert Monks and Nell Minow, two of the best known shareholder activists. See Joseph Grundfest, *Just Vote No: A Minimalist Strategy for Dealing With Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 903 (1993) (describing Monks and Minow's approach).

47. See I.R.C. § 401(k) (1994).

tain, because many of these assets may move to the effective control of the major mutual fund families that manage 401(k) plans.

Overshadowing even this uncertainty is the possible privatization of Social Security. If the assets of Social Security are even partially invested in the stock market, a new type of institutional investor could emerge; possibly, even the federal government could emerge to assume a role and stance equivalent to that of a state public pension fund.

4. *Can Coordination Costs be Reduced?* The logic of collective action suggests that the development of more formalized networks among institutional investors represents the most efficient way to economize on the transaction costs of corporate governance. But the slow progress to date on this score suggests that the different categories of institutional investors do not really want to agree on much. Little wonder. Union pension plans, corporate pension plans, and day-trading mutual funds share little in common. Nonetheless, the most logical scenario is for the development of umbrella groups that do not attempt to be so comprehensive or inclusive as to wind-up being stalemated.

5. *Will a Stock Price "Correction" Change Institutional Behavior?* Since the more aggressive confrontations of 1992 and 1993, there has been a recent relative honeymoon between institutions and managements. Again, this is no surprise, because the stock market has soared to record, stratospheric levels. If what went up comes down, however, institutions may themselves face unprecedented pressures, particularly in the case of mutual funds where shareholders can exit quickly (if not costlessly).

Ultimately, the future seems as unpredictable to me as it does to Useem. In contrast to him, however, I am certain that it cannot be shaped or determined by investor relations departments staffed by human relations specialists. To focus on the process (as he does) may be useful (and at times he is highly perceptive), but to confuse process for substance is a fundamental flaw. As a result, this book marks the boundary between where good journalism ends and acceptable scholarship begins.

Looking beyond this particular book, I cannot resist the temptation to comment on the future of qualitative social science as applied to corporate governance studies. The field is indeed open, and the prospect for significant research is bright. The best candidates for this research are probably more like Useem than Conley and O'Barr, who only too recently exchanged their pith helmets for Brooks Brothers suits (the tribal costumes of their intended quarry). In contrast, Useem is well versed in the economic knowledge that members of the corporate culture assume others know. But the more basic problem is that the most interesting research

lies at the seam where two distinct subcultures meet: the bureaucratic world of public pension funds and the free enterprise culture of the large public corporation. Perhaps in the past, anthropologists contented themselves with studying one tribe or one culture (at least one at a time). Nonetheless, what is most interesting in this arena is the interaction between conflicting cultures. Neither Useem nor Conley and O'Barr have focused on this area where the different cultures collide. Nonetheless, this is where the action is.