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ARTICLES

THE AGENCY COSTS OF AGENCY CAPITALISM: ACTIVIST INVESTORS AND THE REVALUATION OF GOVERNANCE RIGHTS

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Equity ownership in the United States no longer reflects the dispersed share ownership of the canonical Berle-Means firm. Instead, we observe the reconcentration of ownership in the hands of institutional investment intermediaries, which gives rise to "the agency costs of agency capitalism." This ownership change has occurred because of (i) political decisions to privatize the provision of retirement savings and to require funding of such provision and (ii) capital market developments that favor investment intermediaries offering low-cost diversified investment vehicles. A new set of agency costs arises because in addition to divergence between the interests of record owners and the firm's managers, divergence exists between the interests of record owners—the institutional investors—and the beneficial owners of those institutional stakes. The business model of key investment intermediaries like mutual funds, which focus on increasing assets under management through superior relative performance, undermines their incentive and competence to engage in active monitoring of portfolio company performance.

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Such investors will be "rationally reticent"—willing to respond to governance proposals but not to propose them.

We posit that shareholder activists should be seen as playing a specialized capital market role of setting up intervention proposals for resolution by institutional investors. The effect is to potentiate institutional investor voice, to increase the value of the vote, and thereby to reduce the agency costs we have identified. We therefore argue against recent proposed regulatory changes that would undercut shareholder activists' economic incentives by making it harder to assemble a meaningful toehold position in a potential target.

INTRODUCTION

The canonical account of U.S. corporate governance, which stresses the tension between dispersed shareholders and company managers in large public firms, has become factually obsolete and now provides a misleading framework for contemporary corporate governance theorizing.[1] In this account, framed eighty years ago by Adolf Berle and Gardiner Means, shareholders individually own too few shares to monitor

1. See, e.g., Clifford G. Holderness, The Myth of Diffuse Ownership in the United States, 22 Rev. Fin. Stud. 1377, 1384, 1388 (2009) (noting, for S&P 500 firms, 89% have blockholders, and for all U.S. public firms, blockholder ownership averages 39%); see also Brian Cheffins & Steven Bank, Is Berle and Means Really a Myth? 83 Bus. Hist. Rev. 443, 467 (2009) (noting U.S. ownership patterns are not monolithic, though ownership separation is useful reference point).

management's performance and confront coordination costs that make collective monitoring difficult.[2] But as we shall see, the Berle-Means premise of dispersed share ownership is now wrong. In 2011, for example, institutional investors owned over 70% of the outstanding stock of the thousand largest U.S. public corporations.[3]

In this Article, we address the impact on corporate governance of the ownership reconcentration of U.S. public corporations. Beneficial owners now typically hold their equity interests through a set of intermediary institutions like pension funds and mutual funds, which are the actual record owners and hold equity as fiduciaries for their beneficiaries. This shift from the Berle-Means archetype of widely distributed ownership to concentrated institutional ownership gives rise to what we call "agency capitalism," an ownership structure in which agents hold shares for beneficial owners. The consequence is a double set of agency relationships: between shareholders and managers and between beneficial owners and record holders.

The familiar Berle-Means agency problem arises because of the divergence between the interests of managers and shareholders.[4] In an agency capitalism world, there is added a new agency problem that results from the gap between the interests of institutional record owners and beneficial owners. As developed below, a significant percentage of these institutional fiduciaries have business models that limit their incentives and capacity to monitor the business choices of their portfolio companies except through assessing stock market performance.[5] The combination of limited institutional investor incentives and limited capacity establishes strong reasons to sell the stock of underperformers rather than to undertake a governance intervention.[6] Record owners prefer exit to the exercise of governance rights even when a governance approach is more valuable to the beneficial owners. This devaluing of governance rights means that the reconcentrated (record) owners will have limited interest in or capacity to reduce the Berle-Means agency problem.

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2. See Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 47–65 (rev. ed. 1967).

3. See Investor Responsibility Research Ctr. Inst. & Institutional S'holder Servs., Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review 9–10 (2012), available at http://irrcinstitute.org/pdf/FINAL-Controlled-Company-ISS-Report.pdf (on file with the *Columbia Law Review*) (providing empirical evidence of significant blockholdings in U.S. public corporations); Holderness, supra note 1, at 1379–85 (same).

4. See Berle & Means, supra note 2, at 112–16 (explaining "divergence of interest between ownership and control").

5. See infra Part III (discussing limitations of institutional ownership and agency costs).

6. See infra notes 96–105 and accompanying text (discussing reasons institutional investors are reluctant to undertake governance intervention).

Some jurisdictions, including the United Kingdom,[7] the European Union,[8] and Israel,[9] have sought to bridge this gap by advocating a new set of governance obligations—those of "stewardship" or "sustainable engagement"—for institutional owners generally. From this perspective, the task is to "fix" the existing governance model to improve the operation of the capital markets. We present a very different view. We argue that the disinterest of these institutions in serving as active monitors of portfolio companies is an endogenous response to the particular agency relationships that arise from reconcentrated record ownership in investment intermediaries.[10] In turn, the appearance of activist shareholders,

7. See Fin. Reporting Council, The UK Stewardship Code 6 (2012), available at http://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx (on file with the *Columbia Law Review*) (emphasizing "institutional investor's duty is to act in the interests of its . . . benficiaries" and describing "[s]tewardship activities" as including "monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance"); John Kay, The Kay Review of UK Equity Markets and Long-Term Decision Making 44 (2012) [hereinafter Kay, The Kay Review], available at http://www.bis.gov.uk/assets/BISCore/business-law/docs/K/12-917-kay-review-of-equity-markets-final-report.pdf (on file with the *Columbia Law Review*) ("All participants in the equity investment chain should act according to the principles of stewardship, based on respect for those whose funds are invested or managed, and trust in those by whom the funds are invested or managed . . . .").

8. See Commission Green Paper on the EU Corporate Governance Framework, at 11–12, COM (2011) 164 final (Apr. 5, 2011), available at http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf (on file with the *Columbia Law Review*) (discussing "lack of shareholder engagement" and European Commission's options to facilitate engagement); Resolution on a Corporate Governance Framework for European Companies, Eur. Parl. Res. (A7-0051/2012) ¶¶ 25, 34, 2012 O.J. (C 161) (adopting text P7_TA(2012)0118) (emphasizing European Parliament "[w]elcomes the development of Stewardship Codes for institutional investors across the European Union" and "believes that a European Stewardship Code could be developed"). Based on the consultation process around its Green Paper, the European Commission recently published its 2012 "Action Plan" for European company law and corporate governance that will include an "initiative . . . on the disclosure of voting and engagement policies as well as voting records by institutional investors." Action Plan: European Company Law and Corporate Governance—A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies, at 8, COM (2012) 740 final (Dec. 12, 2012), available at http://ec.europa.eu/internal_market/company/docs/modern/121212_company-law-corporate-governance-action-plan_en.pdf (on file with the *Columbia Law Review*); see also id. ("Effective, sustainable shareholder engagement is one of the cornerstones of listed companies' corporate governance model . . . .").

9. See Principal Recommendations of the Committee on Enhancing Competitiveness (Isr.), available at http://www.mof.gov.il/lists/list26/attachments/291/2011-1111.pdf (translation on file with the *Columbia Law Review*) (last visited Apr. 23, 2013) (recommending, among other things, encouragement of institutional investors to play activist role). For an analysis finding similar behavior and similar problems by institutions worldwide, see generally OECD, The Role of Institutional Investors in Promoting Good Corporate Governance (2011), available at http://www.oecd.org/daf/ca/corporategovernanceprinciples/49081553.pdf (on file with the *Columbia Law Review*).

10. See infra Part III (discussing limitations of institutional ownership and agency costs).

such as hedge funds, who acquire a significant but noncontrolling stake in a corporation and then try to alter the company's business strategy initially through persuasion but sometimes through a follow-on proxy contest, should be seen as an endogenous response to the monitoring shortfall that follows from ownership reconcentration in intermediary institutions.[11]

In this analysis, the activist shareholders are governance intermediaries: They function to monitor company performance and then to present to companies and institutional shareholders concrete proposals for business strategy through mechanisms less drastic than takeovers. These activists gain their power not because of their equity stakes, which are not controlling, but because of their capacity to present convincing plans to institutional shareholders, who ultimately will decide whether the activists' proposed plan should be followed. As this Article develops, institutional shareholders are not "rationally apathetic" as were the dispersed owners on whose behalf the institutions now hold shares, but instead are "rationally reticent": Intermediary institutional holders will respond to proposals but are unlikely themselves to create them. The role for activist shareholders is to potentiate institutional voice; specialists in monitoring combine through the capital markets with specialists in low-cost diversification to provide a form of market-based stewardship.

The governance problem that arises from the "separation of ownership from control" is the undervaluation of the vote as a mechanism to impose change. The reconcentration of ownership through institutions adds only marginally to the value of the vote, much less than otherwise would be expected, because of the agency problems of agency capitalism. The role of a new entrant into the governance story, the activist shareholder, is to increase the value of the vote held by the institutions by teeing up the intervention choices at low cost to the institutional owners. If the intervention is successful, the activist's equity position will increase in value, as will that of the institutions. The expectation of that increase gives the activist the incentive to proceed, which in turn mitigates a problem of agency capitalism.

As we will show, the move to reconcentrated ownership in investment intermediaries is a consequence of two factors: first, the political decisions to privatize retirement provisioning (beyond the social safety net of Social Security) and to facilitate advance funding; and second, the intellectual triumph of modern portfolio theory, which promotes diversification as the touchstone investment strategy.[12] The result is a fundamental shift, from a Berle-Means capital market characterized by passive dispersed shareholders to one of agency capitalism characterized by concentrated but reticent intermediaries. This shift illustrates both the

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11. See infra Part IV (discussing role of activists as governance arbitrageurs and solution to agency costs of agency capitalism).

12. See infra Part II (discussing these two factors).

fact that corporate governance is bound up with the way capital markets support the transfer of risk to investors, and the direction of causation. Changes in the available mechanisms of risk transfer drive ownership changes; corporate governance institutions then adapt to ensure an allocation of governance rights that facilitates the available risk transfer techniques. Thus, innovation in the capital markets determines the efficient structure of corporate governance: The manner in which risk is transferred and the corresponding governance structure that supports that transfer depend on the evolution of the capital markets.

Contemporary objections to the role of activist investors largely ignore how activist investors are the product of the changes in U.S. equity ownership, and that they operate to revalue governance rights, whose value depreciated as they came to be held by institutions in whose business model governance rights were at best peripheral.[13] Stated simply, the availability of low-cost diversification under the aegis of institutional investors, combined with the corresponding institutional investor business model, creates the agency costs of agency capitalism. A corporate governance structure that was suited to a Berle-Means ownership distribution must evolve in response to the change in ownership distribution.

Regulatory regimes must also adjust. The current debate over new regulatory interventions that can affect the incentives of potential governance activists highlights the need for complementarity between ownership patterns and governance and regulatory structures. As we will argue, debates over the terms of the stock accumulation disclosure triggered under the Williams Act[14] so far have largely ignored the evolution of capital markets since 1967 and the resulting change in ownership patterns, even though the SEC has ample discretion to take those new patterns into account.

Reflecting the authors' expertise, this Article focuses largely on the evolution of U.S. ownership patterns and governance structures. However, our analysis should prove useful in assessing developments in other countries. In particular, the efforts in jurisdictions as different as the European Union, the United Kingdom, and Israel seek to harness institutional investors as "stewards," that is, as active monitors of long-term

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13. E.g., Adam O. Emmerich et al., Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power, 3 Harv. Bus. L. Rev (forthcoming 2013) (manuscript at 1–4), available at http://ssrn.com/abstract=2138945 (on file with the *Columbia Law Review*) (arguing SEC should modify section 13(d) reporting rules to limit activists' ability to acquire substantial stakes without disclosure to market); cf. Lucian A. Bebchuk & Robert J. Jackson, Jr., The Law and Economics of Blockholder Disclosure, 2 Harv. Bus. L. Rev. 39, 47–49 (2012) (examining empirical evidence of value of activist blockholders).

14. See 15 U.S.C. § 78m(d) (2006) (requiring any person acquiring more than 5% of beneficial ownership of registered equity security to file report with SEC within ten days after acquisition).

company performance.[15] These efforts, it will be apparent, ignore that the structure of agency capitalism gives intermediary institutional investors little incentive to play this role; as a result, the institutions largely lack the competence to undertake it.

Part I illustrates the direction of causation between capital markets innovation and corporate governance by rehearsing examples of how changes in the capital markets give rise to responsive changes in governance. Part II then takes up the evolution of agency capitalism in response to developments in the capital markets, stressing the impact of changes in the financing of retirement security. Part III argues that a regime of agency capitalism results in the general undervaluation of governance rights, which sets up Part IV's framing of a role for active investors as governance intermediaries (or, more specifically, as governance rights arbitrageurs). Finally, Part V considers the existing regulatory environment, including current reform proposals, in light of their effect on the supply of activist shareholders, with particular emphasis on proposals in the United States (and actions already taken in the United Kingdom and E.U. member states) to eliminate most of the timing gap between an activist investor's acquisition of the disclosure-triggering percentage of a company's shares and its obligations to publicly disclose its shareholdings. We conclude by reemphasizing the complementarities between institutional investors and activists, in which the activists' willingness to bet their assets, subject to ultimate judgment by the institutions, revalues the institutions' governance rights, and thus makes governance markets more complete.

I. THE DIRECTION OF CAUSATION: FROM CAPITAL MARKETS TO GOVERNANCE

Changes in the capital markets drive the efficient structure of corporate governance, not the other way around. Companies need risk capital to take advantage of new opportunities and to capture economies of scale and scope. Public investors who can diversify their shareholdings are the cheapest risk bearers. Eugene Fama and Michael Jensen made the point explicitly thirty years ago: "Common stock allows residual risk to be spread across many residual claimants who individually choose the extent to which they bear risk and who can diversify across organizations offering such claims."[16] Since diversified shareholders do not bear unsystematic risk, they need not be paid to bear it.[17] The result is a lower

15. See supra notes 7–9 and accompanying text (discussing U.K., E.U., and Israeli proposals).

16. Eugene F. Fama & Michael C. Jensen, Agency Problems and Residual Claims, 26 J.L. & Econ. 327, 329 (1983).

17. Standard portfolio theory decomposes risk into two categories: systematic risk and unsystematic risk. Systematic risk is that which all companies are exposed to—for example, changes in gross domestic product (GDP) and interest rates. Systematic risk

cost of capital. But this cheap risk bearing comes in tandem with the expense of agency costs; someone else must manage the capital provided by dispersed shareholders. The result is dual specialization—investors in risk bearing and managers in managing—made possible by public capital markets. Agency costs resulting from the divergence of interests between professional managers and diversified shareholders are simply the reciprocal of the benefits of specialization.[18]

The laser-like focus of corporate governance reformers on minimizing agency costs, starting at least with Jensen and Meckling's classic 1976 article,[19] is premised on the proposition that diversified shareholders are the cheapest risk bearers, conditional on agency costs being effectively addressed.[20] Put differently, the ability to diversify gives rise both to a demand for governance and, in turn, to its supply.[21] Thus, when innova-

cannot be eliminated by diversification. Unsystematic risk is that which relates to a particular company and can be eliminated by holding a diversified portfolio. See Richard A. Brealey, Stewart C. Myers & Franklin Allen, Principles of Corporate Finance 168–70 (10th ed. 2011).

18. See Berle & Means, supra note 2, at 112–16 (discussing "divergence of interest between ownership and control"). The text somewhat reframes the point Berle and Means were actually making. The separation of ownership and control, however efficient, in their view resulted in corporations run by managers and accountable to no one. Id. The agency problem served as a justification for New Deal efforts to empower regulators to hold managers accountable for their actions.

19. Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

20. Jensen and Meckling left open the possibility that changes in capital market technology would alter the tradeoff between ownership concentration (lower agency costs) and risk diversification. Id. at 319–23, 353–54.

21. This framing raises an example of the causation question given prominence by the law and finance literature, which argues that governance protection of shareholders is necessary for the emergence of diversified shareholders. See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Investor Protection and Corporate Governance, 58 J. Fin. Econ. 3, 15–16 (2000) (examining literature arguing "investor protection encourages the development of financial markets"). We note that the historical evidence supports the direction of causation described in the text: from capital markets to governance, not from governance to capital markets. For the United Kingdom, see Brian R. Cheffins, Mergers and the Evolution of Patterns of Corporate Ownership and Control: The British Experience, 46 Bus. Hist. 256, 275 (2004) ("The experience in the UK correspondingly indicates that buoyant [capital] market conditions can provide a hospitable milieu for transformative merger activity . . . ."); Julian Franks, Colin Mayer & Stefano Rossi, Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom, *in* A History of Corporate Governance Around the World: Family Business Groups to Professional Managers 581, 593–97 (Randall K. Morck ed., 2005) (arguing "main cause" of decline in family ownership and rise of dispersed ownership was equity issuance to outside shareholders, thereby diluting insider shareholdings). For Germany, see Julian Franks, Colin Mayer & Hannes F. Wagner, The Origins of the German Corporation—Finance, Ownership and Control, 10 Rev. Fin. 537, 539 (2006) (noting "existing measures of investor protection" do not explain "the high level of stock market activity at the beginning of the 20th century" in Germany). For the United States, see generally Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994) (arguing populist politics created demand for

tion in the capital markets increases the range of instruments by which risk can be transferred, governance techniques develop to support them.

Consider the following examples. The development of junk bonds in the 1970s, initially used in the finance of noninvestment grade companies, grew into a technique for financing hostile takeovers that greatly expanded the potential targets of a hostile bid. Noninvestment grade bond issuance rose in volume from less than 0.1% of total stock market capitalization in 1977 to a high of 1.5% in 1986.[22] By the mid- to late 1980s, more than half of all junk bond issuances were related to acquisitions.[23] In 1988, for example, an amount equal to 1.25% of total stock market capitalization was available to noninvestment grade issuers to fund takeovers.[24] In turn, the public issuance of subordinated debt could support large amounts of mezzanine financing by bank consortia, thereby substantially leveraging the resources of the junk bond market. Nearly 23% of all major U.S. public companies were the object of a hostile takeover during the period between 1982 and 1989, and 57% received a takeover bid of some kind.[25] The next thirty years of corporate governance debate over the allocation of governance responsibilities for hostile takeovers was then driven by these capital market developments.[26]

The growth in the completeness of the debt market also gave rise to a strong claim concerning a new form of governance. In 1989, Michael Jensen argued that the leveraged buyout (LBO) association, in his view a more efficient form of organizing capital and managing a business, would come to supplant the Berle-Means corporation with its widely distributed shareholders and powerful managers who did not hold a significant equity stake in the organization.[27]

In 2008, Ronald Gilson and Charles Whitehead made a similar connection between the completeness of the capital markets and corporate governance. They argued that the development of risk

investor protection in United States); John C. Coffee, Jr., The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. 1, 80 (2001) (arguing based on U.S. experience that "the cause and effect sequence posited by the LLS&V thesis may in effect read history backwards").

22. Bengt Holmstrom & Steven N. Kaplan, Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s, J. Econ. Persp., Spring 2001, at 121, 126 fig.5.

23. Id. at 125.

24. Id. at 126 fig.5.

25. Mark L. Mitchell & J. Harold Mulherin, The Impact of Industry Shocks on Takeover and Restructuring Activity, 41 J. Fin. Econ. 193, 199 tbl.2 (1996).

26. See Ronald J. Gilson, Catalysing Corporate Governance: The Evolution of the United States System in the 1980s and 1990s, 24 Company & Sec. L.J. 143, 150–51 (2006) (arguing changes in U.S. capital markets, notably access to increased funds through junk bond market, created "the market for corporate control" for "a wide range of major . . . corporations").

27. Michael C. Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept.–Oct. 1989, at 61, 64–66.

management—the transfer of risk in slices rather than through all-purpose risk bearing by common stockholders[28]—could substitute for traditional common stock-based risk capital, with important implications for the governance structure that supported risk transfer.[29] The reduction in the centrality of common stock, which is a result of the higher leverage that risk management allows, in turn facilitates the reemergence of block positions and a change in control patterns.[30]

A final example of the link between capital market innovation and governance structure concerns the relationship between stock market informational efficiency and the role of independent directors. Jeffrey Gordon has shown that the capital markets' evolving informational efficiency facilitated the greatly expanded role of independent directors in corporate governance.[31] Independent directors provide a buffer between corporate management and the capital markets, which allows courts to rely on the directors' assessments of how best to create value rather than the courts having to make that assessment themselves.[32] That stock prices impound the public information about a corporation's current and future performance allows directors plausibly to discharge the function courts assigns them.[33] Again, the capital market's evolving capacity drives innovation in governance structures.

We offer these examples simply as evidence that corporate governance functions to support the transfer of risk to investors and is driven by the instruments that financial innovation makes available through the capital markets. Innovation in the capital markets determines the effi-

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28. See Myron S. Scholes, Derivatives in a Dynamic Environment, 88 Am. Econ. Rev. 350, 366 (1998) ("Equity is a risk-management device. It is an 'all-purpose' risk cushion.").

29. See Ronald J. Gilson & Charles K. Whitehead, Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets, 108 Colum. L. Rev. 231, 263 (2008) ("Risk management at the firm level . . . may be more efficient than risk bearing by diversified shareholders . . . ."). Identifying the particular scholarly contributions that developed this analysis is merely illustrative and therefore somewhat arbitrary. Gilson and Whitehead, for example, drew explicitly on Myron Scholes' 1995 prediction that firms would come to substitute less costly derivatives for equity capital. Myron S. Scholes, The Future of Futures, *in* Risk Management: Problems and Solutions 349, 362–65 (William H. Beaver & George Parker eds., 1995).

30. Gilson and Whitehead argue that the development of risk management techniques completed the capital market infrastructure necessary to support Jensen's argument that the LBO association could substitute for public ownership and could explain the phenomenon of one private equity firm selling a portfolio company to another private equity firm. Gilson & Whitehead, supra note 29, at 251–53.

31. Jeffrey N. Gordon, The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices, 59 Stan. L. Rev. 1465, 1541–61 (2007) [hereinafter Gordon, Independent Directors].

32. See id. at 1523–26 (noting, with rise of independent directors in 1980s, Delaware courts developed strategy to focus on independent directors' "role in reviewing and approving the defensive undertaking").

33. See id. at 1541–61 ("As stock prices become more informative, the directors' monitoring role increasingly consists of using stock price metrics to measure the firm's performance over time and against relevant intra-industry comparisons.").

cient structure of corporate governance; the manner in which risk is transferred and the corresponding governance structure that supports that transfer depend on capital market evolution. Frictions and anomalies arise because the capital markets evolve at a faster rate than governance structures adapt; path-dependent institutions move less quickly than markets, in no small part because adaptation negatively affects those favored by existing patterns.

A range of implications flows from the recognition that the efficient structure of corporate governance is driven by capital market evolution, whether as a result of financial innovation or of political economy.[34] These include, for example, the risk that best practice codes—including those of institutional investors like California Public Employees' Retirement System (CalPERS) and guidelines by Institutional Shareholder Services (ISS), which are necessarily based on where the capital markets have been rather than where they are going—will result in the petrification of the governance process.[35] Similarly, that capital market evolution drives corporate governance implies that ownership structures may become more concentrated, with significant blockholdings, even in countries with strong shareholder protection, as the continued development of derivative markets permits risk transfer in ways that move equity in the direction of an incentive contract most efficiently held by managers.[36]

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34. Thus, for our purposes, we need not address the right combination of financial innovation that makes the capital markets more complete and thereby increases the set of available risk transfer mechanisms, and the political forces that serve to limit them. Importantly, the combination that shaped the path dependency in different countries reflects the influence of local conditions. See, e.g., Ronald J. Gilson, Corporate Governance and Economic Efficiency: When Do Institutions Matter?, 74 Wash. U. L.Q. 327, 329–39 (1996) (explaining link between corporate governance and path dependency, and between governance institutions and industrial organization in United States, Japan, and Germany); Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function, 49 Am. J. Comp. L. 329, 356–57 (2001) (surveying different circumstances of corporate governance convergence and concluding "there can be no general prediction of the mode that convergence of . . . institutions may take").

35. Dani Rodrik makes the same point about the best practice codes of institutions, like the World Bank and the International Monetary Fund, with respect to recommended institutional structures to support economic growth in the developing world. Dani Rodrik, Second-Best Institutions, 98 Am. Econ. Rev. 100, 104 (2008). The OECD, which has promulgated influential corporate governance standards, recognizes the impact of changes in the capital markets on efficient corporate governance practices. As background to an anticipated review of its standards, the OECD is undertaking an inventory of such changes, including changes in ownership patterns. See Mats Isaksson & Serdar Celik, Corporate Governance in Current Equity Markets: A Report to the OECD Project on Corporate Governance, Value Creation and Growth 7–8 (Nov. 7, 2012) (unpublished working paper) (on file with the *Columbia Law Review*) (describing effort).

36. Gilson & Whitehead, supra note 29, at 252. For example, if the firm can hedge the systematic risk associated with a critical input—oil, for example—then managers can bear more firm-specific risk, an arrangement that more closely ties their payoff to matters under their control.

We focus on an important current manifestation of this dynamic: the reconceptualization of the value of governance rights and the role of activist shareholders in the face of capital markets that have come to be dominated by institutional investors acting as investment intermediaries. The next Part takes up the reconcentration of shareholdings that gave rise to agency capitalism and then to activist shareholders.

II. The Reconcentration of Record Ownership and the Rise of Agency Capitalism

In recent years, the centrality of the Berle-Means description of the distribution of U.S. stockholdings to the corporate governance debate has been attacked from two opposite directions. From one direction, critics who start from the Berle-Means account of U.S. equity holdings have pointed out that the United States and the United Kingdom are unique. Widely distributed equity holdings are neither typical of the rest of the world nor even necessarily the direction in which capital market evolution will lead. Everywhere else in the world, including both developed and developing countries, equity ownership of public corporations is characterized by controlling shareholders or blockholders.[37]

A more direct challenge comes from the opposite direction: The Berle-Means description of the distribution of U.S. equity ownership simply is no longer correct. In 1950, the Berle-Means description advanced some twenty years earlier remained accurate. Equities were still held predominately by households; institutional investors, including pension funds, held only approximately 6.1% of U.S. equities.[38] By 1980, however, the distribution of shareholdings had begun to shift away from households toward institutions. At that time, institutional investors held 28.4% of U.S. equities.[39] By 2009, institutional investors held 50.6% of all U.S. public equities, and 73% of the equity of the thousand largest U.S. corporations.[40] Table 1 sets out the institutional ownership of different-size cohorts of U.S. public corporations in 2009.

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37. See Ronald J. Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harv. L. Rev. 1641, 1645–50 (2006) (summarizing relevant literature); Holderness, supra note 1, at 1395 tbl.4 (providing more recent data and comparing block ownership in U.S. and non-U.S. firms); Isaksson & Celik, supra note 35, at 15 (showing share of global capitalization of stock markets in countries with dispersed ownership has dropped by some 30% between 2000 and 2011).

38. Matteo Tonello & Stephan Rabimov, The Conference Bd., Inc., The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition 22 tbl.10 (2010), available at http://ssrn.com/abstract=1707512 (on file with the *Columbia Law Review*).

39. Id.

40. Id. For a time series of institutional ownership between 1950 and 2004, see Gordon, Independent Directors, supra note 31, at 1568 tbl.4 & fig.6. For similar observations, see, e.g., Stuart L. Gillian & Laura T. Starks, The Evolution of Shareholder Activism in the United States, 19 J. Applied Corp. Fin. 55, 57 fig.1 (2007).

TABLE 1: INSTITUTIONAL OWNERSHIP OF LARGEST U.S. CORPORATIONS IN 2009[41]

Corporations Ranked by Size	*Average Institutional Holdings*
Top 50	63.7%
Top 100	66.9%
Top 250	69.3%
Top 500	72.8%
Top 750	73.9%
Top 1000	73.0%

Thus, for the largest U.S. corporations, institutions control the great majority of outstanding shares. Put graphically but not metaphorically, representatives of institutions that collectively represent effective control of many large U.S. corporations could fit around a boardroom table. For example, Table 2 sets out the percentage of the outstanding stock held in 2009 by the twenty-five largest institutions in the ten largest U.S. corporations in which there was not a controlling owner.

TABLE 2: PERCENTAGE OF OUTSTANDING STOCK IN TEN LARGEST U.S. CORPORATIONS WITHOUT A CONTROLLING SHAREHOLDER HELD BY TWENTY-FIVE LARGEST INSTITUTIONS IN 2009[42]

Corporation (in order of market value)	*Percentage of Stock Held by Twenty-Five Largest Institutions*
Exxon Mobil Corp.	25.0%
Microsoft Corp.	31.9%
Apple Inc.	37.0%
Wal-Mart Stores, Inc.	17.2%
Berkshire Hathaway Inc.	19.2%
General Electric Co.	24.8%
Procter & Gamble Co.	29.1%
Bank of America Corp.	28.9%
Google Inc.	44.1%
JP Morgan Chase & Co.	35.8%

To be sure, the enormous growth in institutional holdings of U.S. equities and the corresponding increase in ownership concentration are

41. Tonello & Rabimov, supra note 38, at 27 tbl.13.
42. Id. at 30–34.

quite different from the control or blockholdings observed elsewhere in the world. In their own way, U.S. institutions, like Berle-Means diversified individual investors, are themselves passive with respect to much of corporate governance despite the fact that they confront much lower coordination and other collective action costs than individual investors do. We will argue that the distribution of shareholdings in the United States remains unique, no longer because of its great breadth, but because of the particular structure of the concentrated institutional ownership that has developed. Real blockholders are not insignificant in the United States;[43] however, the central change in equity distribution has been for equity ownership to concentrate in intermediary institutions, like pension funds and mutual funds, that are the record holders of equity on behalf of their beneficiaries, mutual fund shareholders, or pension retirees.[44]

This Part explores the impact on corporate governance of the changes in the capital markets that have led to a pattern of U.S. equity holdings that we call "agency capitalism." By this we mean that the beneficial owners of U.S. equity confront two agency relationships: between the portfolio company management and the institutional record holder and then between the record holder and the beneficial owner. This relationship is depicted in Figure 1. While academics and the courts have explored the management-shareholder agency relationship in great depth, the institutional agency relationship has received far less attention.[45]

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43. See, e.g., Holderness, supra note 1, at 1378 ("Ninety-six percent of thesefirms have shareholders who own at least 5% of thefirm's common stock ('blockholders'). Three times as many firms have majority blockholders as have no blockholders. Blockholders on average own 39% of a firm.").

44. We distinguish this concentration from the nominal concentration that occurs when record ownership is in "street name" or "nominee name," even in the circumstances in which brokers have commonly voted the shares held by beneficial owners. In the street name setup, the retail owner can always claim voting rights,, and even before the recent limits on broker voting, various notification systems mandated by the proxy rules facilitated such voting pass-throughs. The retail investor could also assert control over the disposition of portfolio securities. By contrast, in reconcentration through investment intermediaries, the retail investor has, in effect, an undivided interest in the pool of securities with no way of reclaiming any share of voting rights for any portfolio company. Nor can a retail investor affect the composition of the portfolio.

45. A developing literature examines the extent to which recommendations by ISS and other advisory services influence mutual fund voting. See, e.g., Jie Cai, Jacqueline L. Garner & Ralph A. Walking, Electing Directors, 64 J. Fin. 2389, 2401 (2009) (noting negative ISS recommendation unexplained by firm performance or governance characteristics reduces director votes by 20.7% on average); Stephen Choi, Jill Fisch & Marcel Kahan, The Power of Proxy Advisors: Myth or Reality?, 59 Emory L.J. 869, 906 (2010) [hereinafter Choi, Fisch & Kahan, Proxy Advisors] ("[W]e find that the impact of an ISS recommendation ranges from 6% to 13% for the median company."); James Cotter, Alan Palmiter & Randall Thomas, ISS Recommendations and Mutual Fund Voting on Proxy Proposals, 55 Vill. L. Rev. 1, 55 (2010) ("[M]utual funds voted in line with ISS recommendations much more frequently than with contrary management

We argue that changes in the capital markets, especially in the manner in which retirement savings are channeled, have led to a significant change in ownership distribution and complementary changes in corporate governance. In particular, the intermediary institutions' business model and their corresponding expertise define and limit the role they play in corporate governance. Part III develops how these limits result in a general undervaluation by the market of governance rights. Part IV in turn frames an important role for activist investors. As governance intermediaries or governance arbitrageurs, activist shareholders can, in the right circumstances, serve to reduce the market's undervaluation of governance rights to the advantage of all shareholders.

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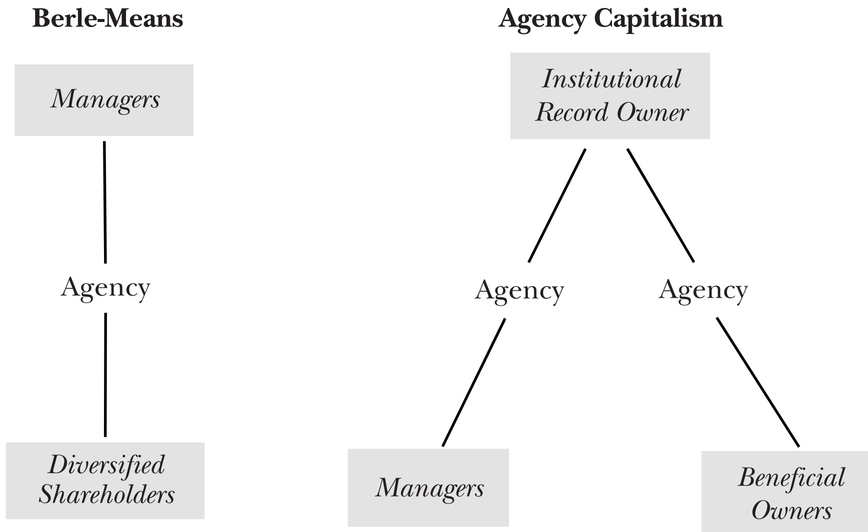
recommendations."). All report measurable but limited influence. Assessing the influence of proxy advisors is beyond the ambition of this Article. For further discussion, see Angela Morgan et al., Mutual Funds as Monitors: Evidence from Mutual Fund Voting, 17 J. Corp. Fin. 914, 927 (2011) (finding "funds tend to support proposals which are likely to positively impact shareholder wealth" and "fund approval rates have a significant impact on whether a proposal is ultimately passed by shareholders and whether management implements that proposal"); Jennifer S. Taub, Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights, 34 J. Corp. L. 843, 846 (2009) ("[T]he greater the dependency of [mutual funds] upon [corporate clients] for asset management business, the less likely the fund family will be [able] to support shareholder-sponsored governance resolutions."); Stephen J. Choi, Jill E. Fisch & Marcel Kahan, Voting Through Agents: How Mutual Funds Vote on Director Elections 12–18 (Univ. of Pa. Inst. for Law & Econ., Research Paper No. 11-28, 2011) [hereinafter Choi, Fisch & Kahan, Voting Through Agents], available at http://ssrn.com/abstract=1912772 (on file with the *Columbia Law Review*) (considering various ways that mutual funds economize on voting costs).

Other literature examines whether forcing institutional investors to reveal their governance decisions, at least as expressed through voting, changes behavior. See, e.g., K.J. Martijn Cremers & Roberta Romano, Institutional Investors and Proxy Voting on Compensation Plans: The Impact of the 2003 Mutual Fund Voting Disclosure Rule, 13 Am. L. & Econ. Rev. 220, 265 (2011) (finding evidence that mutual funds' proxy votes in support of management did not decline after SEC implemented vote disclosure rule); Burton Rothberg & Steven Lilien, Mutual Funds and Proxy Voting: New Evidence on Corporate Governance, 1 J. Bus. & Tech. L. 157, 171 (2006) (providing empirical evidence that mutual funds "voted in general accordance with the policies they laid out in [the] proxy policy disclosures" required by SEC).

Prior discussions of the two-sided agency relationship similar to that in this Article can be found in Stephen M. Bainbridge, Corporate Governance After the Crisis 247–48 (2012) (arguing deficiency in institutional monitoring "merely relocates [the] locus" of principal-agent problem); John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1317–28 (1991) (explaining money managers show "limited interest in corporate governance issues . . . 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"); Jill E. Fisch, Securities Intermediaries and the Separation of Ownership from Control, 33 Seattle U. L. Rev. 877, 878–79 (2010) (noting financial intermediaries, like mutual funds and pension funds, "introduce the same separation of ownership from control" and themselves "function[] much like the Berle and Means corporation").

FIGURE 1: THE SHAPE OF AGENCY CAPITALISM



A. *Retirement Savings and the Rise of Institutional Ownership*

Post-World War II policy decisions concerning how retirement security would be provided were a major, if at the time unrecognized, cause of the rise of the U.S. system of agency capitalism.[46] Three were of particular significance: the initial decision to rely primarily on privately funded pensions rather than to expand Social Security, the enactment of the Employee Retirement Income and Security Act of 1974 (ERISA),[47]

46. See generally Jeffrey N. Gordon, Employees, Pensions, and the New Economic Order, 97 Colum. L. Rev. 1519, 1538–52 (1997) [hereinafter Gordon, New Economic Order] (examining developments in stock market and pension funds); Martin Gelter, The Pension System and the Rise of Shareholder Primacy 3 (Fordham Law Legal Studies Research, Paper No. 2079607, 2012), available at http://ssrn.com/abstract=2079607 (on file with the Columbia Law Review) ("[C]hanges in the pension system helped to transform corporate governance into a system dominated by the shareholder interest and to edge out the managerial model."). Peter Drucker recognized in the mid-1970s the increasing equity ownership by pension funds but greatly overestimated how active pension funds would be in corporate governance. Peter F. Drucker, The Unseen Revolution: How Pension Fund Socialism Came to America 1 (1976) (noting in 1976 American workers owned "more than one-third of the equity capital of American business").

47. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended at 29 U.S.C. §§ 1001–1461 (2006)); see also John H. Langbein, David A. Pratt & Susan J. Stabile, Pension and Employee Benefit Law 78–145 (5th ed. 2010) (surveying history and structure of ERISA); Gordon, New Economic Order, supra note 46, at 1541–44 (discussing passage of ERISA and defined benefit plans); Gelter, supra note 46, at 16–17 (same).

and the later shift in employer-provided pension plans from defined benefit to defined contribution plans.[48]

The immediate post-war period saw a hotly contested debate over how to finance retirement security in the United States: Stated simply, would retirement support come primarily through private pension funds, or through an expansion of the government Social Security program?[49] Retirement assets that went into private pension funds could then be invested in the capital markets, including equities, as compared to taxes paid into the Social Security Trust Fund that have been invested in U.S. Treasury securities. Reliance on private pension plans carried the day; substantial tax incentives encouraged workers and employers to look to such plans as the major source of their retirement savings despite some increase in Social Security benefit levels.

The 1974 passage of ERISA augmented the impact on equity ownership of the private provision of retirement security, which resulted in a further increase in funds available to the capital markets. Responding to abuses in the management and funding of private pension funds, Congress enacted legislation that requires companies to set up special entities to hold pension resources that are governed by trustees having fiduciary duties solely to their beneficiaries. Most importantly, ERISA requires that the defined benefit plans currently fund the actuarially determined annual payments necessary to pay future retirement obligations and pay down any prior unfunded past service costs over no more than thirty years.[50] This requirement resulted from the discovery that many corporations had allowed a substantial build-up of unfunded past service costs.[51] Pension funds covering public employees, although not covered by ERISA, followed suit. The result was an enormous concentra-

48. The rise of institutional owners is also intertwined with the modern understandings of the value of portfolio diversification. See infra Part II.B (discussing triumph of modern portfolio theory).

49. See, e.g., William Graebner, A History of Retirement 215–41 (1980) (tracing legislative, economic, and social factors that encouraged development of private pension funds from World War II through 1950s); Alicia H. Munnell, Employer-Sponsored Plans: The Shift from Defined Benefit to Defined Contribution, *in* The Oxford Handbook of Pensions and Retirement Income 359, 362–63 (Gordon L. Clark et al. eds., 2006) [hereinafter Oxford Handbook] ("[A]fter the Second World War business and labor had to re-create . . . the [employer-sponsored] pension system."); Steven Sass, The Development of Employer Retirement Income Plans: From the Nineteenth Century to 1980, *in* Oxford Handbook, supra, at 76, 78, 83 ("The alternative postwar approach to the old-age income problem, adopted by Anglo-Saxon nations such as the United States . . . relied on an expansion of employer plans.").

50. See I.R.C. § 411(a)(2)(A), (b)(1) (2006) (setting forth minimum vesting requirements for defined benefit plans); Employee Retirement Income and Security Act of 1974 § 203, 29 U.S.C. § 1053 (2006) (same); id. §§ 301–308 (providing for minimum funding standards); Edward A. Zelinsky, The Defined Contribution Paradigm, 114 Yale L.J. 451, 475–78 (2004) (summarizing impact of ERISA on defined benefit plans).

51. See Eric D. Chason, Outlawing Pension-Funding Shortfalls, 26 Va. Tax Rev. 519, 536–43 (2007) (reviewing ERISA funding requirements).

tion of funds that would be invested in the capital markets. From 1980 to 1990, pension fund assets increased from $871 billion to $3.02 trillion.[52]

The impact of this increase on retirement fund assets appears clearly through comparison with, for example, the typical unfunded German pension funds, whose commitment to make retirement payments is simply a promise not backed by dedicated assets.[53] In effect, an unfunded pension fund is fully invested in the company's unsecured debt.[54] Although plainly unintentional, the U.S. requirement—that a pension promise must be supported by assets held in trust rather than by a book entry on a corporate balance sheet—both generated and concentrated very large amounts of funds that would be invested in the capital markets by a class of fiduciaries on behalf of future retirees.[55]

The shift away from defined benefit retirement plans to defined contribution plans also expanded the role of intermediaries at the center

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52. Tonello & Rabimov, supra note 38, at 25 tbl.12.

53. See, e.g., Bert Rürup, The German Pension System: Status Quo and Reform Options, *in* Social Security Pension Reform in Europe 137, 138–43 (Martin Feldstein & Horst Siebert eds., 2002) (describing German pension funding).

54. The European Union is currently considering a proposal that would require balance sheet disclosure of unfunded liabilities of employer liabilities under defined benefit pension plans. See Paul J. Davies, Fears Grow of £600bn Company Pension Bill, Fin. Times (London), Jan. 2, 2012, http://www.ft.com/cms/s/0/9d9fc7b0-3302-11e1-a51e-00144feabdc0.html (on file with the *Columbia Law Review*) ("UK companies will have to pump as much as £600bn ($930bn) into their corporate pension schemes under a revamp of pensions regulation being considered in Europe . . . ."); see also European Ins. & Occupational Pensions Auth., Response to Call for Advice on the Review of Directive 2003/41/EC: Second Consultation 74–85 (Oct. 25, 2011), available at https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP06-11/CfA-1-23-draft_advice_for_consultation_EIOPA-CP-11-006_.doc (on file with the *Columbia Law Review*) (considering "holistic balance sheet" approach "to record and measure on a consistent basis the obligations and resources" of pension funds).

U.S. accounting rules have required such balance sheet disclosure since 1985, another factor that burdened the use of defined benefit plans. See Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 87: Employers' Accounting for Pensions para. 35, at 15 (1985), available at http://www.amac.org.mx/pags/pdf/fas87.pdf (on file with the *Columbia Law Review*) (requiring "unfunded accrued pension cost" to be recognized as liability "if net periodic pension cost recognized pursuant to this Statement exceeds amounts the employer has contributed to the plan"); see also Robert M. Harper, Jr. & Jerry R. Strawser, The Effect of SFAS 87 on Corporate Funding of Defined Benefit Pension Plans, 20 J. Bus. Fin. & Acct. 815, 815–16 (1993) (discussing requirements under Statement of Financial Accounting Standards No. 87).

55. This concentration of votes had an important role in hostile takeover fights. The fiduciary obligations of pension fund trustees under ERISA require trustees to vote on the shares of the employer held by the plan solely in the interests of the beneficiaries, which do not include the interests of future employees in the target company. The result is to force the trustees, typically appointed by the target employer, to consider only the price offered in making a decision whether to tender. See Armin G. Brecher, Simon Lazarus III & William A. Gray, The Function of Employee Retirement Plans as an Impediment to Takeovers, 38 Bus. Law. 503 (1983) (surveying voting obligations of plan trustees in takeovers); Susan J. Stabile, Pension Plan Investments in Employer Securities: More Is Not Always Better, 15 Yale J. on Reg. 61, 93–97 (1998) (same).

of an agency capitalism regime. Again, the motivation for the switch was past service costs. The annual amount that an employer has to deposit in a defined benefit plan depends importantly on the investment return the fund can be expected to earn. A higher-assumed return results in smaller current payments. A defined benefit plan commits the company to providing employees with a specified retirement payment, typically a percentage of their salary measured over a specified period, multiplied by the employee's years of employment with the plan sponsor.[56] This arrangement places all of the investment risk on the company; if overly optimistic predicted investment returns prove too high, so that the fund has too few assets to make expected retirement payments, the company, if solvent, must make up the shortfall. Consistent with that allocation of risk, the trustees of the pension funds, who are appointed by the company, control the fund's investment decisions.

A defined contribution plan, on the other hand, shifts the investment risk from the retirement fund sponsor to the employee. This prevents the employer from getting in trouble as a result of the unfortunate alignment of incentives that favor optimistic predictions of investment returns and a lower current payment to the pension fund (and therefore increased reported earnings). Under a defined contribution plan, the sponsor makes a specified annual contribution to the employee's account, which the employee then decides how to invest. The savings available on the employee's retirement then depend entirely on the success of the employee's investment decisions, with the result that employers (and their balance sheets) do not bear the liability for future investment performance.[57] Most commonly, the employee is given a choice of investment options determined by the pension plan. Increasingly, these choices are largely mutual funds, reflecting the employees' need for investment management advice.[58]

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56. See, e.g., Gordon, New Economic Order, supra note 46, at 1541–42 (explaining operation of defined benefit plan); Zelinsky, supra note 50, at 455–56 (same).

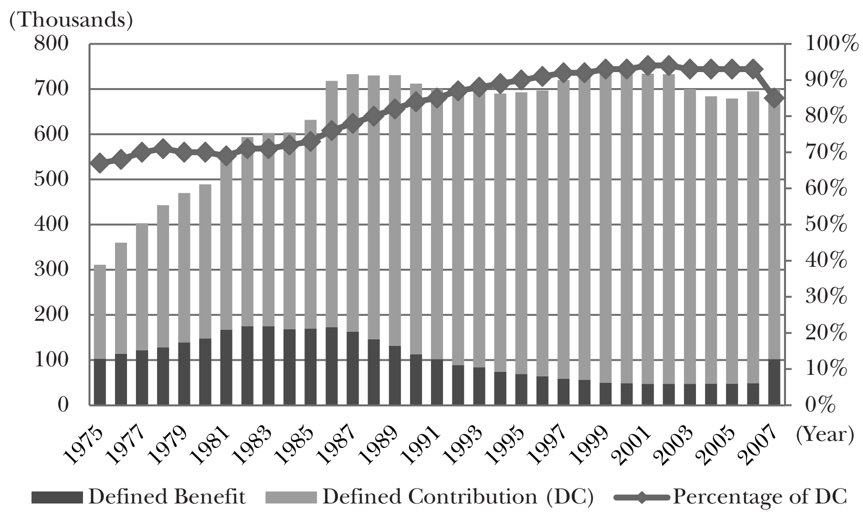
57. Edward Zelinsky describes how the shift from a defined benefit to a defined contribution plan transfers to the employee the risks that investments will earn too little to support retirement, that contributions to the plan actually will be made, and that the employee will outlive his income. Zelinsky, supra note 50, at 458–68.

It was an odd policy choice to shift the investment risk from the employer, who presumably was a more sophisticated investor (or had access to sophisticated investment advice) and could secure economies of scale in managing that risk, to employees who could be expected neither to be sophisticated themselves nor to have access to the same quality of advice as would the employer. This shift has also been lamented on distributional grounds. See Gordon, New Economic Order, supra note 46, at 1546. Defined benefit plan payouts were geared to an employee's final wage, which would be increasing with the firm's success and the employee's experience. Defined contribution plan payouts are less sensitive to final wages and are reduced by employees' investment conservatism.

58. Various factors push employers to move from a defined benefit to a defined contribution plan. See Zelinsky, supra note 50, at 475 (summarizing these factors); see also Gelter, supra note 46, at 16–20 (explaining reasons for this shift).

The result has been a significant shift from defined benefit pension plans to defined contribution pension plans. In 1990, defined contribution plans and Individual Retirement Accounts (IRAs) totaled $1.5 trillion, and private defined benefit plans approximately $1.6 trillion. Almost all of the subsequent growth in retirement assets took place in defined contribution plans and IRAs ($9.2 trillion in total by 2010), rather than in private defined benefit plans ($2.2 trillion by 2010).[59] Figure 2 shows the change in the number of defined benefit and defined contribution plans (as opposed to assets held) over the period from 1975 through 2007. Figure 3 shows the change in the number of participants in each kind of plan. While the number of defined benefit plan participants has remained flat, the number of defined contribution plan participants has steadily risen over the same period.

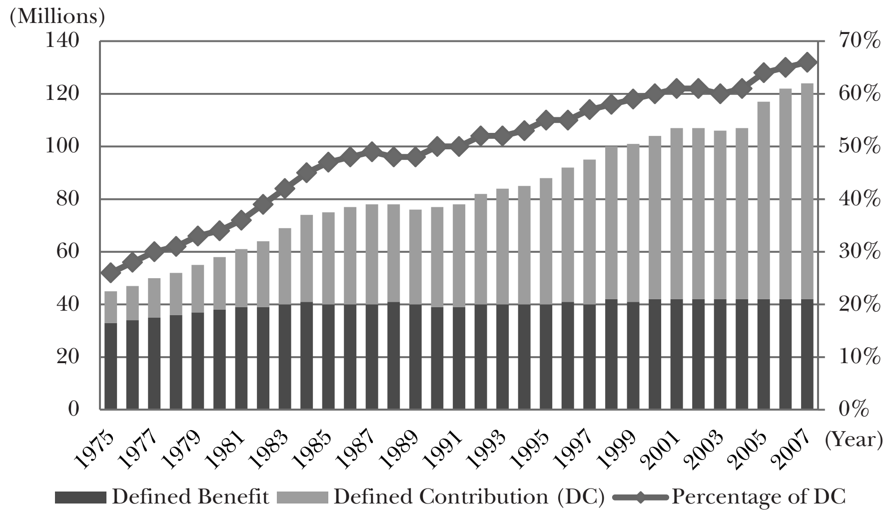
FIGURE 2: NUMBER OF PRIVATE-SECTOR QUALIFIED DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS, 1975–2007[60]



59. Inv. Co. Inst., 2011 Investment Company Fact Book 101 fig.7.2, 102 (2011), available at http://www.ici.org/pdf/2011_factbook.pdf (on file with the *Columbia Law Review*); Tonello & Rabimov, supra note 38, at 25 tbl.12; Gelter, supra note 46, at 13 fig.3. This shift from defined benefit to defined contribution pension plans is also gaining strength in the United Kingdom. See Norma Cohen, Final-Salary Pensions Being Closed Rapidly, Fin. Times (London), Dec. 15, 2011, http://www.ft.com/intl/cms/s/0/a35042ae-2667-11e1-85fb-00144feabdc0.html (on file with the *Columbia Law Review*).

60. Emp. Benefit Research Inst., EBRI Databook on Employee Benefits ch. 10 tbls.10.2a & 10.2b (2011), available at http://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2010.pdf (on file with the *Columbia Law Review*).

FIGURE 3: NUMBER OF PRIVATE-SECTOR QUALIFIED DEFINED BENEFIT AND DEFINED CONTRIBUTION PARTICIPANTS, 1975–2007[61]



For our purposes, this increase and concentration of financial power had two important consequences. First, it created a source of funds that could be deployed to fund large investments and still allow investors to retain a diversified portfolio.[62] For example, mutual funds in 2011 held approximately 49.8% ($4.68 trillion) of defined contribution plans and

61. Id.

62. This growth was facilitated by a final regulation issued in 1979 by the Department of Labor, the government agency charged with overseeing pension fund investments, which stated that the suitability of a particular investment would be judged not in isolation, but as a part of the pension fund's entire portfolio. 29 C.F.R. § 2550.404a-l(b)(2) (2012) (requiring fiduciary of employee benefit plan to give "appropriate consideration" to "[t]he composition of the portfolio with regard to diversification" in discharging fiduciary duties). The official commentary accompanying the regulation effectively endorsed the portfolio approach:

> The Department is of the opinion that (1) generally, the relative riskiness of a specific investment or investment course of action does not render such investment or investment course of action either *per se* prudent or *per se* imprudent, and (2) the prudence of an investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays within the overall plan portfolio.

Rules and Regulations for Fiduciary Responsibility; Investment of Plan Assets Under the "Prudence" Rule, 44 Fed. Reg. 37,221, 37,222 (June 26, 1979).

Since prudence would be determined at the portfolio level, pension funds could make individually risky investments, like limited partnership interests in private equity funds involved in leveraged takeovers. For general background on the new investment standard, see Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52 (1987).

IRA assets,[63] of which approximately 40.8% ($1.91 trillion) were invested in U.S. equities.[64] Second, decisionmaking over these concentrated funds was centralized in a small number of individuals and institutions that were obligated to consider only the best interests of the future retirees. Again, to use mutual funds as an example, the five largest U.S. mutual fund groups in 2005 controlled approximately 37% of total assets invested in mutual funds, the largest ten controlled approximately 48%, and the largest twenty-five controlled approximately 71%.[65]

B. *The Triumph of Portfolio Theory*

The past thirty-five years have seen a sharp increase in U.S. household ownership of equities, but equity mutual funds have been the vehicle. As of 1977, approximately 20% of households owned equities directly. While the percentage of direct owners has remained stable, the rise in mutual fund investment has increased the percentage of households that own equities directly or through mutual funds by 30% to a total of 50%.[66] The increase in household mutual fund ownership has been significantly advanced by the portfolio theory of diversified investing. To be sure, a large fraction of mutual fund owners have come to this form of investment through employer-sponsored defined contribution accounts (in 2011, 32% of all households owned funds only through an employer-sponsored retirement plan), but a significant fraction owned mutual funds even without that connection (31% of mutual fund holders, or 13% of all households, owned funds only outside an employer-sponsored mutual fund plan).[67] Moreover, a

63. Inv. Co. Inst., 2012 Investment Company Fact Book 110 fig.7.5, 117 fig.7.12, 125 fig.7.21 (2012) [hereinafter ICI, 2012 Fact Book], available at http://www.ici.org/pdf/2012_factbook.pdf (on file with the *Columbia Law Review*).

64. Id. at 125 fig.7.21.

65. Inv. Co. Inst., Research Commentary: Competition in the Mutual Fund Business 2 fig.2 (2006), available at http://www.ici.org/pdf/rc_competition.pdf (on file with the *Columbia Law Review*).

66. Gerald F. Davis, A New Finance Capitalism? Mutual Funds and Ownership Re-concentration in the United States, 5 Eur. Mgmt. Rev. 11, 15–16 (2008) (covering 1977–2004 period). Current evidence from the Federal Reserve Board's Survey of Consumer Finances is consistent with this trend. As of the 2010 Survey, approximately 15% of all families directly held stock; 9% directly held "pooled investment vehicles"; and 6% directly held "other managed assets." Jesse Bricker et al., Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances, 98 Fed. Res. Bull., June 2012, at 1, 28 tbl.6, 34–35, available at http://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf (on file with the *Columbia Law Review*). Yet the percentage of families with direct or indirect ownership of stock were approximately 50%, with indirect ownership primarily through tax-deferred retirement accounts, which heavily use mutual funds. Id. at 41. Of the total *number* of household equity holdings, only 32% were through direct stock ownership. The remainder took various collectively managed forms: 20% directly through pooled investment vehicles, 6% through other managed vehicles, and 42% in tax-deferred retirement accounts. Id. at 42.

67. ICI, 2012 Fact Book, supra note 63, at 91.

significant number of mutual fund holders (37%) hold mutual funds both inside an employer account and outside.[68]

What led to this investment pattern? For greater equity investment, one important factor was the relative attractiveness of equity returns compared to returns on bank accounts, especially given the fixed interest rates that prevailed in the 1980s.[69] But why did additional equity investment come through mutual fund investment during the period? Although mutual fund transaction fees declined, as reflected in the rise of no-load funds, so did the transaction costs of direct stock ownership with the end of fixed commissions in 1975.[70] A recent cross-country study of eight advanced economies observes a trend of "shifting stock ownership shares from households to financial institutions" and attributes this change to tax policies that favor such investing, for example, tax-favored retirement accounts.[71] In the United States, tax-favored treatment of defined contribution plans has surely led to such indirect ownership. Households' investment through 401(k) accounts, for example, is channeled into investment intermediaries. Yet as noted above, many investors own mutual funds outside of choice-constrained accounts.[72] Indeed, individual mutual fund ownership is commonly less tax-efficient than direct equity investing. Mutual funds are "flow-through" vehicles for tax purposes, and individuals are required to pay tax on net gains realized by the fund even when the fund is selling stock to meet others' redemption requests.[73]

A capital market innovation supplies the link: the application of Markowitz's Nobel Prize-winning theory on the efficiency of mean-variance investing, which gives rise to the portfolio theory.[74] The lessons were (i) diversification improves risk-adjusted returns; (ii) the broader the portfolio, the greater the diversification; and (iii) since secondary markets in seasoned equities are highly efficient, research that adds value is expensive and its fixed cost is best spread across large portfolios. All of this argues for investing through investment intermediaries that can

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68. Id.

69. See, e.g., Davis, supra note 66, at 15 ("[B]ank savings accounts lost their allure as the government-mandated cap on interest rates failed to keep pace with inflation.").

70. See 17 C.F.R. § 240.19b-3 (1975) (prohibiting national securities exchanges and their members from "charg[ing] . . . any fixed rate of commission for transactions effected on . . . such exchange").

71. Kristian Rydqvist, Joshua Spizman & Ilya Strebulaev, The Evolution of Aggregate Stock Ownership 2, 36–37 (Ctr. for Fin. Studies, Working Paper No. 18, 2011), available at http://www.econstor.eu/dspace/bitstream/10419/57351/1/66759728X.pdf (on file with the *Columbia Law Review*).

72. See supra text accompanying notes 67–68.

73. See Mark J. Roe, Political Elements in the Creation of a Mutual Fund Industry, 139 U. Pa. L. Rev. 1469, 1478–83 (1991) [hereinafter Roe, Political Elements] (surveying regulation and taxation of mutual funds).

74. Harry M. Markowitz, Portfolio Selection: Efficient Diversification of Investments 3 (1959); Harry Markowitz, Portfolio Selection, 7 J. Fin. 77, 77 (1952).

assemble diversified portfolios as the low-cost way to follow this strategy. Index investing is the limit,[75] but the debate over whether households should exclusively invest through such lowest-cost vehicles may obscure the major change, which is that households increasingly invest through diversification-providing intermediaries, mutual funds.

C. *The Reconcentration of Ownership*

The peculiar position of institutional investors in the reconcentration of ownership of U.S. public corporations can be seen most easily from the governance role played by mutual funds, both because of their size and homogeneity, and because of the extensive information that is available concerning their governance activities. Three characteristics are most telling: one with respect to power, one with respect to reticence, and one with respect to responsiveness. First, mutual funds are potentially powerful: They hold a large percentage of U.S. equities. Over recent years, mutual funds held approximately 25% of the outstanding stock of publicly traded U.S. corporations.[76] Given the concentration in the mutual fund industry,[77] twenty-five mutual fund families hold the voting rights for some 18.75% of outstanding U.S. equities.[78] Thus, by any measure, mutual funds have the power to be a significant force in the governance of large U.S. corporations.[79]

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75. See John H. Langbein & Richard A. Posner, Market Funds and Trust Investment Law, 1976 Am. B. Found. Res. J. 1, 1 (defining index investing as "creat[ing] and hold[ing] essentially unchanged a portfolio of securities that is designed to approximate some index of market performance such as the Standard & Poor's 500").

76. ICI, 2012 Fact Book, supra note 63, at 12 fig.1.5, 102.

77. See supra note 63 and accompanying text (explaining concentration in mutual fund industry).

78. The calculation is based on the following two facts. In 2011, the largest twenty-five mutual fund families represented 73% of mutual fund assets under management. ICI, 2012 Fact Book, supra note 63, at 25. In total, mutual funds held approximately 25% of U.S. domestic equities. ICI, 2012 Fact Book, supra note 63, at 12 fig.1.5.

79. In fact, it is likely that the discussion in the text quite significantly understates the voting power of the firms that advise mutual funds. The figures in the text reflect only the holdings of retail mutual funds, likely because the most available source of data on mutual fund holdings comes from the Investment Company Institute, whose data is limited to advisors registered as investment companies under the Investment Company Act of 1940. At the same time, the advisors to mutual funds also manage separate accounts for other institutional investors, like pension funds. These represent a very large concentration of assets. For example, of the $3.673 trillion assets under management by BlackRock, the largest asset manager in the United States, $1.045 trillion is in retail mutual funds and $1.483 trillion is in separate accounts managed for institutional investors. If overall mutual fund advisors manage in separate accounts as many assets as they do for mutual funds, and if the allocation to domestic equities is the same for separate accounts as it is for mutual funds, then the advisors control the voting of roughly twice the percentage of shares shown in the text. The breakdown of the character of BlackRock's assets under management comes from self-reported data provided by BlackRock to eVestment. (The figures here are calculated by the authors based on proprietary data of eVestment.) eVestment, EVestment Report on Funds Under Management by Category 2011 (on file

Second, mutual funds are at least on the surface anything but proactive. For example, during the 2009 proxy season, the proxy statements of Russell 3000 corporations contained 20,434 proposals to be voted upon by shareholders.[80] Of these, shareholders proposed 646 (3.2% of all proposals); the remainder were proposed by management.[81] In turn, during the 2007 to 2009 proxy seasons, mutual funds proposed only eighty-four (4.5% of all shareholder proposals).[82] The last step in this analysis is the character of the proposals mutual funds did make: Sixty-seven (80% of all mutual fund proposals over the same period) concerned social and environmental issues,[83] presumably proposed by so-called socially responsible funds. Thus, over the 2007 through 2009 proxy seasons, mutual funds offered only seventeen (0.9%) shareholder proposals addressed to corporate governance or performance issues.[84] To be sure, mutual funds may be proactive in less visible ways, quietly persuading portfolio companies to take desired actions with the threat of making a shareholder proposal in the background; however, given the limited voluntary action by companies on such matters as requiring a shareholder vote to adopt a poison pill, the magnitude of that effort at least strongly suggests that mutual funds are reluctant to undertake proactive engagement, whether openly or behind the scenes.

Third, while mutual funds are not proactive, they are not passive in the Berle-Means sense: They very frequently oppose management on core corporate governance issues. The most extreme example concerns voting on antitakeover matters—poison pills and staggered boards—and illustrates the extent to which mutual funds vote against management recommendations when the issue is presented to them. Over the 2004 and 2005 proxy seasons, mutual funds voted in favor of shareholder proposals to require shareholder approval before adopting a poison pill almost 80% of the time, and in favor of proposals to declassify the board of directors 90% of the time.[85] The same results appear for the 2003 through 2008 period: Mutual fund voting in favor of shareholder proposals to declassify the board reached 87.4%,[86] and with respect to

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with authors); see also eVestment, https://www.evestment.com/about/company (on file with the *Columbia Law Review*) (last visited Apr. 23, 2013) (providing data and analytical tools to institutional investors).

80. Inv. Co. Inst., Trends in Proxy Voting by Registered Investment Companies 2007–2009, 16 Res. Persp., Nov. 2010, at 4 fig.1 [hereinafter ICI, Trends in Proxy Voting], available at http://www.ici.org/pdf/per16-01.pdf (on file with the *Columbia Law Review*).

81. Id.

82. Id. at 8 fig.6.

83. Id.

84. Id.

85. Morgan et al., supra note 45, at 920 tbl.2.

86. Cotter, Palmiter & Thomas, supra note 45, at 38.

shareholder proposals to require shareholder approval for a poison pill, 68.4%.[87]

D. *The Puzzle of What to Do with Institutional Investors*

The reconcentration of ownership of U.S. equities in intermediary institutions has resulted in conflicting views of the corresponding governance structure. On the one hand, concentration of ownership holds out the possibility that the institutions will, like Pinocchio, come to act like real boys—like "real" owners (or "stewards" in the more polite vocabulary)[88] and actively supervise the performance of professional management. This view is reflected in current discussions in, for example, the European Union, the United Kingdom, and Israel[89] concerning how institutions can, and might be made to, play a more proactive role in corporate governance. On the other hand, institutions have continually failed to play this role; despite the urging of academics and regulators, they remain stubbornly responsive but not proactive.[90] Capital market evolution thus has concentrated governance rights in fewer hands, which despite continual urging, conversely appear to have little interest in playing or capacity to play an active stewardship role in portfolio company governance. The next Part considers how the combination of agency capitalism and the complementary limitations of intermediary competence and incentives results in an undervaluation of governance rights.

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87. Id. at 44 tbl.5A. The percentage given in the text is the weighted average of the mutual fund voting in favor of proposals supported by ISS (89.5%, 21,699 proposals) and those not supported (21.9%, 9,870 proposals). To look at another measure: "Withhold votes" for management's director nominees have somewhat increased over the 2007 to 2009 period because of concerns about executive compensation, although the overall level of support (approximately 90%) is still high. See ICI, Trends in Proxy Voting, supra note 80, at 11–12 fig.8, 14.

88. See supra note 7 and accompanying text (discussing "stewardship" proposal in United Kingdom).

89. See supra notes 7–9 and accompanying text (discussing U.K., E.U., and Israeli proposals).

90. For example, some twenty-two years ago, institutions were urged to help nominate a minority of directors who were both independent of management and dependent on shareholders. See Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863, 881–85 (1991) (arguing current proposals on improving governance were limited because "they merely make outside directors independent of management, rather than *dependent* on shareholders," and proposing creation of new position of "professional outside director" which would satisfy both criteria). The proposal still attracts comment but not action. See Ronald J. Gilson & Reinier Kraakman, The Directors Guild, N.Y. Times, June 8, 2009, at A19 (advocating proposal of "independent professional directors" after U.S. Treasury bailed out private corporations).

III. Why Institutional Ownership Will Undervalue the Vote and Create New Agency Costs

As our analysis thus far has shown, the mechanisms of risk transfer and the resulting change in the distribution of ownership are driven by the evolution of capital markets or political economy factors like pension reform. The need to develop complementary corporate governance innovation follows. In the United States, institutional investors collectively have become the majority owners of most large public firms.[91] This is because of two sets of factors: public and private decisions over how best to mobilize and protect retirement savings,[92] and private decisions in favor of a particular organizational form for investors to achieve diversified wealth management.[93]

In theory such institutional ownership should mitigate the managerial agency cost problems of the Berle-Means corporation. Fewer owners, larger positions, more sophistication—the combination should reduce coordination costs and spontaneously generate more active monitoring. Reality has fallen short, however, as demonstrated by Part II's account of institutions' peculiar form of passivity. Mutual funds and other for-profit investment managers are almost uniformly reticent—very rarely proactive but responsive to others' proposals.[94] Public funds are more likely to be proactive but largely limited to governance matters rather than firm strategy or implementation.[95] At most, institutions might engage in "governance activism," not "performance activism."

One way to frame the question then is to ask why institutions place so little value on the vote that, despite their collective majority holdings, they largely choose to be responsive to the initiatives of others. More engaged firm-specific voting could reduce managerial slack at specific firms; perhaps, more grandly, it could improve performance across an entire portfolio and, in theory, enhance social welfare by improving resource allocation throughout the economy.

What accounts for the missed gains that would come with the full exercise of governance rights? The answer, we think, stems from the agency costs of agency capitalism, rooted in the institutions' desire to deliver competitively superior performance for their beneficiaries (pension funds) or shareholders (mutual funds) while minimizing costs. This competitive pressure will lead institutions to focus externally and

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91. See supra Table 1 (showing institutional ownership of largest U.S. corporations in 2009, ranging from 63.7% of top fifty corporations to 73% of top thousand).

92. See supra Part II.A.

93. See supra Part II.B.

94. See supra Part II.C–D.

95. See Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1057–62 (2007) (explaining how relatively low pay and incentives, political constraints, and conflicts of interest inhibit public funds from pursuing aggressive activist strategies).

internally on relative performance. Such performance metrics do not readily accommodate much shareholder activism, especially performance activism, even though it would be in the beneficiaries' (shareholders') interest for the institutions to pursue value generation in this way.

Take first the case of mutual funds (including separate accounts managed by mutual fund advisors)[96] and other private wealth managers. Fundamental analysis, which identifies poor governance that affects performance or a poor business strategy, has a dual use: It could be used as the premise for a shareholder intervention to improve the situation or to provide a trading opportunity. A successful intervention will produce benefits enjoyed by all shareholders, including the mutual fund's competitors. But a shared gain, unlike the private gain of a successful trade, provides little competitive advantage to the proactive investment manager whose portfolio products and services are chosen in comparison to competitors offering similar products or services. In an environment in which fund managers are evaluated in relative terms, absolute performance will play a secondary role.[97] Investment managers thus have little private incentive to address proactively strategy and performance problems at portfolio companies and *therefore do not develop the expertise to engage in that activity, even if such activity would benefit their beneficiaries*.[98] This gap between the beneficiaries' and the fund's interests represents a particular kind of agency cost that is of special concern because it interacts with the more familiar species of agency cost: This agency cost locks in managerial slack at the portfolio companies. Together these are the "agency costs of agency capitalism."[99]

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96. See supra notes 76–79 and accompanying text (discussing share ownership of mutual funds).

97. Absolute performance is not irrelevant, of course, since flows in and out of all funds are affected by general stock market trends, as demonstrated by large outflows from equity funds in the post-fall 2008 period. An individual fund has little influence over such secular trends. See infra note 108 and accompanying text (observing high correlation of stock price volatility following financial crisis).

98. Investment companies are further constrained by the limit on the number of shares they can hold in a portfolio company. For example, pass-through taxation is available to mutual funds only if they do not hold more than 10% of the voting securities of a portfolio company. See Investment Company Act of 1940 § 5(b)(1), 15 U.S.C. § 80a-5b(1) (2006) (providing requirements for "diversified management company"); see also I.R.C. § 851(b)(3)(A)(ii) (2006) (defining regulated investment companies); id. § 11(c)(3) (exempting regulated investment companies from taxation on corporate income). In this respect, it is important to note that this restriction applies to individual mutual funds, rather than to entire fund families like Fidelity or Vanguard. From this point, however, things get complicated (or, perhaps, interesting). The Investment Company Act of 1940 does not recognize the existence of fund families, so the board of directors of a mutual fund owes duties only to the shareholders of a particular fund, undiluted by the interests of other funds within the fund family. This disconnect between the law and the organization of the industry has gone largely unexamined.

99. Cf. Isaksson & Celik, supra note 35, at 31 ("[A] great majority of intermediary investors actually lack the incentives to exercise their ownership functions."); Kay, The Kay Review, supra note 7, at 42 ("In the current market environment both analysis and

Take next the case of pension funds. Pension funds do not have to compete for funds because their beneficiaries are locked in—California public employees cannot opt out of CalPERS. Yet assuming these funds are acting in good faith, pension fund beneficiaries will be in roughly the same position as mutual fund shareholders. The pension fund trustees will be looking for internal or external portfolio managers who deliver superior relative returns at the lowest cost.[100] And these agents will face the same strong disincentives to make governance investments that will not redound to their competitive advantage. In effect, the good-faith monitoring by investment intermediaries of the relative performance of their portfolio managers reinforces the agency costs of agency capitalism.

We can now turn to our central claim: The agency costs of agency capitalism will result in the chronic undervaluation of governance rights. Effective use of governance rights requires firm-specific investigation and firm-specific activism, both of which are costly and will be undersupplied by institutional investors.

First, the logic of diversification cuts against governance activity. No single stock accounts (or, in the case of a mutual fund, can account) for a significant portion of either the fund's portfolio or the outstanding stock of the portfolio company,[101] so even highly successful interventions (say a 10% stock price improvement) will have so small an effect on portfolio returns that the opportunity cost of the capital expended might

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engagement have something of the character of public goods—most of the benefits accrue to people who do not undertake them."). Both reports note the tension between beneficiaries' and institutions' interests, but neither addresses the role of activist investors. Cf. Leo E. Strine, Jr., One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?, 66 Bus. Law. 1, 8–12 (2010) (noting "separation of ownership from ownership" but focusing on share turnover rate and skeptical of role of activist hedge funds).

100. A recent study of U.K. pension funds finds that "the vast majority" delegate investment management in a manner that will "predispose pension funds to give primary emphasis to fund investment performance rather than an engaged approach to ownership." Anna Tilba & Terry McNulty, Engaged Versus Disengaged Ownership: The Case of Pension Funds in the UK, 21 Corp. Governance: Int'l Rev. 165, 166 (2013). In general pension funds have increasingly moved to a decentralized model, in which specialist managers are hired to pursue specific investment strategies. See David Blake et al., Decentralized Management: Evidence from the Pension Fund Industry, J. Fin. (forthcoming 2013) (manuscript at 9–11), available at http://dx.doi.org/10.1111/jofi.12024 (on file with the *Columbia Law Review*) (providing empirical evidence).

101. See supra note 98 (noting 10% limit on percentage of shares mutual funds can hold in portfolio company). For a description of mutual fund diversification/anti-concentration rules, enforced through both the 1940 Investment Company Act and contemporaneous tax legislation, see Roe, Political Elements, supra note 73. Roe argues that these requirements arose from characteristic efforts throughout U.S. history to limit the potential power of financial intermediaries. See id. at 1470–71. More recently, John Morley argues that mutual funds lobbied for these restrictions to "brand" themselves as passive, low-risk investors. John Morley, Collective Branding and the Origins of Investment Management Regulation, 6 Va. L. & Bus. Rev. 341, 345 (2012).

well exceed the gains.[102] This "no (or negative) effect" relative performance problem is particularly evident in the maximally diversified portfolio of the index investor, but it will be an inhibitory factor for all diversified investors. Additionally, the success of governance intervention is probabilistic, both in terms of whether the objective is attained (e.g., board turnover or the sale of a division) and whether the performance effect will be positive. Yet the costs incurred will, with certainty, reduce the fund's returns. A benefit-cost calculation typically will point to de minimis governance expenditures by the diversified intermediary institution.[103] Further, even if the intervention is successful and cost-justified, it still may degrade *relative* performance. Start with an index fund. The gains will be enjoyed by all other index investors, except that the activist fund will have incurred costs that lower its net relative performance. Next take an actively managed fund. In order to benefit relatively, it must overweight a company it has identified as poorly managed. If it succeeds, it will earn some positive returns (net of costs) that may give it some edge relative to *some* of its competitors (especially those who underweighted the stock), but diversification limits the relative gains. On the other hand, if the initiative fails, it may be facing losses on its overweight holdings in a company it has credibly identified as poorly managed. These losses come on top of the costs for the campaign—not a very promising calculus. This begins to sound like a brief for the Wall Street Rule: If the issuer is badly run, sell the stock and fire the portfolio manager.[104]

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102. As an example of the impact of these diversification/anticoncentration rules, imagine a governance intervention that increases the value of the portfolio company. The fund's ability to benefit is limited both in the percentage of the company it may own (less than 10%) and the fraction that this investment may represent of the fund's total portfolio. Assume a major position by the fund, 3% of total assets, that represents a 5% ownership interest in the portfolio company, and an intervention that results in a 10% gain in the portfolio company's stock price. The gain in the fund's assets will be 0.3% (a 10% increase in a 3% position); 95% of the benefit from the fund's actions goes to others, yet the fund may pay 100% of the costs, which will reduce its 0.3% gain. In such circumstances, the fund may be better off (meaning, will be more likely to increase assets under management and thus fees) by spending the cost of the governance intervention on marketing. In some cases, governance intervention may serve as marketing. See BlackRock, Corporate Governance and Responsible Investment at BlackRock: Annual Review 2011 (2011), available at http://www2.blackrock.com/content/groups/global/documents/literature/1111157291.pdf (on file with the *Columbia Law Review*) (detailing governance practices and policies in investment management company's marketing material).

103. On the cost constraints and other disincentives to institutional investor activism, see Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 595–608 (1990) (providing classic account of "institutional money manager incentives and conflicts of interest" and "evidence on how these conflicts alter patterns of voting and activism"); Kahan & Rock, supra note 95, at 1047–70 (discussing incentives to monitor and conflicts of interest of mutual funds, hedge funds, and public pension funds).

104. Robert Pozen, then a senior executive at Fidelity, made this point twenty years ago at a conference attended by the authors, whose focus was on encouraging institutional

Second, the institution's internal mechanisms for monitoring portfolio performance, based on benchmarking or performance relative to peers, cut against activist exercise of governance rights. Keep in mind that this is not the result of institutions' misunderstanding as to what investors actually want. For-profit institutions like mutual funds have learned that investors follow relative performance and direct assets accordingly. Pension funds also follow relative performance in selecting and monitoring portfolio managers, whether in-house or external. Such relative performance evaluation falls out of contemporary portfolio theory.[105] Factors that ramify market wide—for example, the recent financial crisis, to pick an extreme example of a general phenomenon—affect a portfolio "systematically." Such risks are not readily diversifiable, if at all. Therefore, the performance question is comparative: Given the state of the economy, how does this portfolio compare to "unmanaged" portfolios in the same "space"? A portfolio manager can outperform by omitting or underweighting (relative to market capitalization) a stock from his or her otherwise diversified portfolio.

This has implications for shareholder activism. The process by which the portfolio manager acquires and uses information is not focused on identifying opportunities when the activist exercise of governance rights can improve company strategy. The portfolio manager's mission is to determine how the current stock price matches his or her best estimate of the future stock price; that judgment determines a decision to buy, sell, or hold. Information comes in continuously; the comparative evaluation occurs continuously. A diagnostic thought process—what sort of shareholder intervention would improve performance—is simply a different inquiry. Next, assume that the portfolio manager decides that a portfolio company is underperforming. The most assured way to grab the value of that insight is selling the stock rather than incurring the costs and speculative future benefits of a shareholder intervention. That is, the fact of poor governance or poor management at a portfolio company may be an element in comparative evaluation, but the indicated action for the institution—but not its beneficiaries—may be to "sell," not to "intervene."

Third, the institutions' compensation structures have a complicated relationship to any form of shareholder activism. For mutual funds, the

investor governance action. If Fidelity found itself invested in a company that was badly managed, Pozen said, the portfolio manager had made a mistake. For Fidelity, the key was not to make the mistake in the first place. See Michael T. Jacobs, Break the Wall Street Rule: Outperform the Stock Market by Investing as an Owner 12 (1993) (describing "the Wall Street Rule" as "the common practice of selling your shares when you are dissatisfied with the performance of a company").

105. For a recent effort to incorporate the impact of fund flows as a result of relative performance on portfolio strategy, see Dimitri Vayanos & Paul Woolley, An Institutional Theory of Momentum and Reversal 2 (Aug. 2, 2010) (unpublished manuscript), available at http://ssrn.com/abstract=1305671 (on file with the *Columbia Law Review*).

Investment Advisers Act of 1940 sharply limits the compensation that a fund's shareholders can pay—that is, the incentive structure of the fees that Fidelity mutual funds pay to Fidelity.[106] It would be very difficult to reward a fund with an incentive-based fee tied directly or indirectly to the returns from a particular kind of investment management activity. On the other hand, superior relative performance is the major driver of a fund's profitability. Superior performance draws new assets that can be charged a fixed fee (no incentives), yet the fund's largely fixed investment costs mean that the fund's profits sharply increase with fund size.[107] As a result, there is no special incentive for activism, meaning that no reason exists to devote internal resources to the activist use of governance rights as opposed to pursuing other ways that might improve portfolio performance. But there would be a powerful incentive to engage in activism if it delivered returns that would improve the relative performance of the fund. The dearth of this activity suggests that while potential gains from activism may exist—there is ample evidence of managerial slack—the institutional investor's business model makes it an unlikely candidate to pursue those gains.

Fourth, evaluation alternatives to benchmarking, based on "absolute" returns, may push portfolio managers even further away from the granular evaluation that maps onto firm-specific activism. This style of investment focuses on asset allocation and regards equities as merely one among many asset classes that a portfolio manager can draw from; it invites macro- rather than microanalysis. In environments of high macroeconomic uncertainty, this strategy may contribute to high correlation among stock price movements. The observed high correlations of the post-financial crisis period[108] thus undercut the business case for institutional activism. If firm-specific performance is submerged in general market movement, this will lower the expected returns to activism.

Intermediary institutional investors, then, present a problem for corporate governance. This efficient risk transfer and management

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106. See 15 U.S.C. § 80b-5(b) (2006) (allowing compensation based on performance of fund "averaged over a specified period and increasing and decreasing proportionately with [its] investment performance . . . in relation to the investment record of an appropriate index of securities prices"); Edwin J. Elton, Martin J. Gruber & Christopher R. Blake, Incentive Fees and Mutual Funds, 58 J. Fin. 779, 780 (2003) (describing Investment Company Act's constraints on mutual fund incentive fees, which require "fulcrum fee" arrangements that reward good performance and penalize bad performance symmetrically).

107. That is, the decision costs associated with a particular portfolio investment are mostly fixed. Size determines the assets over which those costs will be distributed. As assets increase, costs as a percentage of assets and as a percentage of the management fee paid by the investor will decrease. The firm's profit margins increase with size and so does its profitability.

108. See Edward G. Fox, Merritt B. Fox & Ronald J. Gilson, Economic Crisis and Share Price Unpredictability: Reasons and Implications 63 (Jan. 14, 2011) (unpublished manuscript) (on file with the *Columbia Law Review*) (finding dramatic increase in firm-specific volatility following all financial crises since early twentieth century).

structure—delivering low-cost, high-powered diversification and scale economies in active management—gives rise to significant problems in the efficient assignment of governance rights. As in the standard Berle-Means analysis, beneficial owners are rationally passive; governance rights are of little value to them. Institutional owners who are not seeking private benefits of control are rationally reticent;[109] they also will assign a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor's profitability and ability to attract assets depends. As a result, institutions can be expected to be skilled at managing portfolios, not at developing more profitable alternatives to a portfolio company's business strategy, creating better governance structures for the firm, or mastering the skills of governance activism. The institutions' performance, and hence their success in attracting funds and earning profits, is evaluated by the performance of their portfolios, measured in comparative terms. In light of the mismatch between skills and incentives with respect to active company management, as opposed to portfolio management, governance rights will be chronically undervalued.[110]

Thus, we need to take seriously the governance environment created by the joint forces of capital market evolution and political economy, which at this moment can be described as "latent" activism (using Mancur Olson's terminology to refer to voters that are susceptible to organization because of well-defined common interests but are passive because of mobilization costs), and look for useful adaptations.[111] Costs, lack of expertise, and incentive conflicts reduce the value of governance rights in the hands of intermediary institutions.

109. See supra notes 80–87 and accompanying text (noting mutual funds are not proactive in governance issues but respond to activists' governance proposals).

110. This account of mutual funds' (and similar intermediaries') incentives provides a sounder basis for corporate governance theorizing than some recent models put forth in the finance literature. For a summary of this literature, see Amil Dasgupta & Giorgia Piacentino, The Wall Street Walk When Blockholders Compete for Flows 1–7 (June 2012) (unpublished manuscript), available at http://ssrn.com/abstract=1848001 (on file with the *Columbia Law Review*). For further discussion of our perspective on current finance scholarship on institutional investor selling behavior, see infra note 132.

Gerald Davis has similarly observed the reconcentration of share ownership yet the passivity of institutional owners. Davis, supra note 66. His explanation is somewhat different (conflicts of interest) and somewhat complementary (relatively short holding periods). See id. at 19 (finding Fidelity and American Funds "routinely liquidate[] very large ownership positions"); id. at 20 (noting conflict of interest between investment management and pension businesses). Recent evidence on conflicts of interest is mixed. See Choi, Fisch & Kahan, Voting Through Agents, supra note 45, at 6–7 (noting studies on mutual fund conflicts of interest "arrive at inconsistent results"). Relatively short holding periods are consistent with our account, in which institutional investors' business model would lead to sales rather than governance activism at firms that institutions decide are mismanaged.

111. Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups 125–31 (1971).

IV. ACTIVISTS AS GOVERNANCE ARBITRAGEURS

Investment intermediaries have arisen to facilitate the channeling of retirement savings into capital markets and to provide individuals with the advantages of diversified portfolios. These investment intermediaries specialize in managing risk, adding to and taking advantage of increasing capital market completeness. But this specialization, reinforced by the link between scale and profitability, may leave a governance gap, an embedded shortfall in the monitoring of managerial agency costs. Institutional investors have little appetite for an active governance role; in consequence, they are unlikely to have developed the additional skills suited to it.

This gap, however, creates an arbitrage opportunity. Instead of pushing institutional investors into roles for which they may be unsuited, we should expect specialization. Addressing the governance gap—the agency costs of agency capitalism—plausibly requires a new set of actors to complement the diversified investment and portfolio optimization in which intermediary institutional investors now engage. Such actors would develop the skills to identify strategic and governance shortfalls with significant valuation consequences, to acquire a position in a company with governance-related underperformance, and then to present reticent institutions with their value proposition: a specified change in the portfolio company's strategy or structure.

Once the issue is framed and presented, the undervaluation of governance rights is reduced: The institutions will vote (or indicate willingness to vote) in favor of the specialized actors' perspective if the issue is framed in a compelling way. We see such specialized actors in the capital markets—activist investors of various types—and indeed a complicated interaction between the actors and the institutions has arisen whose shape has been described in a recent comprehensive study by Nickolay Gantchev of 1,164 activist campaigns over the 2000 to 2007 period.[112] It is interesting that the activists often achieve their stated objectives, but not invariably: They succeed in approximately 29% of the cases.[113] As we elaborate below, an activist campaign is best seen as a multistep process, the outcome of which critically depends on the extent to which the activist can garner significant institutional support for the proposed actions. The public campaign is a backdrop to the behind-the-scenes shareholder plebiscite. Shareholder activists make their strategic proffers; the relevant institutional investor constituency is willing to consider and assess them.

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112. Nickolay Gantchev, The Costs of Shareholder Activism: Evidence from a Sequential Decision Model, 107 J. Fin. Econ. 610 (2013).

113. Id. at 620 tbl.3 (finding highest success in pursuing sale or privatization of target, restructuring of inefficient operations, and additional disclosure, but less in obtaining higher dividends or repurchases, CEO removal, and executive compensation changes).

From our perspective, responsibility to beneficial owners for maximizing performance is split between specialists: Activist investors specialize in monitoring portfolio company strategy and formulating alternatives when appropriate for presentation to the institutional investors; in turn, institutional investors specialize in portfolio management and in evaluating proposals presented by activist investors. This specialization is more efficient than having a single actor play both roles. Each requires a different business model, and combining them may degrade the performance of both.

This specialization addresses both sides of the agency capitalism triangle depicted in Figure 1. Activist shareholders are not control-seekers, in the sense that they are neither motivated by the pursuit of private benefits of control, nor do they anticipate actually managing a portfolio company. Rather they are governance entrepreneurs, arbitraging governance rights that become more valuable through their activity monitoring companies to identify strategic opportunities and then presenting them to institutional investors for their approval—through a proxy fight, should the portfolio company resist the proposal. By giving the institutions this choice, the activists increase the value of governance rights; the institutions' exercise of governance rights then becomes the mechanism for creating value for beneficial owners.[114]

The point of tangency between these two specialists is that both activist and institutional shareholders must agree for a proposal to go forward. While activist investors frame and seek to force governance/performance changes, they are successful only if they can attract broad support from institutional investors capable of assessing alternative strategies presented to them, even if they will not formulate the strategies themselves. In effect, activists must make their case to sophisticated but not proactive governance rights holders.[115] Such a reactive role is a more plausible model for institutional investor engagement, reflecting both their expertise and incentives.[116] This interaction between intermediary

114. For a survey of evidence showing value creation for target shareholders by public hedge fund activism and evidence showing similar gains through private activism in Europe, see Marco Becht, Julian Franks & Jeremy Grant, Hedge Fund Activism in Europe 5, 20–24 (European Corporate Governance Inst., Finance Working Paper No. 283, 2010), available at http://ssrn.com/abstract=1616340 (on file with the *Columbia Law Review*).

115. See supra notes 80–87 and accompanying text (providing evidence that institutional intermediaries are "rationally reticent").

116. Critics might object that this sort of specialization overly empowers the proxy advisory services, especially ISS, because of the extent to which institutions have de facto outsourced shareholder voting decisions, a strategy that economizes on governance costs. For a survey of literature on the role of ISS recommendations, see supra note 45. But even sharp critics of the general role of ISS regard the institutions as engaging in different decisionmaking in "votes with clear economic significance (such as mergers or election contests)." Latham & Watkins LLP, The Parallel Universes of Institutional Investing and Institutional Voting 1 (2010), available at http://www.lw.com/upload/pubContent/_pdf/pub3446_1.pdf (on file with the *Columbia Law Review*). Such decisions are made by

institutions and shareholder activists, each with complementary specialized capacities, thus can mitigate the agency costs of agency capitalism through a mechanism that complements the reconcentration of record ownership.

This happy complementarity requires an adequate supply of shareholder activists, and thus the focus shifts to the return to activist shareholders: It must be high enough when the activists are right—that is, when the intermediary institutions agree with the proffered strategy and the strategy in fact works—to warrant their effort, in light of the facts that the bulk of the gains from their effort will be captured by other shareholders, and that their efforts will not always succeed.[117] Gantchev's recent work sheds light on the costs of hedge fund activism and its returns. A campaign that culminates in a proxy contest costs nearly $11 million on average, he estimates.[118] When costs are taken into account,

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economically focused portfolio managers, not by centralized governance specialists who work from normative premises about value creation. See id. Recent evidence suggests that ISS's influence may well be overstated. See Choi, Fisch & Kahan, Proxy Advisors, supra note 45, at 906.

117. A recent client letter from Wachtell, Lipton, Rosen & Katz, a leading proponent of restricting activist shareholders, stated:

> [S]everal significant victories by boards of directors and corporations over activists could reduce hedge funds' appetite for activism or alter their tactics or target selection criteria. AOL, Forest Laboratories and Cracker Barrel all successfully defended against months-long proxy fights . . . . Companies have succeeded in proxy fights by focusing on their business strategy, highlighting positive changes, whether financial or in corporate governance, and pointing out when the dissident had no long-term business strategy.

Andrew R. Brownstein et al., Wachtell, Lipton, Rosen & Katz, Mergers and Acquisitions—2013, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Feb. 4, 2013, 9:48 AM) [hereinafter Wachtell 2013 Client Letter], http://blogs.law.harvard.edu/corpgov/2013/02/04/mergers-and-acquisitions-2013 (on file with the *Columbia Law Review*). This is just the kind of constructive interplay that complementary specialization contemplates: The activists may propose, but the institutions dispose.

118. Gantchev, supra note 112, at 623 tbl.7A. Gantchev models hedge fund activism as a sequential process and attaches costs to each stage, beginning with demand negotiations ($2.94 million on average), then requesting board representation ($1.83 million on average), and finally, waging a proxy contest ($5.94 million on average). Thus, the average amount of costs for a campaign that goes through each stage is $10.71 million. Id. Of the 1,164 campaigns Gantchev tracked in the 2000 to 2007 period, only 7% resulted in a proxy contest. Id. at 618 tbl.1. But approximately 57% of these proxy contests resulted in activist success (meaning the attainment of the ultimate stated objective, which was not necessarily a board seat). Id. at 620 tbl.3B. In cases where the activist demanded board representation (the second stage, representing less than 20% of the sample), the success rate was approximately 39%. The initial intervention, styled a "demand" for negotiation, had the lowest success rate at approximately 7%. Id.

Gantchev also replicates prior literature that reports evidence inconsistent with hedge fund "short termism," the conventional criticism that "hedge fund activists [are] short-term investors who make a quick profit at the expense of long-term shareholders." Excluding campaigns in which the activist made no formal demand, the average duration of an activist campaign is nineteen months. Id. at 621. The variation around that average skews to the right, however; the seventy-fifth percentile for a campaign with specific nominal hedge fund returns are on average cut by approximately two-thirds.[119] These benefit-cost considerations become important when considering the regulatory framework within which activism operates.

In this analysis, the specialization of institutional investors in portfolio management—including assessing proposals presented by activist shareholders—and the specialization of activist shareholders in actively monitoring management performance and strategy and proposing alternatives are complementary, a result of the evolution of conditions in the capital markets. The rise of intermediary institutional investors and the corresponding reconcentration of ownership result in both the undervaluation of governance rights and the corresponding opportunity for activist shareholders to arbitrage that valuation differential. Yet this is not a classic arbitrage opportunity because the payoff depends upon both the credibility of the activist and the persuasiveness of its proposal to the controlling institutional shareholders.[120]

The average activist block is roughly 8%, far less than a control block.[121] When the activist nonetheless succeeds, what is the source of the success? It is unlikely that the activist shareholder bedazzles management with the astuteness of its strategic and operating proposals. In cases where management adopts some or all of the activist's proposals without a proxy contest, management presumably believes that the activist can persuasively address the institutional investors who own a majority of the firm. In cases where the activist pursues a proxy contest, the vote is a plebiscite that requires shareholder approval of the activist's proposals.

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demands is twenty-six months, and the twenty-fifth percentile is six months. Id. at 621 tbl.4A. The average initial ownership stake at the beginning of a campaign is 8%, which increases only to 9% over the course of the campaign; apparently the size of the activist's ownership stake does not affect the probability of success (where success is defined in terms of initial demand outcomes). Id. at 621, 622 tbl.5A.

119. Id. at 625 tbl.8C, 626. Much like the case with venture capitalism, skill in identifying situations where activism can both produce returns and succeed is not randomly distributed. The top quartile of activists earns most of the returns. Id. at 625 tbl.8. It is also likely that more successful activists will take on large firms. Success brings more resources, which means capacity to acquire "activism" blocks in bigger firms. Activism costs do not increase much with firm size. See supra note 107 and accompanying text (noting decision costs of portfolio management are fixed). Thus, assuming available resources to make the block acquisition, larger firms should be targeted by the more successful activists.

120. This is consistent with empirical literature showing that activists are likely to target firms with significant institutional ownership, and in evaluating otherwise equivalent firms are more likely to target the firms with higher institutional ownership. See Alon Brav et al., Hedge Fund Activism, Corporate Governance, and Firm Performance, 63 J. Fin. 1729, 1750 tbl.III (2008) [hereinafter Brav et al., Activism and Firm Performance] (noting target firms on average have about 45% institutional ownership); Gantchev, supra note 112, at 622 tbl.6, 623 ("[T]argets have significantly higher institutional ownership, which is a critical determinant of campaign success in the more confrontational stages of activism.").

121. Gantchev, supra note 112, at 622 tbl.5A; see also Brav et al., Activism and Firm Performance, supra note 120, at 1747 tbl.IIA (noting median initial ownership is 6.30%).

In short, governance markets become more complete through interactions in which activists propose and institutional investors dispose.

Recent empirical work is consistent with this account. Gantchev models the sequential process of governance activism and describes the frequency of each stage.[122] First, the activist shareholder assembles a toehold position, acquiring shares at a price as yet unaffected by the activist's plans. Public knowledge of the activist's efforts comes with the filing of a statement on Schedule 13D that discloses the activist's greater-than-5% ownership stake and its intentions and objectives.[123] Next comes the "demand negotiation" stage, in which the activist seeks to persuade target management to voluntarily adopt the activist's proposal. If this fails, then a "board representation" stage begins, in which the activist threatens a proxy contest and recruits director nominees. Should management still refuse to adopt the proposal, the final step is an actual contest.[124] Of particular interest is the declining frequency of each stage and the increasing success rate at the later stages.[125] For example, of the initial 13D filings by hedge fund activists, only approximately 30% go to the negotiation stage.[126] This pattern is consistent with the interaction we posit. After public posting of a bond (the toehold investment) to establish its credibility and secure the chance of its return, the activist undertakes a nonpublic campaign to elicit a favorable institutional response.[127] Subsequent actions reveal the outcome of such efforts. With approbation, the activist proceeds; without, it withdraws, realizing that the chances for success are low. The relatively low fraction of initial interventions that proceed to the next stage suggests a high burden of persuasion for institutional support.

Gantchev also shows that the success rate (as measured in terms of initial demands) increases as the activist persists.[128] Presumably this is because the activist evaluates the likelihood of success at each stage in

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122. Gantchev, supra note 112, at 612–14.

123. See 17 C.F.R. § 240.13d-1(a) (2012) (requiring any person acquiring beneficial ownership of any equity security of more than 5% to file with SEC statement on Schedule 13D within ten days after acquisition); Gantchev, supra note 112, at 613 (explaining announcement of activist intentions as initial step).

The activist shareholder's predisclosure acquisition of a significant toehold is critical to its business model. The timing of required disclosure thus directly affects the activist's expected returns. Part V below considers current proposals to accelerate the disclosure requirement and thereby limit the activist's return by reducing the amount of predisclosure stock that can be acquired.

124. Gantchev, supra note 112, at 613–14.

125. Id. at 620 tbl.3B.

126. Id.

127. See Marco Becht et al., Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund, 22 Rev. Fin. Stud. 3093, 3108–11 (2009) (suggesting shareholder activism is predominantly executed through private interventions both with target management and with other institutions). Just as sometimes the best auctions are silent, so too are activism campaigns.

128. Gantchev, supra note 112, at 620 tbl.3B.

deciding whether to continue, and the target makes the same assessment at each stage as it seeks out information about institutional sympathy for the activist's proposals.

There is a growing empirical literature that documents the impact of activist shareholder efforts on target company stock prices. Gantchev reports average (median) "raw" shareholder returns of approximately 39% (33%) over the average nineteen-month campaign period and average (median) annualized market-adjusted returns of approximately 4% (4%).[129] Brav et al. report average (median) raw target shareholder returns of 42% (18%) over the campaign period and annualized average (median) market adjusted returns of 21% (4%).[130] Klein and Zur report average target shareholder market-adjusted returns of approximately 22% over a one-year post-initiation period.[131]

Part III has shown that the agency costs of agency capitalism arise in significant part from the specialization of intermediary institutions in providing beneficial owners low-cost diversification at the cost of a business model that does not value governance rights. This Part then shows that specialization by activist investors in arbitraging the value of governance rights—the difference between the value of institutions' governance rights before and after the intervention of an activist investor—may be part of the cure. Institutional investors specialize in portfolio selection and performance; activist shareholders specialize in framing alternatives to existing company strategies and thereby increasing the value of governance rights to institutional investors. In effect, capital market evolution has broken up the ownership bundle between rationally reticent institutional investors and potentially activist shareholders. To support effective governance, the legal regime needs to foster conditions in which the bundle can be reassembled through the complementary capacities and engagement of both.[132] Part V turns to

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129. Id. at 625 tbl.8, tbl.4A.

130. Brav et al., Activism and Firm Performance, supra note 120, at 1760, 1761 tbl.VI.A.

131. April Klein & Emanuel Zur, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors, 64 J. Fin. 187, 188, 226 (2009). Although hedge fund targets experience higher returns upon 13D filing than other activists' targets, the reverse is true for subsequent gains; at the end of the year, the totals are approximately the same. Id.

132. As an alternative mechanism, others have suggested pass-through voting by the holders of beneficial interests in investment intermediaries. See, e.g., Richard M. Buxbaum, Institutional Owners and Corporate Managers: A Comparative Perspective, 57 Brook. L. Rev. 1, 47–52 (1991) (discussing pass-through voting by pension fund beneficiaries); Taub, supra note 45, at 888–89 (extending suggestion to mutual fund shareholders). Such suggestions seem highly likely to fail because of the original Berle-Means problem: the passivity of dispersed owners.

Gantchev and Jokikasthira propose an alternative hedge fund/institutional investor interaction, in which institutional exit reduces an issuer's stock price and may also signal an underperformance problem. This in turn may trigger an activist intervention. See Nickolay Gantchev & Chotibhak Jotikasthira, Hedge Fund Activists: Do They Take Cues present regulatory initiatives that would skew the balance against the control of the agency costs this Article has identified.

V. THE IMPLICATIONS OF THE REGULATORY REGIME

The sustainability of the collaboration between institutional investors and activist shareholders depends on the regulatory regime that governs the activists' accumulation of shares. The activist incurs costs: the research necessary to identify an opportunity to improve a target's business strategy; the financing and opportunity costs of its equity position; the idiosyncratic risk resulting from holding an undiversified position; and the costs of the activist campaign, from engagement with the target to the costs associated with a proxy contest, including legal counsel, proxy advisors, solicitation costs, and the like.[133] The activist needs to anticipate recovering these costs and earning a favorable risk-adjusted return before it will enter the business in the first place and engage with identified companies.

The cost recovery and the profits come from the returns on the activist's toehold equity position secured before public disclosure of that position and the activist's plan. Consider alternative sources of cost recovery. A contract with institutional owners to cover expenses or share gains would both incur significant coordination costs and entangle the institutions in the regulatory regime that covers share accumulations, an unattractive scenario.[134] The target is also an improbable source of cost

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from Institutional Exit? 23 (Feb. 12, 2013) (unpublished manuscript), available at http://ssrn.com/abstract=2139482 (on file with the *Columbia Law Review*) (finding "strong positive relationship" between institutional selling volume and chance of being targeted by activists). From our perspective, even if the institutional investor's exit can be seen as a governance device, it requires a complementary action by an activist in order to be most effective.

Thus we may see the emergence of a new ecology for the monitoring of managerial underperformance. The signal associated with institutional selling reduces the activist's investigation costs; the subsequent activist intervention increases the value of the institutions' voting rights. Even if the selling institution will not benefit from the particular intervention (because it has exited from its position), its beneficiaries will benefit from an environment of superior monitoring. The potential triggering of activist intervention adds to the governance value of the institutional decision to exit. Integrating the role of the activist investor amplifies the expression of institutional "voice" as recently developed in the finance literature. See, e.g., Anat R. Admati & Paul Pfleiderer, The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice, 22 Rev. Fin. Stud. 2645 (2009) (observing blockholder selling exerts influence through effect on management's stock-related compensation). A compensation effect is a relatively "weak form" of governance check; by contrast, drawing in a shareholder activist is a "strong form" of governance check. The institutional/activist interaction magnifies the governance impact of institutional selling and lowers the activist's cost of target identification.

133. See supra note 118 and accompanying text (discussing average costs of activist campaign).

134. Section 13 of the Securities Exchange Act of 1934 and Regulation 13D-G promulgated thereunder make it clear that any such agreement would render all parties

recovery. Precisely because the activist's campaign typically is not to elect a board majority, the activist cannot anticipate that a post-proxy fight-friendly board would elect to reimburse its expenses.[135] An activist's pursuit of adoption of a shareholder bylaw calling for reimbursement of proxy contest expenses, newly permitted under Delaware law,[136] is both highly speculative and dilutes the activist's single minded campaign to increase the target's stock price and thus the activist's credibility. The activist's return depends on stock price appreciation, gains that are shared pro rata with other shareholders.[137]

In a "success" case, the activist's return is a function of the size of its block and the increase in the target's stock price as a result of the target's adoption of the proposal, whether voluntarily or following a proxy contest. A great deal of empirical evidence shows that the target's stock price immediately appreciates upon disclosure of the activist's block, depending importantly on the expectation that the activist has a substantive policy proposal.[138] This appreciation increases with the activist's

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members of a "group" that is deemed to have beneficial ownerships of the shares of all such parties. If the group owns more than 5% of an issuer's outstanding stock, group members have a filing obligation. 15 U.S.C. § 78m(d)(3) (2006); 17 C.F.R. § 240.13d-5(b) (2012). This will impose costs and liability risks on all parties who have entered into the agreement.

135. See, e.g., Rosenfeld v. Fairfield Engine & Airplane Corp., 128 N.E.2d 291, 293 (N.Y. 1955) (holding board may, though is not required to, reimburse successful proxy contestants in proxy fights over corporate policy).

136. Del. Code Ann. tit. 8, § 113 (2012).

137. Cf. supra note 102 and accompanying text (explaining institutional investor would have to share benefits from intervention with competitors but would bear all costs).

138. See, e.g., Brav et al., Activism and Firm Performance, supra note 120, at 1760 ("The large average abnormal stock return around the Schedule 13D filing date is consistent with the view that the market anticipates that hedge funds' activism will result in actual value improvement."); Klein & Zur, supra note 131, at 188 (summarizing studies that suggest "the market believes activism creates shareholder value"). For earlier studies on potential control entrepreneurs, see Clifford G. Holderness & Dennis P. Sheehan, Raiders or Saviors? The Evidence on Six Controversial Investors, 14 J. Fin. Econ. 555, 562–63 (1985) (finding first public announcement by "corporate raiders" of their stockholdings led to positive abnormal returns); Wayne H. Mikkelson & Richard S. Ruback, An Empirical Analysis of the Interfirm Equity Process, 14 J. Fin. Econ. 523, 533 (1985) ("The announcements of [13D] filings appear to increase the stock price of both acquiring and target firms."). For a useful survey, see generally Alon Brav, Wei Jiang & Hyunseob Kim, Hedge Fund Activism: A Review, 4 Found. & Trends Fin. 185 (2009) [hereinafter Brav et al., Review].

There is debate over the source of gains associated with hedge fund activism. Greenwood and Schor suggest that the gains come almost exclusively from subsequent takeovers. Robin Greenwood & Michael Schor, Investor Activism and Takeovers, 92 J. Fin. Econ. 362, 368–70 (2009). This seems at odds with the extended average holding period documented by Brav et al. See Brav et al., Review, supra, at 205 (finding average holding period of hedge fund activist's position is "close to two years"); supra note 118 (discussing Gantchev's study which reports average duration of activist campaign is nineteen months). More recently, Brav, Jiang, and Kim used plant-level data drawn from the U.S. census to show that improvements in production efficiency at target firms and efficiently redeployed capital are significant channels for the realization of activist-associated gains. See Alon reputation for successful engagement;[139] the immediate market reaction anticipates a very large fraction of the gains associated with a successful activism campaign. These dynamics make the regulatory choices over the timing of disclosure critical: The activist's business model depends on being able to secure a large enough equity position before required disclosure of that position drives up the price of the target's stock. Thus, the centrality of the disclosure regime sets the context for understanding regulatory initiatives in the United States and the European Union to accelerate the disclosure of the activists' initial positions. These initiatives contain three elements: reducing the ownership threshold that triggers disclosure, shortening the period for disclosure following the ownership trigger being hit, and limiting the use of equity derivatives by including them in calculating the ownership amount.[140]

Each of these elements will have the effect of reducing the returns to activist shareholders. This is because they will reduce the economic stake that an activist shareholder can accumulate before mandatory disclosure of its holding drives up the price of the target company's stock. As noted previously, toehold acquisitions are the major source of the activist's return;[141] these regulatory initiatives would reduce the returns to activism. It is not just that smaller blocks would undermine the activist's credibility and thus effectiveness. Rather, and more importantly, reducing the size of the toeholds that activists can accumulate before disclosure reduces their returns. The likely outcome would be that the activist sector would shrink, fewer firms would be identified as targets for strategic initiatives, and the activists would reduce costly campaign efforts. The result would be greater undervaluation of voting rights because of the reduced attraction of arbitraging the difference in the value of governance rights to reticent institutional investors and to an activist shareholder.[142]

Brav, Wei Jiang & Hyunseob Kim, The Real Effects of Hedge Fund Activism: Productivity, Risk, and Product Market Competition 27–28 (Nat'l Bureau of Econ. Research, Working Paper No. 17517, 2011), available at http://www.nber.org/papers/w17517.pdf (on file with the *Columbia Law Review*).

139. See Emanuel Zur, The Power of Reputation: Hedge Fund Activists 29–30 (Dec. 15, 2008) (unpublished manuscript), available at http://ssrn.com/abstract=1267397 (on file with the *Columbia Law Review*) (finding higher announcement premium associated with hedge funds' reputation for being successful in gaining board seats).

140. See infra notes 143–144 and accompanying text (discussing regulatory initiatives by U.K. and E.U. authorities); infra notes 146–147 and accompanying text (discussing proposals in United States).

141. See supra notes 134–137 and accompanying text (explaining toehold position is essential to cost recovery by activists because alternative sources of gain are not satisfactory).

142. This can be understood as a particularized application of Grossman and Stiglitz's demonstration that capital markets cannot be perfectly "informationally efficient"; arbitrageurs would no longer engage in the activity that impounds information into price if inefficiency did not allow an arbitrage profit. See Sanford J. Grossman & Joseph E. Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 393, 405 (1980) ("[B]ecause information is costly, prices cannot perfectly reflect the

The United Kingdom and the European Union have moved far down this road. The United Kingdown has adopted an ownership disclosure threshold of 3% and a two-day disclosure requirement.[143] Comparable initiatives are also underway in other E.U. member states and Canada.[144] From our perspective, there is considerable irony in this

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information which is available, since if it did, those who spent resources to obtain it would receive no compensation."). Reducing the returns to activist investors would similarly reduce their efforts to move the value of the company toward its fundamental efficiency.

143. For disclosure rules in the United Kingdom, see Fin. Servs. Auth., Disclosure Rules and Transparency Rules §§ 5.1.2, 5.8.3 (2013), available at http://media.fshandbook.info/content/full/DTR.pdf (on file with the *Columbia Law Review*) (requiring shareholder to notify U.K. issuer of percentage of shareholder's voting rights when it "reaches . . . 3% . . . and each 1% threshold thereafter up to 100%" in no later than two trading days).

144. For Germany's maximum four-day lag, see Gesetz über den Wertpapierhandel [WpHG] [Securities Trading Act], Sept. 9, 1998, BGBl. I at 2708, § 21(1), last amended by Gesetz [G], June 22, 2011, BGBl. I at 1126, art. 3, translated in Securities Trading Act, BaFin: Fed. Fin. Supervisory Authority, http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg_101119_en.html (on file with the *Columbia Law Review*) (last visited Apr. 23, 2013) ("Any party . . . whose shareholding in [a German] issuer . . . reaches, exceeds or falls below 3 percent, 5 percent, 10 percent, 15 percent, 20 percent, 25 percent, 30 percent, 50 percent or 75 percent of the voting rights . . . shall . . . within four trading days . . . notify . . . the issuer and . . . the Supervisory Authority . . . ."). For France's four-day provision, see Code de Commerce [C. Com.] art. L. 233-7, translated in The French Commercial Code in English 262–63 (Philip Raworth trans., 2009) (requiring any person who comes into possession of shares representing more than 5% of issuer's voting rights to inform issuer within time limit set by Council of State); General Regulation of the Autorité des Marchés Financiers art. 223-14 (last amended Sept. 27, 2012), available at http://www.amf-france.org/documents/general/7552_1.pdf (on file with the *Columbia Law Review*) (specifying Article L. 233-7 notification shall be filed no later than close of trading on fourth trading day after shareholding threshold has been crossed). For Italy's five-day maximum, see Regulation Implementing Italian Legislative Decree No. 58 of 24 February 1998, Concerning the Discipline of Issuers art. 121, available at http://www.consob.it/documenti/english/laws/reg11971e_2009_art.116-ter_121.pdf (on file with the *Columbia Law Review*) ("Declarations of holding . . . shall be made without delay and in any event within five trading days of the date of the transaction leading to the obligation . . . .").

For a discussion and critical analysis of actions and proposals throughout Europe to require disclosure of equity derivative positions, following the U.K. model, including a recent consultation by the Committee on European Securities Regulation (CESR), now the European Securities Market Authority (ESMA), see Maiju Kettunen & Wolf-Georg Ringe, Disclosure Regulation of Cash-Settled Equity Derivatives—An Intentions-Based Approach 16 (Univ. of Oxford Legal Research Paper Series, Paper No. 36, 2011), available at http://ssrn.com/abstract=1844886 (on file with the *Columbia Law Review*).

Canada has proposed revisions to its ownership disclosure regime that would drop the triggering percentage from its current 10% level to 5%. Canadian Sec. Adm'rs, Proposed Amendments to MI 62-104 Take-Over Bids and Issuer Bids, NP 62-203 Take-Over Bids and Issuer Bids, and NI 62-103 Early Warning System and Related Take-Over Bid and Insider Reporting Issues (Mar. 13, 2013), available at http://www.osc.gov.on.ca/documents/en/Securities-Category6/mi_20130313_62-104_take-over-bids.pdf (on file with the *Columbia Law Review*). The Canadian proposal would leave in place the obligation to file the disclosure report two days after reaching the trigger and to report subsequent position. On the one hand, the United Kingdom in its Stewardship Code and the European Union in comparable measures both seek greater institutional investor engagement with portfolio companies.[145] In our view, this effort is likely to fail, since it conflicts with the institutions' business model. On the other hand, the analysis in Part IV highlights shareholder activism as addressing the agency costs of institutional ownership—the undervaluation of governance rights that, if exercised, would benefit the beneficial owners—by creating a new channel for otherwise reticent institutional voice. In effect, shareholder activism is what the stewardship movement desires but cannot achieve on its terms. Because institutional investors ultimately decide whether an activist's campaign will succeed, activism potentiates institutional voice by putting choices to the institutions. Reducing the size of a predisclosure stake that an activist shareholder can acquire has precisely the wrong effect: Reducing the returns to activist shareholders would reduce the number of strategic initiatives by activist shareholders and ultimately result in reticent intermediary institutions continuing to undervalue governance rights. So in sidelining activist investors, the United Kingdom and the European Union are also sidelining the institutions—just those whose roles are simultaneously sought to be expanded into stewardship.

A. *Proposal of Reducing the Ownership Threshold and Shortening the Disclosure Window*

The SEC has received recent importuning to follow the United Kingdom and various other countries in shortening the disclosure window and broadening the definition of beneficial share ownership to cover purely economic positions generated by derivative trades.[146] The SEC has signaled that its current position—a ten-day disclosure period and a more restrictive definition of beneficial ownership—may be reconsidered.[147] Because the authors write as American legal academics,

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increases of more than 2%. The proposal would extend the updating obligation to decreases of more than 2%. Id.

The proposed amendments to the Canadian disclosure regime would also expand the instruments included in calculating a shareholder's ownership for purposes of the disclosure trigger to encompass derivatives, such as total return swaps. It would also require lenders of securities to report loans of more than 2% of an issuer's outstanding shares. Id.

145. See supra notes 7–8 and accompanying text (discussing U.K. and E.U. proposals).

146. Wachtell, Lipton, Rosen & Katz, Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, at 1–2 (Mar. 7, 2011) [hereinafter Wachtell Petition], available at http://www.sec.gov/rules/petitions/2011/petn4-624.pdf (on file with the *Columbia Law Review*) (requesting SEC to "shorten the reporting deadline and expand the definition of beneficial ownership under the reporting rules" under 1934 Act).

147. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §929R(a), 124 Stat. 1376, 1866 (2010) (amending section 13 of Securities Exchange Act of 1934 and specifically authorizing SEC to reduce trigger period for disclosure); Mary L. Shapiro, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the

this Article will address the proposals made to the SEC with more specificity; however, some of the policy proposals here have carryover value for other jurisdictions.

Part of what animates the proponents of faster disclosure after the activist crosses the disclosure-triggering threshold is the concern that activists can accumulate ownership positions far in excess of the 5% threshold during the current ten-day period before disclosure is required.[148] There are anecdotes to this effect, although evidence shows that activists on average take blocks under 10%.[149]

There are two objections to activists more aggressively exploiting the ten-day window. First, public shareholders who unknowingly sell to the activist are disadvantaged, because they are selling at a price that excludes the potential benefits of the activist's initiative.[150] Second, the activist may be able to accumulate a control position or at least a position of strong influence without paying a control premium, or for reasons that threaten majoritarian shareholder interests.[151] As discussed below, these are weak arguments or point to problems otherwise readily addressed in the U.S. setting.

The first objection fails on the stating of it. A shareholder's decision to sell results either from liquidity needs or the shareholder's reservation price for the security in question. Any asymmetry of information involved in the transaction arises from the activist's private information about its own intentions, which may include a forecast as to the likely target firm response. Why does the selling shareholder have an entitlement to share in the value of information created by the analysis of other investors? The thin logic of an argument whose goal is to facilitate a free riding strategy becomes even clearer when the question is examined from the ex ante shareholder perspective, a familiar analytic approach. Assume that share-

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Transatlantic Corporate Governance Dialogue (Dec. 15, 2011), http://www.sec.gov/news/speech/2011/spch121511mls.htm (on file with the *Columbia Law Review*) (noting SEC planned to review and modernize beneficial ownership reporting rules, including whether to shorten ten-day window and whether to include use of cash-settled equity swaps).

148. See Wachtell Petition, supra note 146, at 2–3 (arguing statutory purposes of 13(d) reporting requirement are disserved by investors exploiting ten-day reporting window to accumulate shares at lower price).

149. Gantchev's analysis of 1164 campaigns over the 2000 to 2007 period shows that the activists' mean (median) stock ownership position at the outset of the campaign was 8.5% (7.0%). Gantchev, supra note 112, at 622 tbl.5A. In the seventy-fifth percentile, initial ownership was still only 10%. In the ninety-fifth percentile, initial ownership was 16%. Id. Interestingly, the initial ownership for successful campaigns was on average 6.81%, less than the 7.16% for unsuccessful campaigns. Id. at 622 tbl.5B.

150. See Wachtell Petition, supra note 146, at 6 (arguing disclosure lag "result[s] in a substantial transfer of value to [activists] . . . from the public shareholders who sold their shares during the ten-day window without knowledge of the [activists'] plans").

151. See id. at 3 (arguing ten-day reporting lag "serves the interest of no one but the investor seeking to exploit this period of permissible silence to acquire shares at a discount to the market price that may result from its belated disclosures").

holders are diversified (or have the opportunity to diversify) and that whether one is a selling shareholder or a holding shareholder is unbiased. Immediate disclosure will restrict the activist's opportunity to build a toehold stake, thereby reducing the returns to activism, and thus the occasions for activism and the net gains to other shareholders from the activist's revaluation of institutional shareholders' governance rights across a portfolio of firms. Shareholders ex ante would presumably prefer a rule that increased their average wealth, even if in a particular case they lost an opportunity to free ride on the activist's efforts. The shareholders can't have it both ways: A regulatory structure that gives shareholders the opportunity to free ride on knowledge of activists' strategies reduces the shareholders' opportunity to gain from the activists' strategic monitoring and presentation of strategic alternatives to reticent institutions.

Shareholders would have the same view of the current SEC rule that allows institutional investors who do not seek to influence control to delay public disclosure of their accumulation of positions in a company until they have completed the acquisition.[152] For example, the SEC allowed Berkshire Hathaway to delay reporting its acquisition of a significant stake in IBM stock because disclosure of the stake would have made it more costly for Berkshire Hathaway to acquire it in the first place.[153] Since shareholders as a group benefit from Berkshire Hathaway's accumulation, premature disclosure would hurt rather than help.[154]

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152. See Securities Exchange Act of 1934 § 13(f)(3), 15 U.S.C. § 78m(f)(3) (2006) (allowing SEC to exempt institutional investment manager or security from reporting rules); 17 C.F.R. § 240.13f-1(a)(1) (2012) (requiring certain "institutional investment managers" who exercise "investment discretion" to file report on Form 13F with SEC "within 45 days after the last day of each . . . calendar quarter[]"); Form 13F, Report of Institutional Investment Manager Pursuant to Section 13(f) of the Securities Exchange Act of 1934, id. § 249.325.

153. See Serena Ng, Erik Holm & Spencer E. Ante, Buffet Bets $10.7 Billion in the Biggest Tech Foray, Wall St. J., Nov. 15, 2011, available at http://online.wsj.com/article/SB10001424052970204323904577037742077676990.html (on file with the *Columbia Law Review*) ("Berkshire secretly had been accumulating the shares . . . receiving confidential treatment from the Securities and Exchange Commission, which otherwise mandates that big investors disclose their holdings . . . .").

154. Thus we have concerns about the recent rulemaking petition of the NYSE Euronext and management-side governance groups seeking a shortened reporting deadline for postquarter disclosure of institutional investor ownership positions, see supra note 152, from forty-five days to two days. NYSE Euronext, Soc'y of Corporate Sec'ys & Governance Prof'ls & Nat'l Investor Relations Inst., Petition for Rulemaking Under Section 13(f) of the Securities Exchange Act of 1934, at 9–10 (Feb. 1, 2013), available at http://www.sec.gov/rules/petitions/2013/petn4-659.pdf (on file with the *Columbia Law Review*). Although transparency as to institutional ownership positions is generally desirable, it needs to be balanced against potential harms to those who own shares through an institutional intermediary. As noted in the text, if the institution is in the midst of position-building or unwinding, the fortuity of a quarter ending point ought not to impose extra costs. Such a concern applies to "reticent" institutions as well as "active" institutions who have not entered the special disclosure regime of section 13(d). Among

To be sure, the first objection may have in part motivated Congress to adopt section 13(d) of the Securities Exchange Act in 1967.[155] We know now more about how capital markets work than was known in 1967, however, and in all events, the issue is not the repeal of any disclosure regime governing share accumulations, but whether the SEC should extend the reach of the current regime—a decision within the SEC's discretion, rather than simply a blind application of congressional intent in 1967.[156] In this context, congressional intent does not have a forty-five-year-long shadow.[157]

The second objection—that the activist may be seeking to acquire control, near-control, or at least overwhelming influence in the ten-day window—should be taken more seriously but with a caveat. In the decades of various forms of shareholder activism since the adoption of the current disclosure regime, the instances of significant block building in the ten-day window are relatively few.[158] This is in part because rapid significant accumulation becomes known to market intermediaries and is impounded in the price,[159] thus undercutting the economic rationale for

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other considerations, forcing immediate postquarter disclosure will distort trading patterns as the quarter-end approaches. To avoid harm, a shortened disclosure deadline would need to be coupled with a reaffirmed waiver policy.

155. This claim of legislative intent is vigorously presented by Emmerich et al., supra note 13 (manuscript at 4–9) (reviewing legislative history of Williams Act and noting explicit congressional mandate for transparency and full and fair disclosure of large accumulations of public company stock).

156. This, of course, assumes that "congressional intent" as manifested in anything other than the statutory text is a meaningful interpretive guide, a premise that the current fashion for "textualism" might contest. See, e.g., William N. Eskridge, Jr., The New Textualism, 37 UCLA L. Rev. 621, 640–56 (1990) (outlining tenets of "new textualism" and discussing criticisms of traditional approach relying on legislative history); John F. Manning, Textualism and Legislative Intent, 91 Va. L. Rev. 419, 420, 424 (2005) (noting modern textualists "deny that Congress has a collective will apart from [statutory text]" but believe "the only meaningful collective legislative intentions are those reflected in the *public meaning* of the final statutory text").

157. In a similar vein is Delaware Supreme Court Justice Jack Jacobs' recent invitation to rethink elements of the state's case law in light of changing patterns of share ownership and other capital market conditions. Jack B. Jacobs, Does the New Corporate Shareholder Profile Call for a New Corporate Law Paradigm?, 18 Fordham J. Corp. & Fin. L. 19, 26–31 (2012).

158. See supra note 149 and accompanying text (noting small ownership at outset of activist campaigns).

159. See Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 569–72 (1984) ("[E]ven a single knowledgeable trader with sufficient resources[] can . . . cause prices to reflect information by persistent trading at a premium over 'uninformed' price levels."). Indeed, the empirical evidence suggests that rapid accumulations without significant price impact will be difficult for all but the highest-liquidity stocks. See Pierre Collin-Dufresne & Vyacheslav Fos, Do Prices Reveal the Presence of Informed Trading? 35 fig.3 (Aug. 31, 2012) (unpublished manuscript), available at http://ssrn.com/abstract=2023629 (on file with the *Columbia Law Review*) (showing activists gradually accumulate their pre-13D blocks on high-volume trading days). This evidence is consistent with market participants' views that significant, sudden

accumulation, and also because the activist's idiosyncratic risks are increasing in investment size. Remember that a genuine governance entrepreneur, not a control seeker, requires approval of its proffered strategy by sophisticated investors after having heard the target company's vigorous argument on the other side. Failing that, the campaign itself will fail, leaving the activist with large potential losses.[160]

And emphasizing the importance of changes in the capital markets and corporate governance over the last forty-five years, private ordering (with the not insubstantial assistance of the Delaware Supreme Court) already provides a response to the concern about secret control changes that deprive shareholders of a premium. The poison pill affords a remedy that can effectively prohibit undisclosed accumulations.[161] The authors hardly endorse the "just say no" version of the pill, which is seemingly blessed by the Delaware courts,[162] but a time-limited pill

share acquisitions would materially move market prices. See, e.g., Christopher R. Concannon, Virtu Financial LLC, Remarks at Columbia Program on the Law and Economics of Capital Markets: High Frequency Trading (Nov. 29, 2012), available at http://www.law.columbia.edu/center_program/capital-markets/cap_mktsWorkshops2 (on file with the *Columbia Law Review*) (noting significant price impact from large, even medium, orders in present market and particular shortfall in liquidity for stock beyond top 1000).

160. See Wachtell 2013 Client Letter, supra note 117 (noting in 2013 companies like AOL, Forest Laboratories, and Cracker Barrel successfully defended against months-long proxy fights because institutional investors were not persuaded by activists).

161. The standard "flip-in" "shareholder rights plan" establishes an ownership threshold (commonly between 10% and 20%), the crossing of which will trigger massive dilution of the acquiror's position. For periodic updates on pill practices, see SharkRepellent.net, http://www.sharkrepellent.net (on file with the *Columbia Law Review*) (last visited Apr. 23, 2013). A critical feature in most pills is that the definition of beneficial ownership either tracks the "acting in concert" provisions of the SEC's 13D-G regulations or broadens them. See Steven M. Davidoff, Netflix's Poison Pill Has a Shareholder-Friendly Flavor, N.Y. Times DealBook (Nov. 6, 2012, 2:14 PM), http://dealbook.nytimes.com/2012/11/06/netflixs-poison-pill-has-a-shareholder-friendly-flavor (on file with the *Columbia Law Review*) ("[C]ompanies have adopted group language like 'acting with conscious parallelism,' 'acting in concert' or 'cooperating' in order to prevent activist hedge funds from working together."); cf. 17 C.F.R. § 240.13d–3(b) (2012) (including within definition of "beneficial owner" any person who "creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device . . . to evade . . . section 13(d) or (g) of the Act"). The effect of such pill provisions is to make it difficult for significant shareholders to collaborate on an activist initiative. See, e.g., Stahl v. Apple Bancorp, Inc., No. 11,510, 1990 WL 114222, at *2 (Del. Ch. Aug. 9, 1990) (upholding pill provisions that would include committee participation, forming joint slate, or expense sharing within definition of acting in concert). SharkRepellent.net reports that the largest fraction of recent pill adoptions, which were not routine but responsive to specific threats, have been in connection with activism and control issues. John Laide, 2012 Poison Pill Impetus, SharkRepellent.net (Nov. 27, 2012), https://www.sharkrepellent.net/request?an=dt.getPage&st=undefined&pg=/pub/rs_20121127.html&2012_Poison_Pill_Impetus&rnd=369637 (on file with the *Columbia Law Review*).

162. See Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1376 (Del. 1995) (holding target board's adoption of poison pill was not preclusive but "a proportionate defensive response to protect its stockholders from a 'low ball' bid"); Air Prods. & Chems., Inc. v.

authorized by shareholders rather than unilaterally adopted by management, a form of "chewable pill," would address this potential problem.[163] A threshold of 15% or 20% would accommodate activism without opening the way to the accumulation of a control block.[164]

One way to read the current campaign to compel quicker disclosure of shareholder accumulations is as an effort to persuade the SEC to impose the equivalent of a poison pill with a very low trigger at a time when institutional investors are successfully pressuring boards to turn away from poison pills. There is a history here. The genius of the poison pill was that shareholder approval was not necessary; all that was necessary was board approval.[165] In the not-so-distant past, almost all firms could be assumed to have pills, either already adopted or subject to adoption at a moment's notice; in effect, a virtual pill. But, in no small measure because institutional investors came to oppose pills, when proposals to redeem them come to the shareholders, more boards have let pills lapse, or have not adopted them, even when a control battle may be brewing.[166]

Airgas, Inc., 16 A.3d 48, 127–29 (Del. Ch. 2011) (Chandler, C.) (holding Delaware law permitted retention of pill even after incumbent board lost election proxy contest and shareholders had more than one year to consider bidding offer); Ronald J. Gilson, *Unocal* Fifteen Years Later (And What We Can Do About It), 26 Del. J. Corp. L. 491, 493–501 (2001) (reviewing Delaware case law).

163. In this form, the pill would be a contractual version of the Delaware Chancery Court's preferred position with respect to the pill announced initially in City Capital Associates Ltd. Partnership v. Interco Inc., 551 A.2d 787, 798–800 (Del. Ch. 1988) (holding target board's decision not to redeem poison pill was unreasonable because it would "in effect permanently foreclose their shareholders from accepting a noncoercive offer for their stock," a threat "far too mild to justify such a step"), overruled by Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989) (rejecting *Interco* approach because "it would involve the court in substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors"). The Delaware Chancery Court recently reaffirmed its preference in *Interco* in *Airgas*, while acknowledging the contrary controlling Delaware Supreme Court view. 16 A.3d at 101.

164. Other barriers to rapid accumulation of equity positions are also significant. For example, for large capitalization firms, the requirement to file under section 7A of the Clayton Act, 15 U.S.C. § 18a (2006), which is keyed to the value of the stock acquired rather than the percentage of outstanding equity acquired, will often limit the toehold to a level far short of that allowed under § 13(d). This, in turn, makes the issue of extending the computation of beneficial ownership under § 13(d) to derivatives more important. See infra Part V.B. The current thresholds are set forth at Revised Jurisdictional Thresholds of the Clayton Act, 78 Fed. Reg. 2406 (Jan. 11, 2013).

165. See, e.g., Ronald J. Gilson & Reinier Kraakman, Takeovers in the Boardroom: Burke Versus Schumpeter, 60 Bus. Law. 1419, 1431 (2005) ("It is not far fetched to claim that, were a shareholder vote to be required, very few firms now could secure approval of a broadly framed poison pill.").

166. Andrew L. Bab & Sean P. Neenan, The Conference Bd., Inc., Poison Pills in 2011, at 2 (2011), available at http://www.conference-board.org/retrievefile.cfm?filename =TCB%20DN-V3N5-11.pdf&type=subsite (on file with the *Columbia Law Review*) ("Over the past decade, fewer and fewer public companies have maintained traditionally structured poison pills.").

Moreover, although the rare circumstance may validate a low threshold (5%) pill,[167] higher triggers are much more prevalent,[168] reflecting both expectations about unstated judicial limits and board reluctance to take an extreme position in the face of institutional investor opposition. Shortening the disclosure period would go far toward capping the activist's ownership stake, not because of a legal prohibition against acquiring more, but because the economics would militate against it. And it is at this point that the promanagement beauty of the proposed SEC action to accelerate disclosure under the Williams Act emerges from the cloud of advocacy. From the perspective of those urging lower and quicker disclosure triggers at a time when *neither* the shareholders *nor* the board will adopt a pill trigger that is directed at activist shareholders, the proposed SEC rule change will impose it on all corporations without the approval of *either* shareholders *or* boards. Put differently, the SEC would be adopting a regulatory pill directed at activist shareholders at precisely the moment that boards, increasingly, would not adopt one—a genuine coup for those who prefer not only more protection for management from its shareholders, but now more protection from its board as well.[169]

B. *Proposal of Including Economic Exposure Through Derivatives*

The second policy question posed by the proposal to the SEC relates to whether, independent of the timing of disclosure, economic exposure generated through derivatives should count within the definition of beneficial ownership for determining the disclosure threshold.[170] Here the issue is not the accumulation of shares with voting rights, but the acquisition of a purely economic interest. The technique provides economic returns to the activist shareholder on its activity without watering

167. See Versata Enters. v. Selectica, Inc., 5 A.3d 586, 601–06 (Del. 2010) (finding target's "adoption of a 4.99% trigger for its Rights Plan would not preclude a hostile bidder's ability to marshal enough shareholder votes to win a proxy contest" and was reasonable response to threat of change in control and loss of company's net operating loss carryforwards); Paul H. Edelman & Randall S. Thomas, *Selectica* Resets the Trigger on the Poison Pill: Where Should the Delaware Courts Go Next?, 87 Ind. L.J. 1087, 1098–1111 (2012) (discussing *Selectica* and its implications).

168. See Bebchuk & Jackson, supra note 13, at 56 (showing in recent survey 85% of 805 public companies that have pills in place have ownership threshold of higher than 10%, while 24% have pills triggered by higher than 15%).

169. Emmerich et al. cleverly but unpersuasively argue that boards' reluctance to adopt pills is a reason for the SEC to act. See Emmerich et al., supra note 13 (manuscript at 15–16).

170. See Wachtell Petition, supra note 146, at 7–9 (proposing SEC expand definition of "beneficial ownership" under Regulation 13D-G to include ownership through derivatives); see also Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §766(e), 124 Stat. 1376, 1799 (2010) (providing sale or purchase of security-based swaps constitutes beneficial ownership only to extent that SEC deems it so by rule); cf. supra note 144 (discussing proposals to require disclosure of derivative position in E.U. member states and Canada).

down the critical test that the activist must survive to earn that return—the approval of the institutional shareholders.

The easiest way for the activist shareholder to achieve an economic interest divorced from voting rights that could influence the corporation's response to the proffered strategy is through a cash-settled "total return swap," in which the party taking the long side of the swap gets exactly the return of the equivalent equity position without actually holding or obtaining the shares.[171] The swap is a bet about the movement of the stock price. When the swap is unwound, the parties settle up. Stock appreciation results in a cash payment of the gains to the activist; a stock price decline requires the activist to pay out the losses on the deemed position to the counterparty.

In theory, this should be unobjectionable as a policy matter in four separate respects. First, the activist is doubling down on its investment without gaining additional voting leverage to force the adoption of its proposal. This reduces the risk of opportunistic behavior by the activist or other forms of private benefit extraction because the bet increases while decision rights do not. The separation of cash flow rights from control rights goes in the direction that tilts against the activist's goals if those goals are defined as securing voting rights. Second, for the institutional shareholders who ultimately decide whether to support an activist's proposal, the fact that the activist takes a greater economic stake based solely on the performance of the stock is a credible signal of a high-quality proposal: It increases the size of the activist's bet on its proposal without influencing the corporation's decision whether to accept it. Third, for the activist, the synthetic stock position increases its returns from its toehold equity investment and thus encourages the investment in the first place. Fourth, for shareholders generally, the opportunity for higher returns to the activist through proposals that are screened by disinterested institutional decisionmakers will increase the occasions of high-quality shareholder activism, thereby generally reducing the agency costs of agency capitalism.

As developed in the literature[172] and one important case,[173] a major concern is that a total return swap in practice can convey voting rights in

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171. See Henry T.C. Hu & Bernard Black, Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership, 13 J. Corp. Fin. 343, 344 (2007) [hereinafter Hu & Black, Decoupling] (explaining cash-settled equity swap); infra notes 172–173 and accompanying text (explaining total return swaps can give voting rights in addition to economic interest).

172. See Alon Brav & Richmond D. Mathews, Empty Voting and the Efficiency of Corporate Governance, 99 J. Fin. Econ. 289, 289 (2011) ("[S]ome funds may use 'empty voting'—a practice whereby they accumulate voting power in excess of their economic share ownership—to manipulate shareholder vote outcomes and generate trading gains."); Hu & Black, Decoupling, supra note 171, at 344–45 (describing "decoupling" of economic ownership from voting power via derivatives); Henry T.C. Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 79 S. Cal. L. Rev. 811, 828–32 (2006) (same); Kahan & Rock, supra note 95, at 1075–77 (describing

addition to an economic interest and thereby undercut the policy behind the 5% ownership disclosure trigger. Moreover, assembling this trans-threshold economic stake can occur with relatively low visibility, such that it will not activate the self-checking mechanism of block building through market purchases.[174] This is because the "short" swap counterparties will hedge their position by "going long" the stock, that is, through stock purchases.[175] And because of their client relationship with the activist, the argument is that counterparties will not be unbiased in their behavior: They will vote in favor of the activist's proposal in an effort to sustain relationships with their client.[176] Moreover, the stock is available for acquisition whenever the activist chooses. The activist has control over the timing of the swap's unwinding. When the swap is unwound, the counterparties want to reverse their hedge, the sooner the better, and the activist stands ready to buy the blocks and the vote.[177]

The analysis here is a "possibility theorem." Counterparties claim not to behave in this way and are especially sensitive after the federal district court's opinion in *CSX Corp. v. Children's Investment Fund Management (UK) LLP*.[178] Nevertheless, the SEC is called to arms to avoid this scenario through an amendment of the Regulation 13D rules to include even purely economic stock positions, as through cash-settled swaps and other derivatives, within the scope of beneficial ownership and so further limit

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"empty voting" as result of derivative position as "example of an old problem—conflict of interests created by exploiting the separation of legal and beneficial ownership—aggravated by modern financial innovation"); Shaun Martin & Frank Partnoy, Encumbered Shares, 2005 U. Ill. L. Rev. 775, 780 (describing as "economically encumbered" shareholders who lack "homogenous incentives" because they "hold both a share and a short or other derivative position"); Wolf-Georg Ringe, Hedge Funds and Risk-Decoupling—The Empty Voting Problem in the European Union, Seattle U. L. Rev. (forthcoming 2013) (manuscript at 6–21), available at http://ssrn.com/abstract=2135489 (on file with the *Columbia Law Review*) (discussing examples and problems of empty voting in United States and European Union); Michael C. Shouten, The Case for Mandatory Ownership Disclosure, 15 Stan. J.L. Bus. & Fin. 127, 160–63, 170–72 (2009) (discussing "hidden ownership" and "empty voting").

173. CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 519–23 (S.D.N.Y. 2008) (explaining mechanism and purposes of total return swaps), aff'd, 292 F. App'x 133 (2d Cir. 2008), aff'd in part, vacated in part, 654 F.3d 276 (2d Cir. 2011).

174. By "self-checking," we mean that increases in stock price associated with sustained direct purchasing will commonly impose practical restraints for activists seeking to profit from price appreciation in the blocks they acquire. See supra note 159 and accompanying text (explaining how share accumulation is impounded in market price).

175. See *CSX*, 562 F. Supp. 2d at 541–42 (explaining swap counterparties are not "in the business . . . of taking on the stupendous risks entailed in holding unhedged short (or long) positions in significant percentages of the shares of listed companies" and "their positions could not be hedged through the use of other derivatives").

176. See id. at 545–46.

177. See id. at 546.

178. See id. at 552 (holding defendant's total return swap position constituted "beneficial ownership" under Rule 13d-3 because it had ability to influence voting, purchase, or sale decisions by swap counterparties).

the size of the economic stake an activist can take in support of its strategy.[179]

We have two responses. First, in the post-Dodd-Frank world, counterparties may come to lose their hypothesized behind-the-curtain power to deliver votes and shares. Equity derivatives may come to be traded on exchanges, or the process of central clearing may interpose a central clearing party between the two sides to the trade.[180] In other words, hedging may come to be effected quite differently, in a way that drastically reduces the possibility of hidden votes. The SEC should at least wait to see how that plays out before defining beneficial ownership in a fashion that is dictated only by beliefs concerning the informal operation of the derivatives market and the relationship between transacting parties.

Second, the SEC could address the issue more narrowly and more directly simply by defining beneficial ownership to exclude a total return swap that has been "sterilized" through a mirrored voting commitment with respect to any proposal or proxy contest mounted by the activist counterparty. In a sterilized swap, the counterparties are obliged to cast their votes to mimic the voting behavior of the disinterested shareholders. This proposal preserves the advantages of letting activists increase the size of their economic bet on their proposal, while still protecting section 13(d)'s policy of restraining the possibility of sudden control shifts.

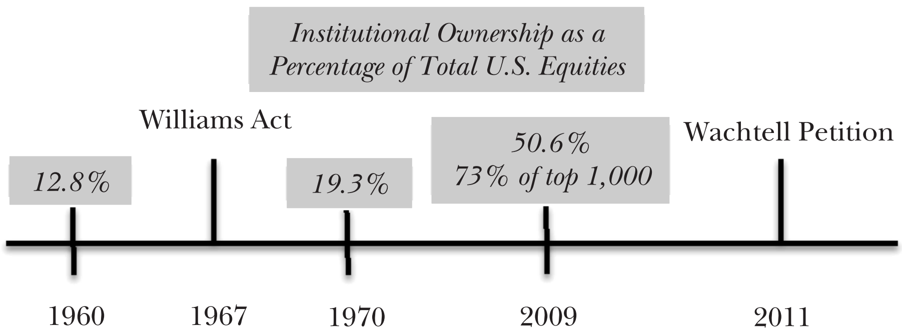
In the end, the case in favor of accelerating the disclosure of an activist shareholder's toehold stake is a claim that the legislative history that animated the Williams Act and section 13(d), based on the structure of the capital markets forty-five years ago, should dictate the SEC's exercise of its discretion now in the face of radically different capital markets and after the reconcentration of share ownership that has given rise to agency capitalism.[181] Figure 4 illustrates the mismatch between this argument and current conditions.

179. See supra note 170 and accompanying text (outlining such proposals).

180. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 723(a)(3), 124 Stat. 1376, 1675–81 (2010) (requiring persons engaging in swap transaction to "submit[] such swap for clearing to a derivatives clearing organization" and requiring swap transactions subject to clearing requirements to be executed on "board of trade designated as a contract market" or "swap execution facility"). The SEC has recently finalized certain rules for security-based swaps, which include equity derivatives, in a release that provides useful background. See Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies, 77 Fed. Reg. 41,601 (July 13, 2012) (to be codified at 17 C.F.R. pts. 240, 249).

181. See supra notes 155–157 and accompanying text (discussing argument based on legislative history).

FIGURE 4: SETTING THE CONTEXT



In 1967, institutional investors collectively owned a relatively small percentage of U.S. equities. Stock ownership was still largely in the hands of individuals. The governance problem was that of Berle and Means: managers who were not accountable to widely dispersed shareholders. As Part II shows, the evolution of the capital markets over the last forty-five years has reconcentrated ownership: Institutional investors now own 73% of the largest one thousand U.S. corporations,[182] and the three largest mutual fund families own 18.75% of total U.S. public equities and direct the voting of a much larger percentage.[183] The result has been to shift governance concerns to those of agency capitalism: the devaluation of governance rights that results from those rights being held by investment intermediaries who rationally undervalue them. Activist shareholders then function as a response to concentrated institutional ownership and as a means to arbitrage the value of governance rights by creating the opportunity for reticent institutional record shareholders to act in their beneficiaries' interest. Nothing requires that the SEC ignore dramatic changes in the capital markets over the last forty-five years when evaluating the current section 13(d) disclosure regime.

CONCLUSION

We have described an embedded monitoring shortfall in the dominant form of share ownership in the United States and other jurisdictions as well. Intermediary institutional investors are highly effective vehicles for financial intermediation and risk bearing. Their effectiveness derives in part from the specialization that also gives rise to what we have called the agency costs of agency capitalism. Rather than insist that institutions remodel themselves in a fashion that is inconsistent with their business model and therefore unlikely to succeed, we have suggested that the downside of specialization may be best addressed by fostering the development of a complementary set of specialists, in this case, activist

182. See supra Table I.
183. See supra notes 78 and accompanying text.

shareholders, a species of hedge funds. On the governance dimension, institutional investors are not so much rationally passive as rationally reticent. The interaction between shareholder activists and institutional investors—one proposing, the other disposing—gives value to the institutions' low-powered governance capacities, in effect operating to arbitrage the undervaluation of governance rights in the hands of reticent institutional investors. Governance markets thus become more complete. The net result is better monitoring and, perhaps, lower agency costs in the real economy.

To be sure, there is a risk that both institutional investors and activist investors may be myopic, to the end of increasing the value of a speculative option.[184] But there is a corresponding risk that company managers may be hyperopic, acting to increase the option value of their control by extending its length, especially if, because of poor performance and strategy, it is then out of the money. No governance structure will perfectly distinguish between those alternatives, in part because the conflicting views are not mutually exclusive and both sides may have come to hold those views in good faith. In the end, we do best by allowing activist shareholders to bet their assets on their ability to persuade sophisticated institutional investors that they are right in their assessment of portfolio company strategy.

184. See, e.g., Patrick Bolton & Frederic Samama, L-Shares: Rewarding Long-Term Investors 13–16 (Nov. 2012) (unpublished manuscript), available at http://ssrn.com/abstract=2188661 (on file with the *Columbia Law Review*) (designing security that would make investors more long-term-oriented).

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