INSTITUTIONAL INVESTORS, ACTIVIST FUNDS AND OWNERSHIP STRUCTURE

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INTRODUCTION

One of the important developments underlying capital markets is the dramatic increase in the size and influence of institutional investors. Institutional investors hold 41% of global market capitalization.[1] In the United States, for example, institutional investors collectively own 70-80% of the entire U.S. capital market.[2] Moreover, a small number of asset managers hold significant stakes at each public company.[3] A typical large public corporation has between three to five large institutional investors as shareholders, each holding approximately 5-10% of the corporation's stock. Other institutional investors (mutual funds, pension funds, insurance companies, etc.) hold smaller percentages, comprising up to an additional 50% of the corporation's shares.[4]

These ownership patterns, however, are not uniform across countries. In Europe, institutional investors hold only 38% of market capitalization,[5] and institutional investors' share of the market is even smaller in Asia.[6] Moreover, US-domiciled investors account for 65% of global institutional investor holdings.[7]

Since its early days, the rise in institutional investors' ownership has produced academic studies on the corporate governance role of institutional investors. The literature initially celebrated these investors' ability to actively monitor insiders,[8] but then focused on institutional investors' shortcomings in improving corporate performance. Academics have identified many reasons—ranging from conflicts of interest to collective action problems and suboptimal fee structure—that undermine institutional investors' incentives to monitor management.[9] More recently, the literature has addressed the differences between active and

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1 *See* Adriana De La Cruz, Alejandra Medina & Yung Tang, *Owners of the World's Listed Companies*, OECD CAPITAL MARKET SERIES (2019), www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.htm.

2 *See* Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 69, 74 (2017).

3 This Chapter refers to those that make investment decisions on behalf of the funds as "asset managers."

4 *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES 98 tbl. L.208 (2014), https://www.federalreserve.gov/releases/z1/20141211/z1.pdf [http://perma.cc/7A29-78S7].

5 See *Owners of the World's Listed Companies*, *supra* note 1, at 11. This includes the United Kingdom, where the average holdings by institutional investors are much higher. *See id.* at 12.

6 *Id.* at 11.

7 *Id.* at 6.

8 *See* Bernard S. Black, *Agents Watching Agents*: *The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

9 *See, e.g.*, Jill E. Fisch, *Relationship Investing:Will It Happen?Will It Work?*, 55 OHIO ST. L.J. 1009 (1994).

passive investors,[10] the antitrust implications of common ownership,[11] strategic voting,[12] and the passivity of mutual funds in filing lawsuits against insiders.[13]

The academic literature, however, tends to focus on U.S. institutional investors. A substantial body of empirical literature, for example, studies the investor-level qualities that might affect mutual funds' voting patterns.[14] Outside the United States, in contrast, only a limited number of studies, on countries such as Israel,[15] the Netherlands,[16] and the United Kingdom,[17] offer an empirical account of institutional investors' voting patterns.

The governance role of institutional investors depends on myriad economic, cultural, and regulatory factors that vary across countries. The structure of the pension market (private v. public; defined benefit v. defined contribution) determines the size of the local asset management industry and its share of domestic capital markets.[18] Local regulations determine institutional investors' incentive structure and the nature of their duties to their own clients. Business or ownership ties between asset managers and public companies determine the extent to which conflicts of interest might affect institutional investors' stewardship.

Finally, social norms and local culture might dictate the extent to which (domestic) institutional investors are willing to openly confront management. Indeed, there is evidence that, in several markets, foreign institutional investors tend to be more confrontational than local ones.[19] And a recent study about

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[10] *See generally* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019); Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17 (2019); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018); Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* (N.Y. Univ. Sch. Law, Working Paper No. 18-39, 2018).

[11] *See* José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1558 (2018).

[12] *See* Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, 2019 U. ILL. L. REV. 223 (2019).

[13] *See* Sean J. Griffith & Dorothy S. Lund, *Toward a Mission Statement for Mutual Funds in Shareholder Litigation*, U. CHI. L. REV. (forthcoming 2020).

[14] *See, e.g.*, Alon Brav, Wei Jiang, Tao Li, & James Pinnington, *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* (Mar. 1, 2018), https://ssrn.com/abstract=3101473; Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds* 20 (Feb. 14, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3124039.

[15] *See* Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17 REV. FIN. 691 (2012).

[16] *See* Christoph Van der Elst & Anne Lafarre, *Shareholder Stewardship in the Netherlands: The Role of Institutional Investors in a Stakeholder Oriented Jurisdiction* (ECGI - Law Working Paper No. 492, 2020), https://ssrn.com/abstract=3539820.

[17] *See* Suren Gomtsian, *Shareholder Engagement by Large Institutional Investors* (July 1, 2019), https://ssrn.com/abstract=3412886l.

[18] See Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909 (2013).

[19] See, for example, Reena Aggarwal, Isil Erel, Miguel Ferreira & Pedro Matos, *Does Governance Travel Around the World? Evidence from Institutional Investors*, 100 J. FIN.

Japan, for example, argues that the objective of Japan's stewardship for institutional investors was to "change the attitude of domestic institutional investors so as to make Japanese corporate governance more oriented towards the interests of shareholders rather than stakeholders."[20] In other countries, such as Germany, the premise that institutitiuional investors' should actively exercise stewardship is a matter of debate.[21]

These multi-dimensional differences question the extent to which findings about institutional investors' in one country can be generalized to offer a single theory with universal application. In this chapter, therefore, we focus on one dimension by which institutional investors' governance role may vary across countries: the ownership structure of public companies. Specifically, we analyze the governance implications of the rising influence of institutional investors against the background of another development, namely, the rise of activist hedge funds. Using proxy fights and other tools to pressure public companies into making business and governance changes,[22] activist funds have had a dramatic impact on modern capital markets.[23] The success of activist funds crucially depends on the support of institutional investors. In fact, the role of activist hedge funds in driving change seems to have grown with the rise of institutional investors' ownership.[24]

We advance several arguments in this chapter. First, the rise of institutional investors reinforces the differences between widely held and controlled companies. In widely held companies, especially in countries where hedge fund activism is more prevalent and the asset-management industry is more concentrated, institutional investors have tremendous influence over companies in their portfolio. At controlled companies, in contrast, the growth of

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ECON. 154 (2001).

20 See Gen Goto, *The Logic and Limits of Stewardship Codes: The Case of Japan*, 15 BERKELEY BUS. L.J. 365, 372 (2019).

21 See Wolf-Georg Ringe, *Stewardship and Shareholder Engagement in Germany* (ECGI - Law Working Paper No. 501, 2020), https://ssrn.com/abstract=3549829.

22 For an early review of activist hedge funds, see generally Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007). For more recent reviews, see generally Ajay Khorana, Anil Shivdasani & Gustav Sigurdsson, *The Evolving Shareholder Activist Landscape (How Companies Can Prepare for It)*, 29 J. APPLIED CORP. FIN. 8 (2017). *See also* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296 (2016).

23 In 2019, for example, 147 activist investors targeted 187 companies and won 122 board seats, while in 2018 a similar number of 131 activist investors targeted 226 companies and won 161 board seats. *See* LAZARD S'HOLDER ADVISORY GRP., 2019 REVIEW OF SHAREHOLDER ACTIVISM 2-6 (2020) [hereinafter LAZARD 2019 REVIEW], https://www.lazard.com/media/451141/lazards-2019-review-of-shareholder-activism-vf.pdf; LAZARD S'HOLDER ADVISORY GRP., 2018 REVIEW OF SHAREHOLDER ACTIVISM 1 (2019) [hereinafter LAZARD 2018 REVIEW], https://www.lazard.com/media/450805/lazards-2018-review-of-shareholder-activism.pdf [https://perma.cc/Y24P-8PNG].

24 *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013).

institutional investors is less likely to have a dramatic effect on the allocation of power between insiders and public shareholders.[25]

Second, powerful institutional investors at widely held companies are likely to exert their influence behind the scenes. This is true even for countries in which behind-the-scene influence is not necessarily the product of local norms. Large institutional investors' size and clout mean that they can influence management without resorting to the aggressive tactics used by activist hedge funds.

Third, even among countries with widely held public companies, we do not expect a uniform rise in the influence of institutional investors. Country-specific regulations, political sentiment, social norms or other factors will determine whether and how institutional investors wield their power. For example, behind-the-scenes tactics are likely to be especially prevalent not only in countries where social norms discourage open confrontation, but also where political sentiment run against concentration of power in the hands of few powerful financial actors.

This is especially true for the United States where, coincidently, the regulatory regime practically prevents large institutional investors from making activist moves such as nominating of directors to the board.[26] An intriguing case is that of countries that move from concentrated to dispersed ownership of public companies. As we explain below, institutional investors in these countries can quickly become quite powerful without regulatory impediments to manifesting their power as shareholders.

Fourth, we argue that some activist interventions—those that require the appointment of activist directors to implement complex business changes—cannot be pursued even by powerful and well-motivated institutional investors. This is true even for countries in which the regulatory framework allows institutional investors to nominate director. Activist directors, we argue, need to share nonpublic information with the fund that appointed them. Sharing such information with institutional investors, however, would create significant insider trading concerns and would critically threaten institutional investors ability to trade securities which lies at the basis of their business model. Accordingly, this form of intervention could not be pursued by institutional investors without dramatic changes to their respective business models and regulatory landscape.

I. INSTITUTIONAL INVESTORS' SOFT POWER

This Part considers the implications of the rise of institutional investors' power against two developments: the rise of activist hedge funds and the concentration of power within a relatively small group of asset managers.

The rising power of institutional investors, we argue, has changed and will continue to change the corporate governance of companies without controlling shareholders. With powerful institutional investors and the omnipresent threat of an intervention by an activist hedge fund, both institutional investors and corporate managers have an interest in getting results in a softer way. When a

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25 Almost by definition, activism is limited when the company has a controlling shareholder. *See, e.g.*, Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60 (2016).

26 *See infra* notes 89-90.

few powerful investors collectively control a substantial fraction of voting rights, managers have strong incentives to listen to them, even when they speak softly.

Thus, engagement and other forms of institutional investors' actions are likely to occupy an increasingly influential role for widely held companies. Moreover, this chapter predicts that large asset managers will increasingly focus their engagement efforts on strategic business issues, in contrast to mere governance and public policy matters. This is the result of the incentives produced by the large stake held by the largest asset managers, as well as management's interest to learn about investors' views about the company's performance. We consider first management incentives to engage with institutional investors and then the available evidence on engagement by these investors.

A. *Management Incentives*

There is widespread evidence of the growing influence of institutional investors on corporate governance.[27] A common critique of these investors is that they are not as proactive as activist hedge funds in pushing for changes, especially business-related ones, at their portfolio companies.[28] Critics specifically target asset managers who specialize in passive investments, who are often the investors holding the largest stakes of public companies.[29] Hedge funds, however, commonly buy only slivers of equity in the companies they target.[30] Hedge fund activism's success thus depends on the support of large institutional investors.[31] Without these investors' support, activist hedge funds would be no more than paper tigers, as they would be unable to win proxy fights thus losing their most potent threat against underperforming managers.

In other words, while they do not adopt the same tactics as activist hedge funds, large institutional investors are those that hold the power to determine whether management would continue and run the company. These investors can exercise considerable influence without necessarily resorting to aggressive tactics.

The power held by institutional investors has clear implications for the incentives of management and boards of directors to engage with these investors. In a market environment where large institutional investors collectively determine the outcome of shareholder votes, why would boards go against their largest institutional investors? Moreover, boards have an incentive to avoid costly and public fights with activists, and boards realize that activists with a compelling claim for increasing value are likely to get support from influential investors.

In fact, even without outside pressure by institutional investors, boards might initiate business or operational moves that would make their companies less

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[27] For a review, see Goshen & Hannes, *The Death of Corporate Law*, 94 N.Y.U. L REV. 263, 277-83 (2019).

[28] *See* Gilson & Gordon, *supra* note 24, at 890.

[29] *See supra* note 10.

[30] *See* Martijn Cremers, Saura Masconale & Simone M. Sepe, *Activist Hedge Funds and the Corporation*, 94 WASH. U. L. REV. 261 (2016).

[31] *See* Gordon & Gilson, *supra* note 24, at 867.

attractive as targets for activists.[32] Advisors today urge boards to "think like an activist" and take measures that would mitigate the risk of an activist attack.[33] Given an increase in the perceived threat of activist attacks, even firms that were not targeted by activists might implement changes that are favored by activists, such as increasing leverage or decreasing capital expenditures.[34]

More important, boards and management have powerful incentives to initiate communications with their largest investors.[35] First, management has an interest in learning what its investors, and especially the large ones, think about the company's performance and its management strategy.[36] After all, managers who lose their investors' support increase their chances not only of being targeted by an activist, but also of losing the fight. Good communications with investors may allow managers to win future battles against activists. The same logic applies to managers of activist hedge funds. To secure the backing of the institutional investors, it is wise for hedge funds to engage with them in advance.[37] Otherwise, a large investment by the hedge fund may be in vain.

The DuPont proxy fight illustrates the importance of maintaining relationships with the largest institutional investors.[38] The activist campaign to oust the chairman of the London Stock Exchange provides a UK example.[39] The campaign failed, but only after the two largest shareholders, BlackRock and Qatar's sovereign wealth fund, gave prior indications that they would side with the chairman.[40]

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[32] *See* FRIED, FRANK HARRIS, SHRIVER & JACOBSON LLP, M&A/PRIVATE EQUITY BRIEFING: SHAREHOLDER ACTIVISM 7 (2018), https://www.friedfrank.com/siteFiles/Publications/FFMAPE1H2018DevelopmentstheImpactandtheFutureofActivism092418.pdf [https://perma.cc/9MH5-JR5V].

[33] *Id.* ("Companies, together with outside advisors, should 'think like an activist' to identify and (where appropriate) address potential vulnerabilities that may attract activist scrutiny.").

[34] *See* Nickolay Gantchev, Oleg Gredil & Chotibhak Jotikasthira, *Governance Under the Gun: Spillover Effects of Hedge Fund Activism,* 23 REV. FIN. 1031 (2019).

[35] *See* David R. Beatty, *How Activist Investors Are Transforming the Role of Public-Company Boards*, MCKINSEY & CO. (Jan. 2017), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/how-activist-investors-are-transforming-the-role-of-public-company-boards [https://perma.cc/U9GG-MB4U].

[36] *See id.*

[37] *See* Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Activism: The State of Play*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 10, 2018), https://corpgov.law.harvard.edu/2018/10/10/activism-the-state-of-play-2/ [https://perma.cc/Z8TD-7XEJ].

[38] Trian Partners led a proxy fight to replace four DuPont directors. David Benoit & Jacob Bunge, *Nelson Peltz Launches Proxy Fight Against DuPont*, WALL STREET J. (Jan. 8, 2015, 9:07 PM), https://www.wsj.com/chapters/nelson-peltz-launches-proxy-fight-against-dupont-1420761264. However, direct communication between management and asset managers saved the day for DuPont incumbents. Andrew R. Brownstein et al., *Winning a Proxy Fight—Lessons from the DuPont-Trian Vote*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 18, 2015), https://corpgov.law.harvard.edu/2015/05/18/winning-a-proxy-fight-lessons-from-the-dupont-trian-vote/ [https://perma.cc/SU5X-VPWB].

[39] *See* Phillip Stafford, *LSE chairman wins battle against activist attempt to oust him*, FIN. TIMES (Dec. 19, 2017), https://www.ft.com/content/1c9dd24c-c467-3f4c-9eda-8801892a1b2d.

[40] *See* Huw Jones & Maiya Keidan, *TCI fails in bid to oust London Stock Exchange*

Finally, whether management or the hedge funds have the upper hand in the battle, the determinative force of institutional investors tends to moderate the interaction. As phrased by Gregory Taxin, the co-founder of the proxy advisory firm Glass Lewis "the brute force of ownership is not required anymore because the big institutional players listen to both sides and are willing to back the activist funds if they believe in them."[41]

B. *Engagement Trends*

1. Rise in Engagement

When institutional investors know that—at least as a group—they have the power to replace the board, they have little reason to resort to aggressive tactics to influence companies in their portfolio. Rather, they can convey whatever concerns they may have directly to management or the board.

Institutional investors, therefore, are increasingly likely to "engage" with companies in their portfolio. The term "engagement" describes various types of communications and discussions with portfolio companies, including meetings, e-mails, and phone conversations. As explained above, engagement takes place not only because institutional investors wish to be involved, but also because corporate managers have a strong interest in learning about money managers' views.[42]

These discussions between management and institutional investors are private, thereby making it difficult to reliably track the number of meetings, the nature of the topics raised by money managers, and their ultimate influence on management.[43] Moreover, institutional investors may have a clear interest in presenting a picture of substantial investment in engagement, because regulators and the public expect them to do so.[44] After all, as recently stated by the European Parliament: "Effective and sustainable shareholder engagement is one of the cornerstones of the corporate governance model of listed companies."[45]

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chairman, REUTERS (Dec. 19, 2017), https://www.reuters.com/chapter/us-lse-chairman-vote/tci-fails-in-bid-to-oust-london-stock-exchange-chairman-idUSKBN1ED1I6.

[41] *See* Ernest 'doc' Werlin, *Activist Investors Prove Good for More than Short-Term Profit*, HERALD-TRIB. (May 1, 2014), https://www.heraldtribune.com/chapter/LK/20140501/business/605183887/SH/.

[42] *See* Chris Ruggeri, *Investor Engagement and Activist Shareholder Strategies*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 19, 2019), https://corpgov.law.harvard.edu/2019/02/19/investor-engagement-and-activist-shareholder-strategies/.

[43] *But 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 (2009).

[44] Direct engagements are therefore complemented by the use of corporate proxy voting guidelines published by institutional investors, as well as letters drafted by those investors providing insights into their priorities, views and philosophy. See Asaf Eckstein, *The Push Towards Corporate Guidelines* (working paper, 2020) (on file with the authors).

[45] *See* Directive 2017/828 of the European Parliament and of the Council, May 17, 2017. On the other hand, recent antitrust concerns — arising from the common ownership literature — may encourage the largest institutional investors to underplay their influence on companies in their portfolio.

Management and institutional investors had private discussions in the past.[46] The available sources, however, suggest that the rise in engagement intensity in recent years is notable both in the US and Europe. While in 2010 merely 6% of S&P 500 companies reported engagement with major investors, the number swelled to 72% in 2017.[47] The majority of the large institutional investors currently engage in direct discussions with the management of their portfolio companies,[48] and many of them hold private meetings with board members without management's presence.[49] Engagements between institutional investors and managers of their portfolio companies is becoming more common in Europe as well.[50] Such engagements have become commonplace in the UK, Netherlands, Germany and elsewhere.[51] In a global survey of institutional investors (36% of them from Continental Europe, 25% of which from the US and 15% from the UK), 64% of respondents report engagements with the managements of portfolio companies, and 45% engaged with board members outside of the managements' presence.[52]

In some countries, cultural norms may lead institutional investors to prefer informal avenues of influence. In other countries, in contrast, such soft tactics may be a necessity for large institutional investors. As John Morley explains, different types of regulation practically prevent large institutional investors in the United States from adopting some activist tactics.[53] Such regulatory restrictions are consistent with the political economy of U.S. financial regulation. As Mark Roe famously argued, American politics has a long history

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[46] Willard T. Carleton et al., *The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335 (1998).

[47] ERNST & YOUNG, 2017 PROXY SEASON REVIEW 4 (2017), http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/$File/ey-2017-proxy-season-review.pdf [https://perma.cc/FDK8-SDZ4].

[48] *See, e.g.*, Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuk-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 395 (2016) (reporting that T. Rowe Price, large asset manager that concentrates on actively managed mutual funds, "holds hundreds of short, direct conversations with companies owned in portfolios it manages throughout the year on issues that fall beyond the normal due diligence meetings with the companies").

[49] *See* Joseph A. McCahery, Zacharias Sautner & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2906 (2016).

[50] *See* Giovanni Strampelli, *Knocking at the Boardroom Door: A Transatlantic Overview of Director-Institutional Investor Engagement in Law and Practice*, 12 VA. L. & BUS. REV. 187 (2017).

[51] *See* Wolf-Georg Ringe, *Shareholder Activism: A Renaissance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 3, 17 (Jeffrey Gordon & Wolf-Georg Ringe eds., 2015); Klaus J. Hopt, *The Dialogue Between the Chairman of the Board and Investors: The Practice in the UK, the Netherlands and Germany and the Future of the German Coporate Governance Code Under the New Chairman* (EGCI - Law Working Paper No. 365, 2017), https://ssrn.com/abstract=303693.

[52] *See* Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905 (2016).

[53] *See* John Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407, 1423-37 (2019).

of preventing financial institutions from taking a lead position in ownership and governance.[54]

2. Change in Focus

Currently, institutional investors seem to concentrate their interventions on governance, sustainability and market wide policy matters.[55] Institutional investors' focus on governance makes sense as they enjoy economies of scale when dealing with issues they repeatedly encounter in many companies in which they invest.[56]

We believe, however, that these investors will increasingly focus their engagements on business matters. Engagement creates an important channel of communication between institutional investors and corporate insiders. This channel may be used to discuss not only governance concerns, but also company performance and the need for strategic changes. As explained above, management has an incentive to learn about institutional investors' view of the company's strategy. Thus, management might use this channel to initiate discussions about the company's business plan. Second, institutional investors, and especially the largest ones, have an interest in improving the performance of companies in their portfolio, and engagement provides them with a relatively cheap way of doing so.

To be sure, unlike hedge funds, institutional investors might lack sufficiently strong incentives to formulate complicated business plans for portfolio companies,[57] and their staff devoted to engagements are perhaps not savvy in strategic business planning.[58] But institutional investors have the expertise to sense problems in company performance and are the ones who, once an activist arises, analyze solutions offered by the portfolio companies' managers. In fact, the matters that may cause an activist hedge fund to enter the arena and launch an activist campaign are the same matters that may be discussed in these engagements.[59] When necessary then, institutional investors may display

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[54] Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 40-41 (1991) ("popular opinion made it easy for politicians to fragment financial institutions").

[55] As BlackRock's managers explain, "for the most part, the focus of investment stewardship activities is governance-related (e.g., board composition, the board's oversight role)." Barbara Novick, Michelle Edkins & Tom Clark, *The Investment Stewardship Ecosystem*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 24, 2018), https://corpgov.law.harvard.edu/2018/07/24/the-investment-stewardship-ecosystem/ [https://perma.cc/7UFK-XM58].

[56] For passive investors, the focus on governance can also be explained by the competition with active funds. *See* Fisch, Hamdani & Solomon, *supra* note 10, at 20.

[57] Gilson and Gordon believe that institutional investors' business models prevent them from crafting any business plan for portfolio companies. *See* Gilson & Gordon, *supra* note 24, at 893.

[58] *See* Bebchuk & Hirst, *supra* note 10, at 5 ("[T]he Big Three devote an economically negligible fraction of their fee income to stewardship, and . . . their stewardship staffing enables only limited and cursory stewardship for the vast majority of their portfolio companies.").

[59] Some funds act mainly through private engamanets. Hermes, the fund manager of the British Telecom Pension Scheme, frequently seeks and achieves significant changes in portfolio's company strategy through private interventions that are unobservable from the outside. *See* Becht et al., *supra* note 43.

concern or dissatisfaction and urge corporate managers to offer an alternative strategic plan for their review.

Indeed, there are hints for a broader focus of money managers' engagements. A recent study of engagement by a large UK investor found that engagement is not limited to governance concerns.[60] One of the reasons for engagement that BlackRock mentions is "an event at the company that has impacted its performance or may impact long-term company value," and it continues to explain that "[w]here [BlackRock's managers] believe a company's business or governance practices fall short, [they] explain [their] concerns and expectations."[61] Moreover, in his annual letter for 2019 to the CEOs of public companies, Larry Fink, BlackRock's CEO, noted that the second engagement priority for 2019 is "corporate strategy and capital allocation."[62]

If corporate managers do not respond to institutional investors' concerns, institutional investors' dissatisfaction could become louder, thereby reaching the ears of activist hedge funds. Large institutional investors' dissatisfaction may serve as a fertile ground for the operation of hedge funds. Even today, institutional investors do not always take the back seat in initiating activism, and in some cases they even issue an informal "Request for Activism."[63] Although large institutional investors are hesitant to admit this practice, some activist hedge funds are quite open about it.[64]

Bill Ackman, the founder of the hedge fund Pershing Square, has stated, "Periodically, we are approached by large institutions who are disappointed with the performance of companies they are invested in to see if we would be interested in playing an active role in effectuating change."[65] And Jeff Smith, the CEO of the activist hedge fund Starboard, explained that this is an evolving practice: "Mutual funds and passive investors have come not only to appreciate what we do but encourage us. It used to be they would wait and hope. Over the

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[60] Marco Becht, Julian R. Franks, & Hannes F. Wagner, *Corporate Governance Through Voice and Exit* (ECGI – Finance Working Paper No. 633, 2019), https://ssrn.com/abstract=3456626.

[61] Novick, Edkins & Clark, *supra* note 55 (listing BlackRock's main reasons for engagement with companies).

[62] Letter from Larry Fink, CEO, Blackrock Inc., to CEOs, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/JP5U-4JB2].

[63] Merritt Moran, *Ten Strategic Building Blocks for Shareholder Activism Preparedness*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 20, 2016), https://corpgov.law.harvard.edu/2016/12/20/ten-strategic-building-blocks-for-shareholder-activism-preparedness/ [https://perma.cc/ZM9W-CNFP] ("Today, major institutions have frequently sided with shareholder activists, and in some cases privately issued a 'Request for Activism', or 'RFA' for a portfolio company, as it has become known in the industry.").

[64] *See* David Gelles & Michael J. De La Merced, *New Alliances in Battle for Corporate Control*, N.Y. TIMES: DEALBOOK (Mar. 18, 2014, 9:40 PM), https://dealbook.nytimes.com/2014/03/18/new-alliances-in-battle-for-corporate-control/ [https://perma.cc/96TT-2RCR] ("In certain circles, T. Rowe Price . . . has gained a reputation for pursuing hedge funds and encouraging them to take up an activist campaign. The firm denies it suggests certain targets for activists but acknowledges it is in regular dialogue with other investors about the companies in its portfolio . . . .").

[65] *See* Simi Kedia, Laura Starks & Xianjue Wang, Institutional Investors and Hedge Fund Activism 11 (Sept. 2017) (unpublished manuscript), https://www.aeaweb.org/conference/ 2018/preliminary/paper/bFre7SK7.

past five years they have added another choice: they call us and want us to get involved."[66]

To summarize, the description of institutional investors as "arbiters" between activist hedge funds and corporate managers is somewhat misleading.[67] It may imply that institutional investors are passive actors, like judges, who wait until an activism campaign starts and then decide its fate. This chapter prefers to describe their role, and especially the largest asset managers, as "kingmakers." Kingmakers need not be passive or reactive and have much leeway to decide how active they wish to be. They will never take the throne themselves, but they may play a dramatic role. Depending on whether asset managers are satisfied with management efforts or results, they can prevent or facilitate a successful hedge fund activism campaign.

We therefore expect that engagements will displace some forms of activism. Indeed, when more managers become responsive to institutional investors' wishes, the need for an activist hedge fund's intervention becomes smaller. Institutional investors today are careful in exerting their power, and large-scope engagement is a relatively new phenomenon. But both institutional investors and corporate managers have the incentive to develop the capabilities to work out mechanisms that ensure institutional investors' satisfaction with management's performance and strategy without the need for aggressive forms of activism.

The extent to which this process will apply to other countries with widely held companies depends on two important factors. First, the relative size and market concentration of (domestic) institutional investors. The fact that several large asset managers control a significant share of the votes makes it easier for management to communicate with investors and increases management's responsiveness to these investors' views. Second, our analysis assumes that institutional investors would support activist funds that deploy aggressive tactics against poorly performing management. Local norms in some countries (such as Japan) discourage certain types of activism. The lack of a credible threat of successful activist intervention reduces the likelihood that institutional investors would be able to affect corporate management to change its ways.

C. Implications.

Our analysis about the increasing importance of informal communications between management and institutional investors has several implications for academics and policymakers.

First, the increasing reliance by institutional investors on informal channels of influence presents a challenge for researchers of institutional investors and corporate governance. Studies of institutional investors' stewardship typically focus on these investors' public actions—whether they openly confront management by submitting shareholder proposals, voting against management or filing shareholder lawsuits.[68] But, powerful institutional investors are more

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[66] Chris Dieterich, *Activist Hedge Funds Now Fielding Calls from Fund Companies*, BARRON'S (May 7, 2015, 10:07 AM), https://www.barrons.com/chapters/activist-hedge-funds-now-fielding-calls-from-fund-companies-1431007632.

[67] *See* Gilson & Gordon, *supra* note 24, at 917.

[68] *See, e.g.*, Bebchuk & Scott, *supra* note 10; Griffith & Lund, *supra* note 13.

likely to exercise behind-the-scenes influence.[69] The more influential is an institutional investor, the less likely it is to undertake confrontational measures to ensure that its view counts. By their nature, informal avenues of influence are much harder to observe.[70]

Thus, studies that focus only on public expressions of stewardship, such as voting, might offer an incomplete account of institutional investors' governance role. In fact, one important—but difficult to identify—outcome of institutional investors' potency is that management would not even attempt to submit proposals to a shareholders' vote when it knows that the largest institutional investors are likely to object.[71]

Second, for both academics and lawmakers, the growing importance of engagement with institutional investors raises questions about transparency.[72] Institutional investors are required in some jurisdictions to make their voting record public. Yet, at least for the largest institutional investors, behind-the-scenes engagement increasingly becomes more important than voting. To the extent that the "real action" takes place through informal communications between corporate insiders and large investors, policymakers should consider the need for transparency at either the investor, the public company level or both.[73]

For example, policymakers can impose disclosure requirements designed to provide information to investors who are not part of the dialogue with management. Another objective may be providing information to institutional investors' own clients about the nature of engagement activities undertaken by money managers. In both cases, disclosure requirement can cover not only the existence of engagements,[74] but also their content.

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[69] *See, e.g.*, Mallow & Sethi, *supra* note 48, at 395 ("Among the S&P 500 companies that disclosed engagement, almost half (forty-six percent) disclosed changes in practices or disclosure as a result of such engagement in 2015.").

[70] *See* Lucian A. Bebchuk & Michael S. Weisbach, *The State of Corporate Governance Research*, 23 REV. FIN. STUD. 939, 942 (2010).

[71] *See* Rob Bauer, Frank Moers & Michael Viehs, *Who Withdraws Shareholder Proposals and Does it Matter? An Analysis of Sponsor Identity and Pay Practices*, 23 CORP. GOVERNANCE: INT'L REV. 472 (2015).

[72] Others have raised concerns about the transparency of institutional investors' communications with management. See Sarah Haan, *Shareholder Proposal Settlements and the Private Ordering of Public Elections*, 126 YALE L.J. 262, 310 (2016) ("All forty-two of the shareholder proposal settlements reviewed for this study were initiated by institutional investors, who dominate the process to the exclusion of others . . . . [T]hese other stakeholders do not participate in settlements, and if they learn of the settlements at all, it is after the process is completed.").

[73] To the best of our knowledge, most countries do not require institutional investors to disclose information about company-specific engagements. There is, however, some voluntary disclousre. PWC's 2016 analysis of a sample of 100 proxy statements of US S&P 500 companies found that 64% of those companies voluntarily disclosed the existance of engagments. *See* Strampelli, *supra* note 50, at 238.

[74] Others have raised concerns about the Reg FD and selective disclosure issues. *See* Martin Bengtzen, *Private Investor Meetings in Public Firms: The Case for Increasing Transparency*, 22 FORDHAM J. CORP. & FIN. L. 33, 75 (2017); Joseph W. Yockey, *On the Role and Regulation of Private Negotiations in Governance*, 61 S.C. L. REV. 171 (2009).

Third, as one of us has argued elsewhere,[75] the increasing power of institutional investors means that they are less likely to rely on the legal system to address managerial agency costs. Corporate law therefore loses some of its power as a source of binding norms for managers. At the same time, with institutional investors becoming more powerful, lawmakers might need to consider measures to ensure that institutional investors, especially the largest ones, do not opportunistically use their power.[76]

II. DIRECTOR APPOINTMENTS

A notable feature of hedge fund activism is the appointment of so-called activist directors. Critics have pointed to institutional investors' failure to nominate directors as yet another evidence these investors' conflicts and suboptimal stewardship incentives.[77] In this Part, however, we explain that even powerful and well-motivated institutional investors cannot displace hedge funds when activism requires the appointment of directors to drive complex business changes.

To be sure, institutional investors' involvement in director appointments—and even nominating directors—can improve the market for directors by making directors more accountable to public investors. Yet, institutional investors cannot nominate directors that would perform the same function as activist directors. Activist directors, we argue, rely on their ability to share nonpublic company information with the fund that appointed them. Institutional investors, however, are extremely limited in their ability to continuously receive nonpublic information from these directors.

A. *Board Appointments: Activists vs. Institutional Investors*

Activist campaigns often include the appointment of directors to the target's board.[78] Most of these directors are appointed as the result of a settlement between the board and the activist, and only a minority of these directors are appointed by a shareholder vote after a proxy fight. In 2018, for example, only thirty-five out of 161 board seats won by activist funds in publicly traded companies around the world (mostly U.S. and European) were the outcome of a proxy fight (22% percent), while the other 126 seats were obtained via settlements.[79]Activist directors normally compose less than a majority of board

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[75] *See* Goshen & Hannes, *supra* note 27.

[76] *See* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017).

[77] *See* Bebchuk & Hirst, *supra* note 10, at 2098.

[78] In 2019, for example, activists appointed 122 directors to the boards of sixty-five public companies,while in 2018 they appointed 161 directors to the boards of sixty-seven public companies. *See* LAZARD 2019 REVIEW, *supra* note 23, at 15; *see also* LAZARD 2018 REVIEW, *supra* note 23, at 8. These Lazard studies focus only on companies whose market capitalization exceeding $500 billion.

[79] *See* LAZARD 2018 REVIEW, *supra* note 23, at 8. In 2017, only fourteen percent of board seats were won through a proxy fight, and in 2019 the rate was sixteen percent. LAZARD 2019 REVIEW, *supra* note 23, at 15.

members.[80] Moreover, while some activist directors are partners or employees of the activist fund, most of them are not fund employees.[81]

Recall that hedge funds do not hold sufficient votes to appoint their representatives to the board. Rather, they rely on the express or implicit support of institutional investors. Given the rising power of institutional investors, one might expect them to nominate their own candidates to the board without the need to rely on activists. [82] Yet, institutional investors in the United States and the United Kingdom generally refrain from nominating directors to company boards.[83]

We are aware of three countries where institutional investors are active in the process of nominating directors to public company boards. Yet, these countries seem to be an exception to the universal norm.

Italy. In Italy, institutional investors—acting collectively through an association of institutional investors—nominate directors at some of the largest companies. This practice relies on Italy's unique slate voting regime for directors—a legal regime that aims at ensuring minority representation at companies with controlling shareholders.[84] This practice differs from activist directors appointed by hedge funds in several respects. First, these directors are not nominated by a single institutional investor or asset manager, but by an entity that represents the largest institutional investors together. Second, these directors are not employees of institutional investors. Finally, as explained above, these directors are appointed by institutional investors that are minority shareholders at controlled companies.

Israel. In Israel, as more companies became widely-owned, institutional investors (mostly pension funds) began nominating their own candidates to the board. The Israeli regime for nominating directors is shareholder-friendly: every 1% shareholder can nominate a candidate, and there are no burdensome proxy rules. Unlike in Italy, these candidates are nominated by specific asset managers (and not by an association of institutional investors). Indeed, in some cases, several institutional investors nominated candidates that competed for a single

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[80] *See id.* at 14.

[81] In 2019, for example, twenty-eight of the 122 activist directors appointed in 2019 were activist fund employees, and in 2018 thirty-six of the 161 activist directors appointed were activist fund employees. LAZARD 2018 REVIEW, *supra* note 23, at 8; *see also* LAZARD 2019 REVIEW, *supra* note 23, at 15.

[82] In the past, banks used to appoint their representatives to public company boards. This is still the case in some jurisdications. *See e.g.*, Miguel A. Ferreira & Pedro Matos, *Universal Banks and Corporate Control: Evidence from the Global Syndicated Loan Market*, 25 REV. FIN. STUD. 2703 (2012).

[83] Large institutional investors explicitly state such policy. See, e.g., *What we do. How we do it. Why it matters,* Vanguard Investment Stewardship Commentary (April 2019) available at https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/what_how_why.pdf ("We don't: Nominate directors or seek board seats…").

[84] *See* Giovanni Strampelli, *How to Enhance Directors' Independence at Controlled Companies*, 44 J. CORP. L. 103, 136 (2018); Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy* (ECGI - Law Working Paper No. 225/2013, 2014), https://ssrn.com/abstract=2325421.

seat on the board. Yet, in Israel like in Italy, institutional investors do not nominate their own employees to the board.

Sweden. Sweden has a unique regime for nominating directors. The nominating committee of each company is 'external': not all its members are directors. The Swedish Corporate Governance Code requires that at least one member of the committee must be independent of the largest shareholder. A typical nominating committee will comprise representatives of the controlling shareholder, the chair, and two or three (local) institutional investors.[85] More so, the institutional investors who are members of the nominating committee are especially active in recruting directors for widley held companies.[86]

At first sight, and especially at widely held companies, the failure of institutional investors (other than in Israel, Italy and Sweden) to nominate directors seems puzzling. Indeed, in the early 1990s, when institutional investors started to become more powerful, Professors Ron Gilson and Reinier Kraakman envisioned them in such a role.[87] They expected institutional investors to use their clout to appoint professional outside directors to company boards. These directors, they argued, would develop a reputation for leading change at companies and would therefore be appointed by institutional investors whenever the need arises. The rise of institutional investors' influence, however, has led to activist directors that have been nominated by activist hedge funds, and not by mutual funds and other institutional investors.

More recently, Professor Jack Coffee, Jr. proposed that institutional investors form a steering committee and assemble a team of outside directors (i.e., not their employees) they could then place on corporate boards.[88] Under his view, such an initiative would be superior to the current regime under which activists and companies privately decide to appoint activist directors without a shareholder vote.

None of these initiatives materialized. Legal scholars in the U.S. have highlighted the regulatory obstacles that a large asset manager would face if it were to nominate a director.[89] One major obstacle arises under section 13(d) of the Securities and Exchange Act, which in practice means that an institutional investor nominating directors to a public company's board will be subject to extensive and costly filing requirements in connection with its trading of the company's stock.[90]

This argument, however, cannot explain the reluctance of investors—outside the US—to nominate directors. While section 13(d) applies only in the United

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[85] *See* Sophie Nachemson-Ekwall & Colin Mayer, *Nomination Committees and Corporate Governance: Lessons from Sweden and the UK*, SAÏD BUSINESS SCHOOL WP 2018-12, at 15 (2018), https://ssrn.com/abstract=3170397 (reporting that nearly all public companies in Sweden have domestic institutional investors on their nominating committee, and often two).

[86] *See* Sophie Nachemson-Ekwall, *Leveraging on Home Bias: Large Stakes and Long-Termism by Swedish Institutional Investors*, 66(3) NORDIC J. BUS.128, 145-46 (2017).

[87] *See generally* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

[88] *See* John C. Coffee, Jr., *The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* (ECGI – Law Working Paper No. 373, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3058319.

[89] *See* Morley, *supra* note 53.

[90] *See* 15 U.S.C. § 80a-8 (2012).

States, activist hedge funds—and not money managers—take the lead in nominating directors in Europe and other countries as well. The next Section takes a closer look at the role that activist directors play on the board and their interactions with the shareholders that appoint them.

B. *Activist Directors and Information Sharing*

While activist directors are increasingly present on public company boards, few academic studies explain why activists seek to appoint directors and the role that activist directors play on boards. These questions are especially puzzling, since activists appoint only a minority of board members and therefore rely on the cooperation of incumbents to implement their plan.[91]

Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch explain that "incomplete contracting" prevents activists and boards from specifying in the settlement agreement all future actions that management should take.[92] Thus, activist directors are appointed to ensure that management complies with the activist's demands that cannot be specified in contract. Kobi Kastiel and Yaron Nili focus on the need to improve the board's competence to challenge management.[93] As they explain, directors appointed by activist hedge funds continuously rely on the fund's resources and expertise to collect information and analyze it independent of management. Thus, activist directors overcome the "informational capture" that often undermines independent directors' ability to monitor management.[94]

Our account focuses on the role of activist directors in implementing strategy or operational changes. Implementation of these activist agendas, we argue, requires directors that not only monitor management, but also play an active role in making strategic business decisions for the *company* and refining the *fund's* vision for the company. This in turn requires directors with access to the company's nonpublic information. Most importantly, this task requires directors to share this nonpublic information with the activist fund for deeper analysis and consultation.

As explained above, in most companies, management is likely to have addressed preemptively all the "low-hanging fruit" for successful activist interventions. Thus, activist engagements are increasingly likely to focus on sophisticated changes to the company's strategy. Changes of this type require an ongoing process of implementing the activist's vision for the company's future direction.[95]

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[91] *See* Lucian A. Bebchuk et al., *Dancing with Activists* (ECGI – Finance Working Paper No. 604/2019, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2948869.

[92] *See id.* Coffee, Robert Jackson, Jr., Joshua Mitts, and Robert Bishop criticize this reasoning. *See* John C. Coffee, Jr. et al., *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board?*, 104 CORNELL L. REV. 381 (2018).

[93] Kobi Kastiel & Yaron Nili, *"Captured Boards": The Rise of "Super Directors" and the Case for a Board Suite*, 2017 WIS. L. REV. 19.

[94] *Id.* at 23 (arguing that independent directors do not have enough time, resources, or industry-specific knowledge to understand complexities modern board members are tasked with evaluating). Jack Coffee, Jr., in contrast, focuses on the private benefits that activist funds capture from appointing their representatives to the board. *See* Coffee, Jr., *supra* note 88.

[95] This is consistent with evidence that time horizons of activists have become longer.

Activists may need board representation not only to exercise oversight over management, but also to further refine their plan for the company. Activists may need to work with management, through their trusted board representatives, to shape the company's strategy and execute it. This ongoing process requires access to the company's nonpublic information. It is difficult to make the many specific business or operational decisions required to implement a new vision for the company based solely on the information available to outside investors. The directors appointed by activists gain access to management and the company's nonpublic information.

Moreover, to be effective, activist directors may need to share the company's nonpublic information with the fund itself in a back and forth process. As Professors Kastiel and Nili explain, activist directors often rely on the fund's analysts, expertise, infrastructure, and resources to make business decisions. Activist funds offer their directors a "back office" of analysts and experts that help these directors to become more effective.[96] Sharing nonpublic information with the fund helps the fund itself to refine its vision for the company. After all, activists form their initial proposals for the company without having formal access to nonpublic information.

Finally, funds' access to nonpublic company information significantly improves their ability to monitor the directors they nominate to public company boards. Such monitoring is required not only to prevent these directors from being captured by management, but also to ensure these directors are sufficiently qualified. Without access to nonpublic information, including information about board dynamics, shareholders are left to evaluate directors based only on proxies such as stock performance. Activist funds, in contrast, have superior access to information that significantly improves their ability to evaluate director performance. Unsurprisingly, therefore, activist hedge funds that appoint directors to public company boards often secure the right of their designated directors to share information with the fund.[97]

C. *Institutional Investors and Activist Directors*

Our analysis shows that some forms of activist intervention depend on directors with the ability to share nonpublic company information with the party that nominated them to the board. This understanding, in turn, sheds a new light on institutional investors' limited ability to displace some forms of shareholder activism. If activist directors' ability to share nonpublic information with the fund is indeed critical to their success, then institutional investors might be significantly constrained in their ability to appoint activist directors. Moreover, unlike the U.S.-specific 13(d) obstacle, the challenge of sharing information with institutional investors post-appointment applies even outside the United

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See, e.g., SULLIVAN & CROMWELL LLP, REVIEW AND ANALYSIS OF 2017 U.S. SHAREHOLDER ACTIVISM 22 (2018), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Review_and_Analysis_of_2017_US_Shareholder_Activism.pdf [https://perma.cc/ZEE3-M2S9] ("Activist funds are now holding investments longer, regularly up to five years.").

[96] *See* Kastiel & Nili, *supra* note 93.

[97] *See* Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA L. REV. 1246, 1286 (2017).

States and is harder to overcome without dramatic changes the institutional investors' business model and regulatory infrastructure.

First, directors' sharing of nonpublic information with institutional investors would subject these investors to prohibitive insider trading concerns. Funds that receive inside information might be prohibited from trading the company's shares. While it may not be a significant obstacle for an activist hedge fund with concentrated holdings, this constraint could create significant compliance risk for a large fund family with numerous mutual funds and other investment products. Appointing directors who are not employees of the asset manager cannot overcome this constraint. As long as activist directors rely on sharing information with the fund that appointed them, such funds would be subject to the risk of insider-trading liability.

Second, a regime under which directors appointed by large institutional investors share information with these investors and rely on their advice in performing their duties would be a radical departure from institutional investors' traditionally passive role in company affairs. Consider, for example, the recent debate over the antitrust concerns raised by the increasing influence of large asset managers that own a significant stake of virtually any large public company in the United States.[98] Skeptics of these antitrust concerns point to the limited influence that institutional investors have on their portfolio companies.[99] A regime in which large institutional investors with significant holdings in all large public companies not only appoint directors but also regularly communicate with them regarding companies' operations and strategy might raise significant concerns about anticompetitive effect of common ownership and subject the large institutional investors to strict regulatory scrutiny and perhaps even political backlash.

Such a regime would also create second-order problems for large institutional investors. Large fund families, for example, are complex organizations with numerous funds. Some functions are centralized at the fund family level; others are executed at the fund level. If large institutional investors were to appoint activist directors, they would be required to create the infrastructure to support these directors.

This chapter's analysis, therefore, explains why even well incentivized institutional investors cannot displace activist hedge funds in driving complex business changes that require activist directors. To be effective, activist directors need to share the company's nonpublic information with the funds that appointed them. For institutional investors, however, access to such nonpublic information would be prohibitively costly.

Our analysis sheds new light on a recent proposal by Ronald Gilson and Jeffrey Gordon for a new model of boards of directors that would improve directors' ability to review the company's business strategy. Under their Board 3.0 model, "empowered" directors would be charged with monitoring strategy

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[98] *See generally* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016).

[99] For thoughtful analyses of the antitrust implications of common ownership, see Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L.J. 221 (2018); Marcel Kahan & C. Scott Hemphil, *The Strategies of Anticompetitive Common Ownership*, 129 YALE. L.J. 1392 (2020).

and management's operational performance. In their engagement with management, those directors would be supported by an internal "strategic analysis office."[100] Under this proposal, the new type of directors would enjoy superior access to nonpublic information, but would not share such information with shareholders. Accordingly, these directors would be unable to rely on the expertise of shareholders to refine their vision, and institutional investors would need to rely on stock prices to evaluate the quality of these directors.[101] Those directors, therefore, cannot fully displace activist directors of the type nominated by hedge funds."

III. CONTROLLED COMPANIES AND COUNTRIES IN TRANSITION

The central premise underlying our analysis has been that, given the rise in their holdings of public company shares, institutional investors, as a group can determine the outcome of director elections and other important shareholder votes. Management, therefore, has a clear interest in communicating with institutional investors, and especially the largest ones. This premise, however applies only to widely held companies. In this Part, we discuss the role of institutional investors in controlled companies and consider the special case of markets in transition from controlled to dispersed ownership structure.

A. Concentrated Ownership

The rise of powerful institutional investors at widely held companies means that these investors need not adopt aggressive tactics or other formal measures to influence management. Rather, they can deploy soft power and rely on informal means of communications with management. These developments, however, depend on the premise that large institutional investors have the collective power to displace underperforming managers. Thus, they are unlikely to take place at companies with controlling shareholders.

The exiting literature on institutional investors tends to focus on the United States and occasionally the United Kingdom. In both countries, the majority of large public companies are widely held. Concentrated ownership, however, is prevalent around and world, especially in emerging markets.[102] Even the United States has a significant fraction of public companies with controlling shareholders.[103] Technology companies, for example, are increasingly going public with a dual-class share structure that allows founders to control the company without holding a majority of cash flow rights.

Concentrated ownership alters the role of institutional investors along two dimensions. First, like other public investors, institutional investors in controlled

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[100] *See* Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: An Inroduction*, 74 BUS. LAW. 351, 361 (2019).

[101] Gilson & Gordon argue that institutional investors will be able to "observe the performance of the firm over time." *Id.* at 363. In other words, they believe that stock performance would be the measure by which institutional investors would evaluate the quality of directors.

[102] *See* John KS Ho, *Bringing Responsible Ownership to the Financial Market of Hong Kong: How Effective Could It Be?*, 16 J. CORP. L. STUD. 437 (2016).

[103] *See* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377 (2009).

companies are minority shareholders. This means that institutional investors have limited power to affect corporate decisions. As the controlling shareholder dictates the outcome of shareholder votes, even well-incentivized institutional investors have little ability to influence companies in their portfolio, especially if these companies do not tap capital markets on a frequent basis. Even independent directors need the controller support—not of that of institutional investors—to secure continued service on the board.[104]

Second, the main conflict between insiders and investors in controlled companies is the potential diversion of resources by controlling shareholders through self-dealing and other forms of ‘‘tunneling." Moreover, business groups are prevalent in many countries around the world, especially in emerging markets. The presence of business groups can create new sources of conflicts for institutional investors, for example, when dominant groups control institutional investors that make intra-group investments.

The rising power of institutional investors will increase further the differences in corporate governance between widely-held and controlled companies. As discussed earlier, the increase in institutional investors' size means that they are quite influential at widely-held companies, and that much of their influence is likely to take place through engagement and other types of behind-the-scenes activity. This is especially the case for the largest asset managers, such as Blackrock or Vanguard.

In controlled companies, in contrast, even large institutional investors would presumably have little formal or informal influence. Insiders do not rely on support by institutional investors and thus do not have strong incentives to communicate with these investors or take their views into account. Thus, the recent emergence of stewardship codes and other regulatory measures to facilitate institutional investors' activism are unlikely to have a meaningful effect when in jurisdictions in which controllers hold the voting power that allows them to disregard the views of minority investors.[105]

Indeed, there is anecdotal evidence that controllers—even in the United States—openly disregard the views of institutional investors. In 2014, for example, Google decided to issue a new class of nonvoting stock with the purpose of allowing its controlling shareholders to maintain their control over the company even as it continues to grow and raise capital. This change required the company to amend its charter and subject the amendment to a shareholder vote. A majority of disinterested shareholders voted against the proposal to amend the charter. Yet, the company controllers had enough voting power to force the charter amendment against the collective will of a majority of public investors.[106] In other markets—where concentrated ownership is prevalent, institutional investors are smaller in size, and social norms discourage open

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[104] *See* María Gutiérrez Urtiaga & Maribel Sáez, *Deconstructing Independent Directors*, 13 J. CORP. L. STUD. 63 (2013); Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders,* 165 U. PA. L. REV. 1271 (2017).

[105] *See* Luh Luh Lan & Umakanth Varottil, *Shareholder Empowerment in Controlled Companies: The Case of Singapore*, *in* RESEARCH HANDBOOK OF SHAREHOLDER POWER 573, 575–78 (Jennifer G. Hill & Randall S. Thomas eds., Elgar Publ'g 2015).

[106] *See* Zohar Goshen & Assaf Hamdani, *Corporate Control, Dual Class, and the Limits of Judicial Review,* COLUM. L. REV. (forthcoming 2020).

confrontation with corporate insiders— institutional investors are less likely to become collectively influential.

Not surprisingly, empirical studies of hedge fund activism—especially outside the United States—find that activist funds seem to prefer targets without controlling shareholders,[107] including companies that have relatively large (but noncontrolling) blockholders.[108] Both in the United States and in other markets, activists occasionally target controlled companies.[109]

Institutional investors may have greater influence in controlled companies to the extent that corporate law adopts measures to empower minority shareholders. For example, in some jurisdictions corporate law subjects self-dealing transactions to majority-of-minority voting requirements.[110] Corporate law also may empower minority shareholders to appoint some representatives to the board of directors.[111] Indeed, empirical studies find that hedge fund activists that target controlled companies are more likely to succeed when they leverage legal arrangements that empower minority shareholders. A study on hedge fund activism in Hong Kong, for example, found that activists who target controlled companies rarely succeed in nominating directors, as minority shareholders lack the power to influence director nomination. Activists are more successful, however, when they focus on self-dealing, where the law requires a majority-of-minority vote.[112] In Italy, in contrast, activists have taken advantage of the slate voting regime designed to provide minority shareholders' with at least one board seat.[113]

B. Countries in Transition

Countries in transition from concentrated to dispersed ownership of public companies present an especially intriguing case. As Part I explained, institutional investors in widely held companies might prefer engagement and other behind-the-scenes avenues of influence given regulatory constraints enacted to prevent them from becoming too powerful. Countries without

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[107] Becht at al., *supra* note 43, at 2968.

[108] Gaia Balp, *Activist Shareholders at De Facto Controlled Companies*, 13 BROOK. J. CORP. FIN. & COM. L. 341, 394 (2019).

[109] *See* Kastiel, *supra* note 25.

[110] See Bebchuk & Hamdani, *supra* note 104.

[111] See Luca Enriques & Tobias H. Tröger, *The Law and (Some) Finance of Related Party Transactions: An Introduction, in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 1 (Luca Enriques & Tobias H. Tröger eds., 2019).

[112] Yu-Hsin Lin, *When Activists Meet Controlling Shareholders in the Shadow of the Law: A Case Study of Hong Kong*, 14 ASIAN J. COMP. L. 1, (2019) (analyzing activist campaigns in Hong Kong and finding that "among the various legal tools available, minority veto rights are the most commonly used and the most effective tool for activists to leverage their position in controlled firms").

[113] *See* Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: An Empirical Analysis of Hedge Fund Activism in Italy and Germany, and Its Evolution*, 10 EUR. COMPANY & FIN. L. REV. 328 (2013). One critique is that empowering shareholders in companies with controlling shareholders creates a problem of "strong shareholders weak outside investors." *See* María Gutiérrez & Maribel Sáez Lacave, *Strong Shareholders,Weak Outside Investors*, 18 J. CORP. L. STUD. 277 (2018).

experience with dispersed ownership, however, may lack the regulatory restrictions that prevent institutional investors from manifesting their power as owners. Therefore, once institutional investors grow into power, they may step into the vacuum left by the sudden absence of a controlling shareholder, and collectively exert direct and open influence companies in their portfolio.

Consider the case of Israel. In 2013, new legislation resulted in gradual transition of major companies from concentrated to diffused ownership.[114] Consequently, Israeli institutional investors became the collective owners of a majority of shares of several large public companies. Moreover, they faced little regulatory restrictions on their ability to become active by nominating directors, for example.

This new reality led to a dramatic increase in activism by institutional investors. In 2018, for example, each of the four largest institutional investors of Paz, a large energy company, nominated a director to the board.[115] After a proxy fight vis-a-vis the candidates nominated by the company, all the candidates nominated by the institutional investors were elected to the board.[116] Moreover, in the same company institutional investors were successful in their demand to modify the corporate charter in order to add another board position, which in turn was filled by another candidate nominated by an institutional investor.[117] The board changes ultimately led to the removal of company's CEO.[118] Note that all the elected board member were unaffiliated with the institutional investors. Nevertheless, the institutional investors' activism was swift, aggressive and effective. A similar course of action took place in other Israeli companies, with varying degrees of success.[119]

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114 The Law For Promotion of Competition and Reduction of Concentration, 5774–2013. This major piece of legislation limited stock pyramid structures to two public layers, and required separation of ownership between financial and non-financial companies. For the logic behind the legislation, see Israeli Dept. of Treasury Competitiveness Committee's Final Report (Mar. 18, 2012), https://www.gov.il/BlobFolder/unit/competitiveness-committee/he/Vaadot_ahchud_CompetitivenessCommittee_FinalReport_FinalRec.pdf. See also Assaf Hamdani, Yishay Yafeh & Kostantin Kosenko, *Using Regulation to Dismantle Powerful* CORPORATE PYRAMIDS, PROMARKET (MAY 5, 2020), HTTPS://PROMARKET.ORG/USING-REGULATION-TO-DISMANTLE-POWERFUL-CORPORATE-PYRAMIDS.

115 *See* the company's immediate reports (Hebrew) from Oct. 16, 2018 & Mar. 11, 2019, https://maya.tase.co.il/reports/details/1189546; https://maya.tase.co.il/reports/details/1217364.

116 Rachel Bindman & Yaniv Rahimi, *The Institutional Investors Wish to Revolutionize Paz's Board of Directors*, CALCALIST (Sept. 25, 2018), https://www.calcalist.co.il/markets/articles/0,7340,L-3746420,00.html.

117 Rachel Bindman, *Paz's Shareholders Approve Charter Amendment – Avraham Biger's Path to the Board is Paved*, CALCALIST (Dec. 3, 2018), https://www.calcalist.co.il/markets/articles/0,7340,L-3751212,00.html.

118 Golan Hazani, *Now it's Official – Paz CEO Yona Fogel is Retiring*, CALCALIST (Sept. 19, 2019), https://www.calcalist.co.il/markets/articles/0,7340,L-3770671,00.html

119 Omri Cohen, *Entropy Supports the Institutional Investor's Nominees to Mivne's Board of Directors*, GLOBES (Aug. 8, 2019), https:// www.globes.co.il/news/article.aspx?did=1001296534; Amitay Ziv, *An Unusual Incident – Institutional Investors Wish to Replace Bezeq's Board of Directors*, The Marker (Jan. 26, 2018), https://www.themarker.com/technation/1.5767349.

The Israeli case illustrates the dynamic that might take place once ownership structure changes in markets where institutional investors' holdings are substantial. On the one hand, institutional investors may become (collectively) the owners of a majority of public company shares. As a group, they have a power to determine vote outcomes and decide who will serve on the board. On the other hand, as long as concentrated ownership was prevalent, lawmakers did not face pressure to adopt measures to limit the influence of institutional investors. In the absence of regulatory restrictions, institutional investors might openly adopt some activist tactics. The question, however, is whether increased activism by institutional investors will produce a regulatory backlash.

IV. CONCLUSION

This chapter analyzed the governance implications of the rising influence of institutional investors against the background of the rise of activist hedge funds. The rising power of institutional investors will further enhance the difference between controlled and widely held companies. Powerful institutional investors at widely held companies are increasingly likely to exert their influence behind the scenes and without the need to use aggressive tactics. Yet, some activist interventions—those that require the appointment of activist directors to implement complex business changes—cannot be pursued even by powerful and well-motivated institutional investors without dramatic changes to their respective business models and regulatory landscape.