Brave New World: A Proposal for Institutional Investors

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The purpose of this Article is to consider a novel framework for institutional shareholders' activism in the United States. This new activism framework would be aimed at improving, at minimal costs, the performance of the portfolio companies in which institutional shareholders invest. The Article begins by laying out this new activism framework and then compares the proposed framework with the prevalent mode of activism through hedge funds. The Article concludes with a discussion of certain implementation challenges, and calls for future research into the proposed activism framework.

Introduction

Institutional investors in the United States possess a potentially immense power. In the absence of a controlling shareholder in the largest firms,[1] institutional investors as a group effectively control the market. Their potential, however, is constrained and has not yet fully materialized. Collective action problems, conflicts of interest, and a conservative fee structure all serve as barriers to activism. Yet in some cases, these obstacles can be overcome. For instance, proxy advisory firms have helped transform American institutional shareholders from a passive group into a strong reactive force.[2] In addition, in

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* Tel Aviv University, Faculty of Law. For their helpful comments, I wish to thank Michal Barzuza, Lucian A. Bebchuk, Brian R. Cheffins, Zohar Goshen, Assaf Hamdani, Robert J. Jackson, Reinier H. Kraakman, Yair Listokin, Dana Meshulam, Ariel Porat, Edward B. Rock, and Omri Yadlin. My thanks to Ori Bustanai and Dvir Ben-Ami for their able research assistance.

1 Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. Fin. 471, 492-95 tbls. II-III (1999).

2 The Institutional Shareholders Services (ISS) provides its services to more than 1700 institutional investors, advising them how to vote on the corporate matters of over 5900 U.S.-based companies and over 35,000 non-U.S. companies. *See* Morgan Stanley Capital Int'l Inc., Annual Report 9 (2012); *see also* Asaf

recent years we have witnessed the rise of activist hedge funds which harness institutional investors' power in order to promote changes at major U.S. firms. These shareholders conduct operational or strategic activism that refers to the involvement of shareholders in the management of a firm. The purpose of this Article is to examine the possibility of a more direct mechanism for institutional investors' activism. This novel activism framework would seek to improve, at minimal costs, the performance of the companies in which institutional shareholders invest.

The outline for the idea is the following. A parent organization, such as the Institutional Shareholders Services,[3] gathers together teams of experts to form independent task forces for each market sector or well-defined group of corporations. Each task force receives minimal initial funding from each of the relevant institutional investors. Such funding will enable the task force to search for potential activism targets. Once a task force has found a potential target, it will be authorized to make a capital call to cover the costs of actively engaging the target. Importantly, this considerable additional financing would be requested only from those institutional investors with shares in the corporate target, pro rata to their holdings.

This funding structure is crucial in creating the task forces' direct accountability as activism agents to the institutional investors of the specific target in question. If a task force does not serve these investors well, it will soon find itself out of business. Moreover, a provision that allows the task force to engage a target only if the aggregate holdings of the parties to the agreement reach a certain threshold would minimize free-riding. And, to ensure adequate monitoring, proper provisions in the contract could demand the approval of the relevant institutional investors for certain activist actions.

Under these terms and additional contractual arrangements described below, the task force would be closely monitored by and tied to the interests of the institutional shareholders of the specific corporate target. Altogether, considering the vast knowledge, expertise and, most importantly, the financing structure, the task force would be armed with enormous powers and capabilities. If many institutional investors were to sign agreements with the task force, the new player in the activist field would grow to be an extremely powerful and influential agent. The purpose of this Article is to lay down the principles for such a contractual arrangement and leave the details for future research.

Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 Del. J. Corp. L. (forthcoming 2014) (analyzing the important role of proxy advisory firms and the perils of forthcoming regulation).

3 Institutional Shareholder Services, http://www.issgovernance.com (last visited Aug. 23, 2014).

In order to appreciate the advantages of the proposed mechanism, it is useful to compare it to the current common market mechanism of activism by hedge funds. First, the hedge fund business model entails huge transaction costs. Billions of dollars must be raised for the activist to buy a stake in the target and then sell it back to reap a profit. Second, hedge fund activism is not closely monitored, and the activist bears no long-term duties to the large shareholders of the corporate target. Third, instead of retaining all gains from the enhancement of the value of the target (except for the activist's fees), the public and the institutional shareholders must share them with the wealthy individuals who commonly finance the hedge funds' operations and share their profits.

The potential of the activism design suggested in this Article is clear, therefore, when compared to the current structure of hedge fund activism. The new mechanism would not require a third-party purchase of shares to engage a target, thereby saving considerable transaction costs and fees. This activism could quite easily extend to target the entire market, and, in the absence of intermediate transactions, targeted managers would have no early warning of what is to come. Finally and most importantly, the full force of institutional investors' power would be harnessed to work for the activism, which would be conducted under the watchful eye of the long-term shareholders of the specific target firm. Hence, it would be clear that the activism is directed at achieving long-term goals and for the benefit of all shareholders. This is something that hedge fund activism cannot guarantee, even if it does, on average, increase all shareholders' value.[4]

The suggested framework, however, encounters a few barriers. Some of the barriers lie in the existing regulation, including securities regulation that imposes disclosure requirements on activist shareholders, which could spill over to the institutional investors in the proposed framework. A second barrier is the concern that the suggested mechanism could trigger existing shareholder rights plans, otherwise known as poison pills. But above all, the major impediment to the proposed mechanism is the political forces and common sentiments that weakened American institutional investors to begin with. A well-known argument holds that the dominant role played by corporate managers in the U.S. market is the result of regulation and political pressure

4 Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 Colum. L. Rev. 1637 (2013); Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 114 Colum. L. Rev. (forthcoming 2014), *available at* http://ssrn.com/abstract=2291577.

that fragmented and weakened the financial sector.[5] This would operate also against the solution offered in this Article. Therefore, realistically speaking, selling this new model of activism would require a compromise that would weaken its effect. One possibility is to assign the task force an advisory role devoid of the ability to force institutional investors into any action. However, even in this mitigated form of action the task force could revolutionize institutional investors' activism as we know it today.

The Article continues as follows. Part I discusses the role played by institutional investors in the market today. These investors harbor huge potential to influence the market, but this potential remains largely untapped. Part II lays out the framework of the proposed mechanism aimed at encouraging a new type of institutional shareholders' activism. Part III compares the advantages and disadvantages of the mechanism to those of the activism currently led by hedge funds. Finally, Part IV concludes and discusses the legal and political economy impediments to implementing the proposed solution.

I. Institutional Investors — The Sleeping Giants of Corporate America

Institutional investors are the sleeping giants of corporate America. In terms of size and potential impact, they wield immense power. In 2012, mutual funds held shares worth 6300 billion dollars, pension funds held 4150 billion dollars, and insurance companies held 1800 billion dollars.[6] With an aggregate market cap of more than twenty-six trillion dollars for all public companies in 2012,[7] these three groups of institutional investors, combined, account for an unprecedented fifty percent of the market.[8]

In a seminal paper published in 1990, Bernard Black identified this revolutionary ownership trend in U.S. markets, which was already in full

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5 Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance, at xiv (1st ed. 1996) ("American Politics repeatedly prevented financial intermediaries from becoming big enough to take influential big blocks of stock in the largest enterprises.").

6 Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Statistical Release: Financial Accounts of the Unites States: Historical Data 2005 to 2012, at 101 tbl. L.213 (2013).

7 *Id.* The 2013 indexed value of the 735 billion dollars market cap (nominal value for 1965 of the entire stock market) was 5357.19 billion dollars. This means that in indexed values, the market grew by 728%.

8 *Id.*

swing,[9] and had a vision[10]: that institutional investors, who are themselves financial intermediaries investing public funds, would monitor corporate managers — agents watching agents.[11] But this prediction did not materialize in full. Although institutional investors do play an important role in monitoring, their power is constrained by several factors, and first and foremost are the problems of collective action, agency cost, and incentive scheme.

Combined, as we saw above, institutional investors effectively control the market. In most firms — certainly the largest ones — institutional investors as a group hold a majority stake or dominant position. Because institutional investors have a preference for solid and stable investments, the ownership concentration in the largest corporations is amazingly high, with institutional shareholders owning on average more than seventy percent of the stock.[12] However, though this is true regarding the bloc of traditional institutional investors, each individual investor rarely holds more than a small percentage of the stock of each company it has shares in.[13] Thus, when monitoring is

9 In 1995, for instance, mutual funds held stock valued at 1070 billion dollars (thirteen percent of the equity market), pension funds held 1970 billion dollars (twenty-three percent), and insurance companies held 3480 billion dollars (five percent), altogether accounting for about forty percent of the stock market, whose aggregate value at the time was about 8500 billion dollars. *Id.*

10 Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811 (1992) [hereinafter Black, *Agents Watching Agents*]; *see also* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990) [hereinafter Black, *Shareholder Passivity*].

11 Black, *Agents Watching Agents*, *supra* note 10, at 811.

12 In 2009, ownership concentration of institutional investors in the top one thousand U.S. corporations was seventy-three percent. The Conference Bd., 2010 Institutional Investment Report 27 (2010), *available at* http://shareholderforum.com/e-mtg/Library/20101111_ConferenceBoard.pdf. Currently, for instance, the percentage of shares held by institutional investors in Apple is sixty-two percent, *Apple Inc. (AAPL) Major Holders*, Yahoo Finance, http://finance.yahoo.com/q/mh?s=AAPL+Major+Holders (last visited Nov. 24, 2014) and, in Microsoft, sixty-eight percent, *Microsoft Corporation (MSFT) Major Holders*, Yahoo Finance, http://finance.yahoo.com/q/mh?s=MSFT+Major+Holders (last visited Nov. 24, 2014).

13 Black, *Shareholder Passivity*, *supra* note 10, at 567. For instance, currently, the largest institutional holder in Apple is Vanguard Group, Inc., with 4.89%, and, in Microsoft, Vanguard Total Stock Market Index Fund, with 1.28%. *Apple Inc. (AAPL) Major Holders*, *supra* note 12; *Microsoft Corporation (MSFT) Major Holders*, *supra* note 12.

expensive, free-riding thrives as each institutional investor prefers to leave the monitoring task to its peers.[14]

Free-riding,[15] however, is only one of three major barriers to institutional investors' activism. The second obstacle is conflicts of interest giving rise to an agency cost. As the literature has identified, there are many sources of such conflicts that could interfere with the ability of institutional investors to function as effective monitors of the management of public corporations. The underlying problem stems from the fact that the institutional investors are themselves intermediaries who control the funds on behalf of its beneficiaries (the funds' members).[16] Therefore, the institutional investors cannot be expected to strive to maximize the value of the assets under their management instead of their own interests. For instance, private pension funds must maintain good ties with the managements of the corporations they serve or seek to serve, and activism might impair these relations to the point of a prohibitive reputation penalty;[17] or, insurers may be damaged by their own activism because it might trigger directors and officers (D&O) insurance policies that they market.[18]

There is also a third obstacle to institutional investor activism, which stems from the common fee structure of money managers such as insurers,

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14 *See, e.g.*, Black, *Shareholder Passivity*, *supra* note 10, at 528 ("A shareholder proponent bears most of the cost of a proxy campaign, but receives only a pro rata share of the gains from success, while other shareholders free ride on her efforts."); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum. L. Rev. 795, 822 (1993) ("The prototypical free rider problem of corporate governance activities [is] that only the activist bears the costs of activism while all of the firm's investors receive the benefits.").

15 The collective action problem faced by institutional investors should more accurately be described as a volunteer dilemma and not as a general free-riding problem. *See, e.g.*, Andreas Diekmann, *Volunteer's Dilemma*, 29 J. Conflict Resol. 605, 605 (1985) ("N prisoners are sentenced for ten years if there is not at least one volunteer who confesses. In this case the volunteer(s) can expect one-year imprisonment, whereas the other prisoners will be released.").

16 Edward B. Rock, *The Logic and Uncertain Significance of Institutional Investor Activism*, 79 Geo. L.J. 445, 469 (1991).

17 Black, *Shareholder Passivity*, *supra* note 10, at 596-98:

> Pension managers face pressure from corporate officers to vote promanager. Sometimes, the pressure is explicit: the CEO of the sponsoring company orders or urges a money manager to vote promanager, either in general or on a particular issue. Or a CEO of one company writes to other CEOs, urging them to ask their fund managers to vote promanager.

18 D&O insurance policies offer liability coverage for company directors and officers, in order to protect them from possible suits regarding the decisions and actions taken within the scope of their regular duties.

pension funds, and mutual funds, who typically earn an annual fixed fee that amounts to a small fraction of the assets they run.[19] This alone does not offer much of an incentive for active monitoring, since the institutional investor itself, unlike its member-beneficiaries, would reap a very small proportion of the monitoring gains. Moreover, this fee structure includes limitations on the expenses that the money manager can recover from the beneficiaries' funds.[20] If some of the costs of shareholder activism cannot be deducted from the beneficiaries' accounts,[21] they are borne directly by the money manager, which further chills incentives to actively monitor.

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19 *See, e.g.*, Hanoch Dagan & Sharon Hannes, *Managing Our Money: The Law of Financial Fiduciaries as a Private Law Institution*, *in* Philosophical Foundations of Fiduciary Law 91 (Andrew Gold & Paul Miller eds., 2014); Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 Am. U. L. Rev. 225, 318-22 (2007) ("The managers of mutual funds and pension funds . . . generally charge their clients a fee based on the assets that they manage."); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1050-54 (2007):

> [R]egulatory barriers make it difficult for mutual funds to charge performance-based fees. As a result, 97% of all funds, accounting for 92% of all mutual fund assets, charge fees based on a flat percentage of the fund's assets under management. Asset-based fees, however, provide only small direct incentives to engage in costly activism. The median stock fund in 2004 charged investors total expenses of 1.45% of assets, of which roughly half were management fees.

20 *See, e.g.*, U.S. Sec. & Exchange Comm'n, Division of Investment Management Report on Mutual Fund Fees and Expenses (2000), *available at* http://www.sec.gov/news/studies/feestudy.htm:

> Congress and the Commission have sought to protect the interests of fund investors with respect to fund fees and expenses by using a dual approach: (1) procedural safeguards to reduce the conflicts of interest that could lead to inappropriate or inflated fees; and (2) uniform disclosure of fees and expenses by funds to allow investors to make informed investment decisions.

21 Even when the expenses are borne by the fund beneficiaries, they reduce the yield of the fund, which makes it hard for the fund to compete in the market. *See, e.g.*, Kahan & Rock, *supra* note 19, at 1050-51:

> The job of index fund managers is to replicate the performance of the index. An index fund thus competes with other funds replicating the same index principally on the basis of fund expenses. As activism is costly and raises the fund's expenses (or lowers the managing company's profits), index fund managers will be reluctant to engage in activism.

While these obstacles are considerable,[22] experience has shown that institutional investors are still active to some degree.[23] For a start, institutional investors have proven that they can be active (albeit not proactive) with the assistance of a third-party proxy advisor. The best example of this is the Institutional Shareholder Services (ISS) that advises institutional investors on how to vote on managerial proposals. Although the ISS does not initiate any activity, it is quite effective in harnessing the power of institutional investors.[24]

Lastly, some institutional investors are quite active on their own, without any intermediary parties acting on their behalf. This is especially true of one class of traditional institutional investors — public pension funds. Some suggest such activism is possible because they are not plagued by the same conflicts of interest that tie the hands of other institutional investors.[25] But, even when institutional investors are active on their own, they usually intervene in broad corporate governance matters and do not engage in operational or strategic activism that targets the business strategy and business-related decisions of a single company.[26] This is an inexpensive type of activism: it does not cost much to develop the agenda or manifest it, and it does not need to be tailored

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22 *See also* Ronald J. Gilson & Jeffrey N. Gordon, *Agency Capitalism: Further Implications of Equity Intermediation* 8-13 (Colum. Law & Econ., Working Paper No. 461, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2359690 ("Intermediary institutional investors, then, present a problem for corporate governance. This efficient risk transfer and management 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.").

23 *Id.* at 21-22 ("The equity intermediation of the last 30 years gives us Agency Capitalism, characterized by sophisticated but reticent institutional shareholders who require market actors to invoke their sophistication.").

24 *See, e.g.*, James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 Vill. L. Rev. 1 (2010).

25 Black, *Shareholder Passivity*, *supra* note 10, at 524 ("The public pension funds have the weakest promanager conflicts, but no institution is conflict free.").

26 *See* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 Yale J. on Reg. 174, 250 (2001) ("Shareholder proposals, although an increasingly prominent feature of institutional investor corporate governance activism since the mid-1980s, have not had a significant impact on firm performance."); *see also* Marcel Kahan & Edward Rock, *Symbolic Corporate Governance Politics* (Univ. of Pa. Law Sch., Faculty Scholarship, Paper No. 876, 2013), *available at* http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1875&context=faculty_scholarship (discussing the gap between corporate governance rhetoric and substance).

to the business challenges and failures facing any single corporation. The most pressing and grave problems therefore elude this type of activism.

In sum, then, it seems that some activism on behalf of institutional investors can be expected, but there are certain limitations.[27] First, most institutional investors will not stick their necks out. The costs of such action — first and foremost, the reputation penalty involved — are prohibitive for most of them to bear alone. However, if they were to act in concert with other institutional investors while guided by some third party, they could be quite potent and aggressive. In the absence of a mechanism facilitating such collective action, even the most aggressive pension funds, which can tackle general corporate governance problems, are unable to pursue any business agenda on a case-by-case basis.

II. A Preliminary Framework for the Suggested Mode of Activism

The purpose of this Part is to lay out a preliminary and general analytic framework for a new institution that would encourage long-term activism on the part of institutional investors. The basic premise is that a team of experts will be appointed for a given market segment and armed with certain rights and duties as stipulated in a standard agreement to be signed between each task force and as large a group as possible of institutional investors, individually. A parent organization, such as the existing ISS or a new institution, would draft this standard agreement and serve as a clearinghouse for the operation.

The standard agreement would provide crucial two-tier funding for the task force's activities. Tier-one funding would be quite minimal and used to support the task force before it engages in activism. At this stage, the task force would be observing the industry in an initial general search for targets. However, once the task force begins to zero in on a target, it would become

27 Another avenue by which institutional shareholders can influence management is exit (an old tactic known also as the "Wall Street Walk"). Shareholders — particularly blockholders — may induce good managerial behavior by exiting and pushing down stock prices when bad managerial actions are taken. *See* Anat R. Admati & Paul Pfleiderer, *The Wall Street Walk and Shareholder Activism: Exit as a Form of Voice*, 22 Rev. Fin. Stud. 2445 (2009); Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. Fin. 2481 (2009); Alex Edmans & Gustavo Manso, *Governance Through Exit and Voice: A Theory of Multiple Blockholders*, 24 Rev. Fin. Stud. 2395 (2011).

entitled to call for additional and much more substantial tier-two funding.[28] This capital call should be sufficient to cover major possible expenses such as proxy fight costs,[29] litigation, public and investors relations campaigns, etc.[30] Most importantly, the source of funding for the two tiers would differ as follows: the low tier-one funding would be provided by all institutional investors that have signed an agreement with the task force. The amount would be insignificant for each of the member institutions and possibly quite close to the retainer paid to third-party proxy advisory services.[31] However, funding called for after the task force has zeroed in on a target would not come from all the institutional investors. Rather, the tier-two funding would be borne solely by the institutional investors that invest in the specific potential corporate target and pro-rata to their holdings in the target. This capital call to the direct investors of the target forges the link that is missing today between the institutional long-term shareholders of the target of the activism and the agent that executes the activism.[32]

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28 Similar funding structures are common practice in the financial industry. For instance, venture capital agreements commonly include a commitment from the limited partners that allows the general partners to call for additional funding when an investment is identified. A similar procedure exists in other types of private equity funds, including leveraged buyout (LBO) funds. The act is commonly defined as a Capital Call or Draw Down: the act of a private equity fund "calling down" previously pledged capital from its limited partners in order to execute an investment. *See, e.g.*, Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play a Role? Was It Something Lawyers Helped Structure?*, 77 Chi.-Kent L. Rev. 221, 216 (2001); Ibrahim M. Darian, *The New Exit in Venture Capital*, 65 Vand. L. Rev. 1, 8 (2012).

29 Activism costs could easily run into a few million dollars. *See Research Spotlight*, Sharkrepellent, https://www.sharkrepellent.net/request?an=dt.getPage&st=undefined&pg=/pub/rs_20130220.html&Proxy_fight_fees_and_costs_now_collected_by_SharkRepellent&rnd=169632 (Feb. 20, 2013) (presenting data on proxy solicitor fees and proxy fight costs).

30 Another activism cost is the compensation by activist shareholders of their proposed director nominees.

31 At this early stage and in the absence of any actual activism, the main cost is the salaries of the individuals of the task force.

32 *See* Mark J. Roe, *Corporate Short-Termism — In the Boardroom and in the Courtroom*, 68 Bus. Law. 977 (2013) ("[T]he widely held view that short-term trading has increased dramatically in recent decades over-interprets the data; the duration for holdings of many of the country's major stockholders, such as mutual funds run by Fidelity and Vanguard, and major pension funds, does not seem to have shortened.").

In addition to the crucial matter of funding, the standard agreement would also stipulate all other features of the relationship between the task force and its member institutions. The task force would be relatively free to identify the target and design an activism strategy; it would also hold a proxy to act on behalf of the member institutional investors that are shareholders in the corporate target. Thus, in its dealings with management, the task force would wield enormous leverage. This would ensure the task force success when members hold close to fifty percent or more of a target's stock; in fact, in such cases, it is doubtful that a proxy fight would even take place. Moreover, the task force's freedom to act on behalf of the target's institutional investors (which are members of this special contractual agreement), although highly important, would not be unconstrained. The standard agreement would stipulate which measures require approval by vote from the member institutions. For instance, the agreement could require that any campaign to replace management or sell the corporate target in its entirety be preapproved by members.

The need to secure approval for certain steps would not, however, be the main reason why the task force would strive to serve the needs of the institutional investors. It would be only natural for the task force to want to reload its financing and engage additional targets. If the number of targets or level of funding provided for in the original agreement is exceeded, such a financing reload would require the signing of a new agreement (or perhaps a member vote for a number of initial funding reloads). In short, the task force must please its clients and show results.

All in all, this mechanism would open up new horizons and avenues for shareholder activism that is oriented towards the long term. A tremendously powerful agent would search for potential targets in its designated market sector on behalf of institutional investors and then hit these targets with activism when necessary. Crucially, the wide scope of this activism, covering the entire market, would be realized with extremely low transaction costs. This activism would be effective without any need to buy a single share to achieve its goals, thereby eliminating any need to raise heavy funds to purchase shares. Moreover, with its strong backing, a successful outcome would be all but guaranteed. No less important is the fact that the activism through the proposed mechanism would be closely monitored by the long-term investors of the corporation being targeted.

Note also that the new mechanism is and should be devised to overcome certain barriers that exist in the present. To begin with, there is the conflict of interest that institutional investors face that is often cited as an obstacle to activism.[33] This does not seem to be a major concern with the new framework,

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33 *See supra* notes 16-18 and accompanying text.

however. Institutions do not want to gain a reputation for being a troublemaker. They therefore are averse to initiating activism. But being a part of a group that is led by an outside professional has no such reputational effect. Indeed, tellingly, institutional investors will often collaborate with hedge fund activism, either by investing as limited partners in the fund or voting for its initiatives.[34] This is indicative of the potential demand for the mechanism described in this Article. The passive nature of signing an early agreement with the task force, before investors know which target will later be engaged, dramatically alleviates the freezing effect of conflicts of interest. In other words, no one has to stand out as an activist for the new form of activism to take place.

The fear of standing out still warrants attention, however, as a possible factor that may prevent participation. Given that it is a new mechanism, institutional investors may fear that only a few institutions will sign an agreement with the task force, which would not only put the entire scheme at risk but also expose those that signed as activists. The solution is to include a provision in the standard agreement that stipulates that a minimal number of parties to the scheme, say one hundred institutional investors,[35] is a necessary condition for the contracts to take effect. This provision would ease the reputational concern of potentially conflicted institutional investors.

This leads us to the central challenge: the free-riding risk. Why should institutional investors invest in activism for the benefit of others rather than wait for others to invest? A possible solution to this is a contractual stipulation that the task force is authorized to engage a target only if the aggregate holdings of investor members in the scheme top a certain threshold, say twenty-five percent. Such a provision would dramatically diminish members' concern that they will pay much but enjoy only a small portion of the benefits, and it would push more institutional investors to sign a contract with a task force.

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34 *See, e.g.*, Martin Lipton, *Lessons from the 2013 Proxy Season*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (June 12, 2013), http://blogs.law.harvard.edu/corpgov/2013/06/12/lessons-from-the-2013-proxy-season:

> "Activist Hedge Fund" has become an asset class in which institutional investors are making substantial investments. In addition, even where institutional investors are not themselves limited partners in the activist hedge fund, several now maintain open and regular lines of communication with activists, including sharing potential "hit lists" of possible targets.

35 As a comparison, the Council of Institutional Investors, an association that advocates for effective corporate governance and shareowners' rights, has more than 125 members. The organization is comprised of pension funds, other employee benefit funds, endowments, and foundations with combined assets that exceed three trillion dollars. Council of Institutional Investors, http://www.cii.org/index.asp (last visited Nov. 24, 2014).

They would know that if they do not sign, they could often find themselves invested in corporations that are not within the mandate of the task force and less likely to enjoy the direct gains of its activism; moreover, the corporations in their portfolio would not be subject to the full disciplinary force of the activism.

Finally, I maintain that free-riding concerns are substantially exaggerated. Institutional investors that choose to opt out of a scheme that seems socially beneficial would suffer reputational loss by the public whose money they manage. Since many of them are dependent on public investments, their public image can be crucial. This could explain why they often pay for third-party proxy advisory services, even though it is quite easy to learn what such services recommend without paying them. The fact that institutional shareholders nevertheless pay for this public good is encouraging. True, the new mechanism could entail significantly higher costs, but the lion's share of these costs would arise only if there is a possibility of real gain. And regardless, institutional investors are so big that the cost is in fact negligible for them, while the benefit is huge in that it could dramatically fortify the monitoring of the entire market. Overall, the generally passive character of the proposed mechanism seems to fit the needs and habits of the giant institutions that would be involved.

III. A Comparison to Hedge Fund Activism

The controlling or dominant shareholder in a corporation, when such exists, is practically always involved in the firm's management. In the last few years, active intervention of this type has been evident even in corporations with dispersed ownership. This is by and large the activity of activist hedge funds, whereas traditional institutional investors play a secondary role in this context.

The ultimate goal of shareholder activism of this type is to improve shareholders' value by shifting the corporation's business course. Common initiatives include pressuring management to conduct a massive stock buyback or dividend distribution,[36] to spin off major business

36 For instance, Greenlight Capital, a hedge fund with a stake in Apple, is currently battling Apple to return much of its 137 billion dollar holdings in cash to shareholders. Greenlight filed a lawsuit seeking to block Apple's plan for a shareholder vote on a proposal that critics fear will make it harder for the company to issue preferred shares in the future. Greenlight is urging Apple to issue such shares with a perpetual four percent dividend. The court sided with Greenlight, holding that Apple had unfairly bundled the stock proposal with other proposals into a single measure. *Apple and Greenlight Capital*, ECONOMIST, Feb. 22, 2013,

units,[37] to pursue sale of the entire company,[38] or to replace the CEO.[39] Another typical and increasingly-common objective of hedge fund activism is changes to the composition of the target's board of directors, including the installment of hedge fund representatives on the board.[40]

To be sure, activism of this sort is no longer a rare phenomenon. Since 2006, almost one in every six corporations in the Standard and Poor's 1500

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http://www.economist.com/blogs/schumpeter/2013/02/apple-and-greenlight-capital. In addition, activist investor Icahn Partners has amassed more than 4,700,000 shares of Apple's stock, amounting to around 0.5% of Apple's shares. In a letter to Apple's CEO, Icahn urged Apple to pursue an unprecedented 150 billion dollar stock buyback that he said would more than double the value of Apple stock. Dan Nakaso, *Apple in the Sights of Activist Investor Carl Icahn*, San Jose Mercury News (Oct. 27, 2013), http://www.mercurynews.com/business/ci_24399062/apple-sights-activist-investor-carl-icahn.

37 The case of Darden, a casual dining company with a portfolio of well-known restaurant chains, is illustrative of this point. Barington Capital, the activist hedge fund, is pushing Darden's management to split itself into two restaurant companies, one for its mature brands (Red Lobster and Olive Garden) and the other for the faster-growing, higher end restaurants, including Capital Grille, Yard House, and Eddie V's. Avi Salzman, *How to Profit from Today's Shareholder Activism*, Barron's, Nov. 30, 2013, http://online.barrons.com/article/SB50001424053111904253404579208282663688954.html#articleTabs_article%3D0 (by subscription); Letter from James A. Mitarotonda, CEO, Barington Capital Grp., L.P., to the Bd. of Dirs., Darden Restaurants, Inc. (Sept. 23, 2013), *available at* http://www.shareholderforum.com/access/Library/20130923_Barington.pdf.

38 For instance, Research in Motion (BlackBerry's former name) was targeted by an activist campaign demanding the sale of the company. Don Reisinger, *Activist RIM Investor Calls for Sale*, CNET (Oct. 11, 2011), http://news.cnet.com/8301-13506_3-20118637-17/activist-rim-investor-calls-for-sale-ceo-shake-up.

39 For instance, in 2013, Bill Ackman, CEO of Pershing Square Capital Management, began a campaign, which was eventually successful, to replace the Chairman and CEO of Procter & Gamble. *See* Chris Isidore, *Ackman Wins, P&G Dumps CEO*, CNN Money (May 24, 2013), http://money.cnn.com/2013/05/24/news/companies/pg-ceo-ackman.

40 For example, Hewlett-Packard appointed Ralph V. Whitworth, the head of the hedge fund Relational Investors, to its board. At the time, the hedge fund owned about a one percent stake in the company. Michael J. De La Merced, *H.P. Gives Relational's Whitworth a Board Seat*, N.Y. Times, Nov. 17, 2011, http://dealbook.nytimes.com/2011/11/17/h-p-gives-relationals-whitworth-a-board-seat. The Clinton Group Fund won a board seat at Nutrisystem (NTRI) and helped get the CEO removed. Salzman, *supra* note 37.

index has been the target of activist campaigns.[41] The numbers are rising sharply, with about ninety activist campaigns of targets that require over one billion dollars investment by the activist in 2013 alone, fifty percent more than in 2012.[42] Towards the end of 2013, activist hedge funds were running approximately eighty-nine billion dollars, a huge increase from thirty-six billion dollars in 2009.[43] Activist hedge funds have outperformed their non-activist peers and market indices, generating a 19.4% compound annual growth rate since 2009, as compared to 7.5% for all hedge funds and 12.3% for S&P 500 companies.[44]

Activists employ a variety of different tactics to achieve their goals. They can start with letters to management, followed by intensive media and public relations campaigns, then recourse to legal measures against management, up to and including a full-fledged proxy fight. In aggregate, there is no doubt that activist hedge fund investors are quite pleased with their achievements, although some spectacular failures have also been recorded.[45] This is why in recent years, traditional institutional investors have often supported activist

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41 Citi's Corporate & Inv. Banking Div., Rising Tide of Global Shareholder Activism 4 (2013), *available at* http://citibank.com/icg/global_banking/docs/rising_tide.pdf.

42 *See* Scott Hirst, *The Evolving Direction and Increasing Influence of Shareholder Activism*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Dec. 23, 2013), https://blogs.law.harvard.edu/corpgov/2013/12/23/the-evolving-direction-and-increasing-influence-of-shareholder-activism.

43 *See* Salzman, *supra* note 37; *see also* Martin Lipton, *Dealing with Activist Hedge Funds*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Aug. 9, 2012), http://blogs.law.harvard.edu/corpgov/2012/08/09/dealing-with-activist-hedge-funds (estimating activist hedge funds' assets under management at approximately one hundred billion dollars). For the sake of comparison, the entire hedge fund industry (which includes many players that do not engage in shareholder activism) grew by a much lower fifty-seven percent during the same period. *See* Salzman, *supra* note 37.

44 Citi's Corporate & Inv. Banking Div., *supra* note 41. Slightly different figures are reported by the Hedge Fund Research in Chicago. They report an average return of thirteen percent for activist hedge funds between 2009 and 2012 and 9.6% for the first half of 2013. *See* Hirst, *supra* note 42.

45 One prominent example is Pershing Square's failure in Borders Group. Pershing Square, an activist hedge fund, was a major shareholder in the company and had tried to convince the Borders' board to merge with a rival company (Barnes & Noble). Borders eventually filed for bankruptcy. Agustino Fontevecchia, *Borders Finally Throws in the Towel, Big Hit for Ackman and LeBow*, Forbes, Feb. 16, 2011, http://www.forbes.com/sites/afontevecchia/2011/02/16/borders-finally-throws-in-the-towel-big-hit-for-ackman-and-lebow.

hedge funds and are increasingly investing in them as a new type of legitimate asset class.[46]

The more interesting question is whether activist hedge funds do, in fact, improve shareholders' long-term welfare. Hedge funds normally hold on to the shares of the target corporation for a relatively short period, leaving room for the possibility that the market returns they earn may be myopic and no long-term value may be achieved.[47] Yet although the scientific evidence on the long-term effects of hedge fund activism is scant, there is evidence that this activism indeed improves, on average, long-term shareholder value.

An empirical study conducted by Lucian Bebchuk, Alon Brav, and Wei Jiang examined about 2000 corporations that had been the targets of hedge fund activism campaigns.[48] Their study showed that there is no evidence that interventions by activist hedge funds are costly to firms and their long-term shareholders in the long-run. On the contrary: they found that in the five-year period following these interventions, operating performance improved. They also found that the initial positive stock price that followed these interventions correctly reflected their long-term consequences. Additionally, there was no evidence that the activist's exit is followed by abnormal long-term negative returns. The findings contradict the assertion that hedge fund activism pushes for profitable short-term results at the expense of the long-term interests of the targets and long-term shareholders.[49] The study drew much fire from opponents of hedge fund activism, who were disappointed by the findings.[50]

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46 Lipton, *supra* note 34.

47 For the market myopia phenomenon, see generally Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. Econ. 655 (1989); and Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. Pol. Econ. 61 (1988).

48 Bebchuk, Brav & Jiang, *supra* note 4.

49 Similar results were found in Europe. *See* Wolfgang Bessler, Wolfgang Drobetz & Julian Holler, *The Returns to Hedge Fund Activism in Germany*, Eur. Fin. Mgmt. (Feb. 28, 2013), http://onlinelibrary.wiley.com/doi/10.1111/eufm.12004/pdf (finding that hedge fund activists in Germany increase shareholder value both in the short and the long-term and that aggressive activism is initially associated with higher returns which are quickly reversed).

50 Martin Lipton, *The Bebchuk Syllogism*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Aug. 26, 2013), http://blogs.law.harvard.edu/corpgov/2013/08/26/the-bebchuk-syllogism:

> No empirical study, with imperfect proxies for value creation and flawed attempts to isolate the effects of activism over a long-term horizon influenced by varying economic, market and firm-specific conditions, is capable of measuring the damage done to American companies and the American

Note, however, that even if these findings accurately reflect the overall long-term impact of hedge fund activism, it does not mean that this activism always increases long-term value. It only means that on average, it is successful in attaining its goals. The study also does not suggest that there is no better alternative, nor, moreover, does it account for the huge transaction costs that are generated by hedge fund activism. This Article, in contrast, explicitly maintains that hedge fund activism *is* a second-best solution from the perspective of institutional investors and their beneficiaries among the public. The claim here is that institutional investors would be best off replacing the remote middlemen, to both improve results and save transaction fees.

To understand why hedge fund activism is an imperfect tool for these investors, consider the following analogy. A condominium building has been neglected or even abused by the management company to the point that its value has significantly dropped. The unit-holders fail to act and bring pressure on the management company due to collective action problems. The wealthy unit-owners, however, are willing to provide a third party with huge funds and give it a free hand in using this money. This third party begins by purchasing some units in the building. It then uses the remaining funds in a campaign against the management company. Because the third party owns only a few units in the building, its chances of success are not obvious, and thus the management company puts up strong resistance to any change. This fight is bitter and costly, but eventually the management company relents (as so often does the management of a corporation that is an activism target), and the building undergoes renovations. A short while thereafter, the third party sells its condo units for a large profit.

This third party will have improved the condo property to the benefit of all unit-holders, but at huge transaction costs. In addition, were the third party to have the long-run in mind, it might have taken different actions, to increase the long-term profit to all unit-owners. Yet the wealthy unit-owners that funded the third party do not seem to care about the long-term value of the condos. This is because, as we develop the analogy now (and unlike our assumption in the previous paragraph), these wealthy unit-owners are actually wealthy owners of condo units in another building as well. Like the third party, then, they are also interested in only short-term gains. Now replace condominium building, wealthy unit-owners, and third party with corporation, institutional investors, and activist hedge fund, and we have the current story of shareholder activism in the United States.

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economy by the short-term focus that dominates both investment strategy and business-management strategy today.

The same analogy can be useful to explain this Article's proposed mechanism for institutional investor activism. Say a group of wealthy individuals individually invest in many condo units in a variety of different buildings. Some of the buildings are in urgent need of improved management. These wealthy owners appoint an expert to each geographic area, who is provided with initial funding to search in her area for a building in need of renovation. The experts are granted a proxy and broad mandate to act on behalf of the wealthy unit-owners. The wealthy unit-owners also commit to providing further, and much heavier, funding to the experts once they have decided which condo management to engage. The expert is authorized to target only properties in which the wealthy unit-owners will hold enough units in the aggregate to constitute an effective force in the campaign against the management. Furthermore, the funding for the expert's engagement of the condo management is not provided by all the wealthy individuals who signed an agreement with the expert, but rather only by those with units in the targeted condo building, pro rata to their holdings. Under this scheme, the relevant owners will have enough condo units in the building to guarantee the expert's victory against the management company, which will yield to its demands.[51] As a result, the condominium building will be significantly improved to the benefit of all its unit-owners.

Again, replace condo building, wealthy unit-owners, and experts with corporation, institutional investors, and task forces, and we have the essence of this Article's scheme. Transaction costs under this model are minimal. No hefty funding is needed to buy stakes in the condo buildings, no units change hands, and the building is likely to undergo renovation more quickly and with less struggle than under the hedge fund activism model. Moreover, and of considerable importance, the incentives of the task force in this model are much more aligned with the interests of the long-term shareholders than under the hedge fund activism model.

Finally, since my proposed activism scheme is based on existing holdings in the target corporation, all gains (but for the task force fees) are enjoyed only by those investors who were already shareholders in the target prior to its engagement. Profits need not be shared with all investors who finance the hedge fund's activism, as is the case under the prevailing model. And since

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51 Understanding why the expert is likely to be much more powerful than the strongest activist hedge fund lies in the striking difference between the size of the holdings of traditional institutional investors and that of hedge fund holdings: towards the end of 2013, activist hedge funds ran approximately 89 billion dollars, whereas in 2012, mutual funds held shares worth 6300 billion dollars, pension funds held 4150 billion dollars, and insurance companies held 1800 billion dollars. *See supra* notes 6-8, 44 and accompanying text.

institutional investor holdings dominate the market, the proposed mechanism would be highly accessible, and there would be no early warning to alert the target's management of the impending activism. This feature would produce a market-wide disciplinary force. In fact, the proposed mechanism would be so overwhelming that the management of target corporations might not even try to fight the activism, which, in turn, would reduce its costs even beyond what has been shown so far. We remain, then, with one major conundrum: why has this mechanism yet to evolve in the market, and why can we not expect it to emerge spontaneously in the near future? I proceed to this issue in the next, final Part of the Article.

IV. Final Remarks

This Article seeks to empower institutional investors by laying down a new framework for involvement in activism. The proposed scheme where task forces operate on behalf of institutional investors can be seen as outsourcing the function of activism to a third party. Although the involvement in the activism remains somewhat indirect, it is much less so than in the context of shareholder participation in hedge fund activism.

The main advantage of the proposed model is that it is closely aligned with the interests of the largest shareholders of the target firms and its potency derives directly from their holdings in the company. Institutional investors face certain impediments to exercising their powers and rights as shareholders to intervene when necessary in the management of their portfolio companies. Market dynamics have thus far harnessed the power of institutional investors through hedge fund activism. However, this mode of activism is an expensive and suboptimal way to improve value from the perspective of institutional investors. By contrast, this Article has laid out a framework for more direct institutional investor activism that uses an agent that would be more powerful than the most powerful hedge fund.

The proposed model for institutional activism could come up against certain challenges in implementation. To begin with, there could be some regulatory hurdles that would have to be overcome. First, the scheme could rise to a possible antitrust concern because it requires some level of cooperation among competing financial players. A second hurdle would derive from the specific regulation that governs the activity of each type of traditional institutional investor — insurers,[52] pension funds,[53] and mutual funds — which may also raise barriers to cooperation among money managers.[54] I leave for further research the discussion of the necessary relevant regulatory modifications.

But on top of these regulatory hurdles, the mechanism would also have to contend with resistance from management at portfolio companies, who would surely take action to frustrate this new mode of activism. Chief among the tools that could be resorted to is the notorious "poison pill,"[55] which operates to dilute the holdings of any shareholder that buys a stake beyond a certain threshold, commonly between ten percent and twenty percent,[56] without

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52 Insurance companies are regulated mainly by the state governments. The Federal Insurance Office was recently established and authorized to monitor certain aspects of the insurance sector. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); Nat'l Ass'n of Ins. Comm'rs & Ctr. for Ins. Policy & Research, State Insurance Regulation, *available at* http://www.naic.org/documents/topics_white_paper_hist_ins_reg.pdf.

53 The Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (1974), is a federal law that sets minimum standards for pension plans in private industry. The Department of Labor's Employee Benefits Security Administration enforces ERISA. *See The Employee Retirement Income Security Act (ERISA)*, U.S. Dep't of Lab., http://www.dol.gov/compliance/laws/comp-erisa.htms (last visited Dec. 9, 2013).

54 The Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-64 (1940), regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities and whose own securities are offered to the investing public. The SEC oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisors, and mutual funds. U.S. Securities and Exchange Comm'n, *About the SEC*, http://www.sec.gov/about/whatwedo.shtml (last visited Aug. 23, 2014).

55 Sharon Hannes, *The Market for Takeover Defenses*, 101 Nw. U. L. Rev. 125, 132-38 (2007); Wachtell, Lipton, Rosen & Katz, *The Share Purchase Rights Plan*, *in* The Law and Finance of Corporate Acquisitions 58 (Ronald J. Gilson & Bernard S. Black 2d ed. Supp. 2003-2004) (describing common features of a typical poison pill).

56 Institutional S'holders Servs. Inc., 2013 SRI U.S. Proxy Voting Guidelines 25-26 (2013), *available at* http://www.issgovernance.com/files/2013ISSSRIUSPolicy.pdf ("Rights plans should contain the following attributes: No lower than a 20% trigger . . . ."); Marc A. Alpert, Kessar Nashat & Garrett Lynam, *Rights Plans in a New Era: Recent Drafting Trends*, 6 Bloomberg L. Rep. (2012), http://www.chadbourne.com/files/Publication/6009a41f-69b1-421d-bae4-58543e624d3e/Presentation/PublicationAttachment/71251f36-ca16-4b13-9ae3-

management's approval. Although poison pills have fallen out of favor lately, with only a few percentages of the large companies still holding on to them, they could be reinstated. Poison pills could be relevant in our context if they are triggered by the formation of a group of shareholders, including the group supposedly formed by the task force agreements. Such an interpretation of a poison-pill trigger may, however, compromise the sacred "shareholder franchise" — shareholders' right to vote as they see fit — and would face legal hardships. I leave this issue as well for future research.

The real potential foe of the proposed mechanism, however, is neither the existing regulation nor the possibility of triggering a poison pill. Rather, the greatest threat to implementing this model is the political economy forces in the American market and the age-old sentiment against concentration of too much power in the hands of institutional investors.[57] The proposed framework might tilt the current balance of power between managers and shareholders to such an extent as to spark backlash regulation.[58] One possible solution to this political economy challenge that requires further discussion is to reduce the task force's potency so that it would have a strictly advisory role in proxy fights.

Nonetheless, even with such compromise, the manner in which institutional investors' power would be harnessed under the new scheme ensures much lower transaction costs than those entailed under the existing hedge fund model. Finally, and significantly, even in its modified form, the incentives of the agent in the proposed model are better aligned with the interests of the corporate target's biggest shareholders than under the prevailing activism model.

5e863ffdd99d/03.12.12%20-%20rights%20plans%20in%20a%20new%20era.pdf ("Despite ISS's recommendation that poison pills have a trigger of no less than 20 percent, the vast majority (82 percent) of the rights plans we surveyed used a lower trigger.").

57 *See* Roe, *supra* note 5; *see also* Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 131 U. Pa. L. Rev. 1469, 1471 (1991):

> A pattern can be seen in the history of American corporate finance. Institutions that can influence industry are restrained from growing too big. If they do grow anyway, their portfolios are forcibly fragmented. If the fragmented institutions attempt to link themselves together to control industry, law prohibits those links. For banks, insurance companies, pension funds, and mutual funds, the story is the same. Either separately or collectively, they have, perhaps wisely, been stymied from controlling or influencing industry after they have made their investments. What's more, there is a pattern of politics behind these prohibitions.

58 Calls for reform that would limit shareholders' power and tilt the balance towards director primacy are already out there. *See, e.g.*, Stephan M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 Harv. L. Rev. 1736 (2006).