

Capital Markets, Efficient Risk Bearing and Corporate Governance: The Agency Costs of Agency Capitalism

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Through accretion, the link between the structure of capital markets and corporate governance has become the object of attention. In 1989, Michael Jensen argued that the leveraged buyout association, in his view a more efficient form of organizing capital and managing a business, would come to supplant the Berle-Means corporation with its widely distributed shareholders and powerful managers who did not hold a significant equity stake in the organization.¹ In 1998, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishney tied corporate governance and related legal rules to the feasible forms of ownership structure; the protections provided by corporate governance dictated the types of instruments that the capital markets could make available to support the transfer of risk from the corporation to investors and the feasible distribution of investors.² In 2008, Ronald Gilson and Charles Whitehead, building on a growing body of work suggesting that the direction of causation ran from capital markets

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¹ Michael C. Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev. Sept.-Oct. 1989 at 61.

² La Porta et. al., Law and Finance, 106 J. Pol. Econ. 1113 (1998).

to corporate governance rather than the other way around,³ argued that the development of risk management – the transfer of risk in slices rather than through all purpose risk bearing by common stockholders⁴ – could substitute for traditional common stock-based risk capital, with important implications for the governance structure that supported risk transfer.⁵

From this prospective, corporate governance functions to support the transfer of risk to investors and is driven by the instruments financial innovation makes available through the capital market. In this paper, we extend and generalize the developing proposition that innovation in the capital market determines the efficient structure of corporate governance; the manner in which risk is transferred and the corresponding governance structure that supports that transfer, depends on the evolution of the capital market. Frictions and anomalies arise because capital market innovations, by influencing the range of ways by which risk can be transferred, drive ownership changes, and governance institutions must adapt to insure an allocation of governance rights that facilitate the available risk transfer techniques. Governance institutions are rarely in equilibrium because the capital market innovates at a faster rate than governance techniques adapt.

A familiar example illustrates the point. The development of junk bonds in the 1970s, in the first instance as a means of financing non-investment grade companies,

³ Cites, especially Franks and Meyer series

⁴ “Equity is a risk-management device. It is an all-purpose risk cushion.” Myron S. Scholes, *Derivatives in a Dynamic Environment*, 88 *Am. Econ. Rev.* 350, 366 (1998).

⁵ Ronald J. Gilson & Charles K. Whitehead, *Reconstructing Equity: Public Ownership, Agency Costs and Complete Capital Markets*, 108 *Col. L. Rev.* 231 (2008). Identifying the particular scholarly points along this process is merely illustrative and therefore somewhat arbitrary. Gilson and Whitehead, for example, drew explicitly on Myron Scholes’ 1995 prediction that firms would come to substitute less costly derivatives for equity capital. Myron S. Scholes, *The Future of Futures*, in *Risk Management: Problems and Solutions* 348, 362-65 (William H. Beaver & George Parker eds., 1995)

grew into a technique for financing hostile takeovers that greatly expanded the potential targets of a hostile bid. Non-investment grade bond issuance rose in volume from less than one-tenth of one per cent of total stock market capitalization in 1979 to a high of 2.5 per cent in 1988.⁶ By the mid- to late-1980s, more than half of all junk bond issuances were related to takeovers. In 1988, for example, an amount equal to 1.25% of total stock market capitalization was available to non-investment grade issuers to fund takeovers.⁷ In turn, the public issuance of subordinated debt could support large amounts of mezzanine financing by bank consortia, thereby substantially leveraging the resources of the junk bond market. Approaching half of all major United States companies were the object of a hostile takeover in the 1980s.⁸ The trajectory of corporate governance then was driven by these capital market developments.⁹

Similarly, the capital market's evolving informational efficiency facilitated the greatly expanded role of independent directors in corporate governance. As Jeffrey Gordon has shown, independent directors provided the courts with a buffer between corporate management and the capital markets, which allowed courts to rely on the directors' assessments of how best to create value rather than the courts having to make that assessment themselves. That stock prices fairly reflected public information about a corporation's performance, current and future, allowed directors plausibly to discharge

⁶ Bengt Holstrom & Steven A Kaplan, Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s, 15 J. Econ. Perspec. 121 (2001) (Table 5).

⁷ See, e.g, Bernard B. BlackBlack, The First International Merger Wave (and the Fifth and Last US Wave (2000) 54 UMich LRev 799 (2004); Michael Mitchell & J.H. Mulherin, The Impact of Industry Shocks on Takeover and Restructuring Activity, 41 J. Fin. Econ. 193 (1996).

⁸ See sources cited in n 7 supra.

⁹ See Ronald J. Gilson, Catalyzing Corporate Governance: The Evolution of the U.S. System in the 1980s and 1990s, 24 Sec. & Corp Law J. 143 (2006).

the function court assigned them.¹⁰ Again, the capital market's evolving capacity drove governance structures.

A wide range of implications flow from the recognition that the efficient structure of corporate governance is driven by the evolution of the capital market, whether as a result of financial innovation or of political economy.¹¹ These include the risk that best practice codes (including those of institutional investors like CalPERS and ISS guidelines), which are necessarily based on where the capital market has been rather than where they going, will result in the petrification of the governance process;¹² the potential for ownership structures to move back toward more concentrated ownership and block holders, even in countries with strong shareholder protection, as the continued development of derivative markets permits the transfer of elements of systematic risk, thereby moving equity in the direction of an incentive contract most efficiently held by managers;¹³ and the reconceptualization of the value of governance rights and the role of activist shareholders in the face of capital markets dominated by institutional investors.

In this article, we focus our attention on the last implication: how the evolution of the capital market led to the reconcentration of equity ownership in a set of institutions like pension and mutual funds that hold their shares as fiduciaries for their beneficiaries.

¹⁰ Jeffrey N. Gordon, *The Rise of Institutional Investors in the United States: 1950-2005: Of Shareholder Value and Stock Market Value*, 59 *Stan. L. Rev.* 1465 (2007).

¹¹ Thus, for our purposes we need not address the right combination of financial innovation that that makes the capital market more complete and thereby increasing the set of available risk transfer mechanisms, and the political forces that serve to limit them. The combination that shaped the path dependency in different countries will reflect importantly the influence of local conditions. See, e.g., Ronald J. Gilson, *Globalization of Corporate Governance: Convergence of Form or Function*, 49 *Am. J. Comp. L.* 329 (2001); Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter*, 74 *Wash. Univ. L. Q.* 327 (1996).

¹² Dani Rodrik makes the same point with respect to the best practice codes of institutions like the World Bank and the IMF with respect to recommended institutional structures to support economic growth in the Developing world. See Dani Rodrik, *Second-Best Institutions*, 98 *Am. Econ. Rev.* 100, 104 (2008).

¹³ Gilson & Whitehead, *supra* note __, at __.

This shift in ownership patterns from the Berle-Means archetype of widely distributed ownership, to concentrated record ownership through fiduciaries results, we argue, in a form of agency capitalism, in which one agency relationship separates corporate managers from the corporation's record owners, and a separate agency relationship separates the record owner from the beneficial owners holding through the institutional fiduciary. Because a significant percentage of these institutional fiduciaries have business models that limit their capacity to actively monitor the business choices of their portfolio companies other than by assessing stock market performance, one can see the development of activist shareholders functioning as governance intermediaries, claiming to actively monitor company performance and then presenting to companies and institutions concrete proposals for business strategy through mechanisms less drastic than takeovers. Reflecting the authors' expertise, our discussion focuses largely on the evolution of United States governance structures. However, we note that the analysis should prove useful in assessing developments in other countries, as efforts in jurisdictions as different as the EU, the United Kingdom and Israel seek to harness institutional investors as monitors of company performance.¹⁴

Part I illustrates the link between capital market innovation and corporate governance by rehearsing two examples of how a change in the capital market can alter a company's capital structure and thereby the role of equity and the corresponding corporate governance regime. Part II then takes up the evolution of agency capitalism in response to developments in the capital market. Part III then argues that an agency capitalist regime results in the general undervaluation of governance rights and frames a role for active investors as governance intermediaries (or governance arbitrageurs

¹⁴ cites

depending on one's normative stance). Finally, Part IV considers the existing regulatory environment, including current reform proposals, in light of their effect on the supply of activist shareholders. Part V concludes by reemphasizing the complementarities between institutional investors and activists, in which the activists' willingness to bet their assets subject to ultimate judgment by the institutions revalues the institutions' governance rights and thus makes governance markets more complete.

I. Capital Market Innovation and Corporate Governance

There is a canonical account of U.S. corporate governance.¹⁵ Companies need risk capital to take advantage of new opportunities and to capture economies of scale and scope. Public investors who can diversify their shareholdings are the cheapest risk bearers. Fama and Jensen make the point explicitly: "Common stock allows residual risk to be spread across many claimants who individually choose the extent to which they bear risk and who can diversify across organizations offering such claims."¹⁶ Since diversified shareholders do not bear unsystematic risk, they need not be paid to bear it. The result is a lower cost of capital. But this cheap risk bearing comes at the expense of agency costs; someone else must manage the capital provided by dispersed shareholders. The result is dual specialization – investors in risk bearing and managers in managing – made possible by public capital markets. Agency costs resulting from the divergence of interests between professional managers and diversified shareholders highlighted by

¹⁵ This discussion draws on Gilson & Whitehead, *supra* note __, at __.

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

Adolph Berle and Gardiner Means some eighty years ago is simply the reciprocal of the benefits of specialization.¹⁷

The laser-like focus of corporate governance on minimizing agency costs, starting at least with Jensen and Meckling's classic 1976 article,¹⁸ is premised on the proposition that diversified shareholders are the cheapest risk bearers conditional on effectively addressing agency costs¹⁹. But what happens if innovation in the capital market increases the range of instruments by which risk can be transferred? In this section, we offer two illustrations: the impact on governance of being able to substitute tailored derivatives for equity with respect to particular slices of systematic risk; and the potential for such derivatives to fill the gap that will be created by a recent prediction of a shortage in the supply of equity.

Imagine that developments in the derivatives market allow a company to transfer specific elements of systematic risk through a derivative instrument rather than as part of the bundle of systematic risk transferred through common stock. Gilson and Whitehead offer the example of Agricore United.²⁰ Agricore provided handling and delivery services to grain farmers in western Canada. Not surprisingly, the amount of grain Agricore transported for farmers was dependent on the amount the farmers could grow, which in turn was dependent on the weather. Weather swings thus resulted in profits swings for Agricore, and the need to rely on debt and equity capital to offset profits swings to assure continued investment. Agricore then entered into an insurance contract

¹⁷ Misstates what B&M actually said. Berle & Means had negative view – managerial capitalism unchecked by any one. Reframed beginning largely with J&M.

¹⁸ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and the Theory of the Firm*, 3 *J. Fin. Econ.* 305 (1976).

¹⁹ Jensen and Meckling left open the possibility that changes in capital market technology would alter the tradeoff between ownership concentration (lower agency costs) and risk diversification. See *id.*, at 319-323, 353-4.

²⁰ Gilson & Whitehead, *supra* note ___ at 237-239.

with Swiss Re that paid off when grain production fell below the prior five-year average. When weather turned bad and Agricore's profits fell from the drop in grain shipments, insurance payments made up the shortfall. Agricore was able to "increase its debt financing levels, separate a portion of its working capital needs from its risk capital, and lower its overall cost of capital."²¹

The Agricore case illustrates that transferring risk through derivatives rather than common stock shifts the nature of the governance inquiry. Derivatives can be a substitute for equity; if systematic risk can be transferred through derivatives, then less equity is needed. As was the case for Agricore, equity can be replaced with lower cost debt.²² The most general governance implication is that block and control positions should require less investment to secure, and therefore concentrated rather than dispersed control should be feasible across a larger range of companies.²³ And at this point, Michael Jensen's prediction of the evolutionary prowess of private equity governance becomes simply a specialized case of the more general phenomenon – efficient ownership distribution and governance arrangements are driven by capital market

²¹ Id. at 238.

²² The claim that substituting derivatives for equity can reduce confronts the standard Miller-Modigliani response that capital structure is irrelevant to the overall cost of capital. Where cash flow volatility can result in real losses, and where derivatives involve fewer information asymmetries than does equity, a pecking order approach, see Stewart C. Myers, *The Capital Structure Puzzle*, 39 *J. Fin.* 575, 589-90 (1984), suggests derivatives can reduce the cost of capital. See, e.g., Kenneth A. Froot, David S. Scharfstein & Jeremy C. Stein, *Risk Management: Coordinating Corporate Investment and Financing Policies*, 48 *J. Fin.* 1629 (1993). This would be especially true when corporate governance was weak. Gerald D. Gay, Chen-Miao Lin & Stephen D. Smith, 35 *J. Banking & Fin.* 149 (2011), report empirical evidence consistent with the capacity of derivatives to reduce the cost of equity capital of non-financial firms that use derivatives compared to those that do not.

²³ Cite Holderiness; also make point that on inspection many of the largest privately held US corporations have a large commodity base, where developed derivative markets have existed for many years. Note that this reduction in the value of equity was what drove the use of leveraged recaps to put large blocks in the hands of management.

innovation.²⁴ Block and control positions may address the agency costs of professional management more effectively than independent directors, takeovers and proxy fights, albeit with an increase in the potential for private benefits of control, a class of problems that are best addressed through ex post legal rules conditional on an effective judicial system.²⁵

A second example of the potential of derivatives for reducing reliance on equity, and hence on traditional governance mechanisms, is suggested by a recent McKinsey Global Institute report arguing that corporations can expect to experience a shortage in the availability of equity in the near future.²⁶ In important part because derivatives depend on very different governance mechanisms, substituting derivatives for equity may help to reduce that shortfall.

The McKinsey report makes the argument for a coming equity gap in three steps. First, developing country capital markets can be expected to grow more quickly than developed capital markets. Second, the percentage of developed country household financial assets invested in equities can be expected to drop as a result of aging and the corresponding portfolio reallocation in anticipation of retirement. Poor equity returns over the last decade will exacerbate this life cycle effect on portfolios. Finally, developing country households generally allocate a smaller portion of their financial assets to equity than households in developed countries. According to McKinsey, U.S

²⁴ Gilson & Whitehead argue, for example, that the pattern of private equity firms selling portfolio companies to other private equity companies is consistent with the costs of periodic sales between professionals being lower than the agency costs associated with traditional governance regimes. Gilson & Whitehead, *supra* note ___, at 260.

²⁵ Ronald J. Gilson & Jeffrey N. Gordon, Controlling Controlling Shareholders, 152 U. Penn. L. Rev. 785 (2003); Ronald J. Gilson, Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harv. L. Rev. (2006).

²⁶ McKinsey Global Institute, The Emerging Equity Gap: Growth and Stability in the New Investor Landscape, December 2011, available at http://www.mckinsey.com/Insights/MGI/Research/Financial_Markets/Emerging_equity_gap

households allocate 42% of their financial assets to equity, Western European households allocate 29% to equities, while the allocations of households in Latin America, Chinese and emerging Asian nations range from 10% to 14%.

McKinsey then argues that the expected reduction in equity allocation in developed countries, together with the shift in financial assets from developed to developing countries and the smaller equity allocation in emerging countries, will result in a drop in the supply of funds to the equity market. McKinsey estimates the shortfall in the supply of equity relative to the demand at some \$12.3 trillion.

Among a number of suggestions for addressing this shortfall, McKinsey stresses the need for corporate governance reforms to make equity investment more attractive to emerging country investors – to support the transfer of risk:

“What is more critical in most developing countries are the “soft factors” that underpin healthy stock markets: improving financial auditing, reporting, and transparency of listed companies; developing and enforcing legal codes that protect the rights of shareholders.”²⁷

To this list we would add the obvious -- the need for an effective judicial system. As the Russian experience has demonstrated, codes without enforcement are of little consequence.²⁸ We need not rehearse the barriers to credible corporate governance reform in emerging countries to make the simple point that building the required institutional infrastructure will take significant time, not the least because of the political economy constraints in any single country: existing elites may not support capital market reform that increases overall wealth if the effect of reform will be to reduce their

²⁷ The Emerging Equity Gap, supra note __, at 55.

²⁸ Reinier H. Kraakman, Bernard Black & Anna Tarassova, Russian Privatization and Corporate Governance: What Went Wrong? 52 Stan. L. Rev. 1731 (2000).

economic and political power.²⁹ Thus, reformers must be inventive; the real trick is to make governance credible *without* waiting for the development of developed country-like institutions.³⁰

From the perspective of providing a credible commitment despite underdeveloped local institutional support for governance, the substitution of derivatives for equity as a source of risk capital has one straightforward advantage – contractual governance is substituted for corporate governance and the supporting institutional infrastructure shifts from local to international. Our point in this Section, however, is not to trumpet risk management through derivatives as the next corporate governance elixir, whether to treat the agency problem by facilitating the development of blocks or by facilitating resort to debt in the face of a reduced supply of equity. Rather, we mean to show only that the shape of effective governance is a function of the risk sharing instruments that innovation in, or the impact of political economy influences on, the capital market makes available.

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

In recent years, the centrality of the Berle-Means description of U.S. stockholdings to the corporate governance debate has been attacked from two opposite directions. From one direction, critics who take the Berle & Means description of U.S. equity holdings as accurate have pointed out that the U.S. and the U.K. are unique. Widely distributed equity holdings are neither typical of the rest of the world, nor even necessarily the direction in which capital market evolution will lead. Everywhere else in

²⁹ Ronald J. Gilson, Henry Hansmann & Mariana Parglender, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S. and the E.U.*, 63 *Stan. L. Rev.* 475 (2010).

³⁰ See Gilson & Milhaupt, *supra* note __, at __ (describing how some countries provide credible commitments to protect investments even in the absence of western-style institutions).

the world, equity ownership of public corporations is characterized by controlling shareholders or block holders.³¹

From the opposite direction came a more direct challenge: the Berle and Means description of the distribution of U.S. equity simply is no longer correct. In 1950, the Berle and Means description advanced some 25 years earlier remained accurate. Equities were still held predominately by households; institutional investors, including pension funds, held only approximately 6.1 percent of U.S. equities. By 1980, however, the distribution of shareholdings had begun to shift away from households toward institutions. At that time, institutional investors held 28.4 percent of U.S. equities. By 2009, institutional investors held 50.6% percent of U.S. equities,³² and 73 percent of the equity of the 1000 largest U.S. corporations. Table 1 sets out the institutional ownership of different size cohorts of U.S. public corporations in 2009.

Table 1
Institutional Ownership of Largest U.S. Corporations in 2009

Corporation Rank by Size	Institutional Ownership
Top 50	63.7%
Top 100	66.9%
Top 250	69.3%
Top 500	72.8%
Top 750	73.9%
Top 1000	73.0%

³¹ Gilson, supra note __, summarizes the literature. [expand from A& G]

³² The Conference Board, 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition, Table 10 (2011).

Source: The Conference Board, 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition, Table 13 (2011)

Thus, for the largest U.S. corporations, institutions control the great majority of outstanding shares. Put graphically but not metaphorically, representatives of institutions that collectively control many large U.S. corporations could fit around a boardroom table. For example, Table 2 sets out the percentage of the outstanding stock held in 2009 by the 25 largest institutions in the 10 largest U.S. corporations in which there was not a controlling owner.

Table 2
Percentage of Outstanding Stock in 10 Largest U.S. Corporations Without a Controlling Shareholder Held by 25 Largest Institutions in 2009

Corporation (in order of size)	Percentage of Stock Held by 25 Largest Institutions
Exxon-Mobil	25.0%
Microsoft	31.9%
Apple	37%
GE	24.8%
Procter & Gamble	29.1%
Bank of America	28.9%
JP Morgan Chase	35.8%
Johnson & Johnson	29.6%
IBM	30.6%
Wells Fargo	44.3%

Source: The Conference Board, 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition, Table 13 (2011)

To be sure, the enormous growth in institutional holdings of U.S. equities and the corresponding increase in ownership concentration is quite different than the control or block holdings observed elsewhere in the world. In their own way, U.S. institutions, like Berle and Means' diversified individual investors, are themselves passive with respect to much of corporate governance despite the fact that they confront much lower coordination and other collective action costs than those that sidelined individual investors. In this section, we will argue that the distribution of shareholdings in the U.S. remains unique, not because of their wide distribution, but because of the particular structure of the concentrated institutional ownership that has developed in the U.S. Real blockholders are not insignificant in the U.S.,³³ but the central change in equity distribution has been for equity ownership to concentrate in institutions, like pension funds and mutual funds, that in function are the record holder of equity on behalf of beneficiaries, for example, mutual fund shareholders or pension beneficiaries.

In this section, we explore the impact on corporate governance of the changes in the capital markets that has led to a distribution of U.S. equity holdings that we call "agency capitalism." By this we mean that the beneficial owners of U.S. equity confront two agency relationships – between the portfolio company management and the institutional record holder, and then between the record holder and the beneficial owner. While academics and the courts have explored the management-shareholder agency relationship in great depth, the institutional agency relationship has received far less attention.³⁴ We argue in this section that changes in the capital market, especially in the manner in which retirement savings are channeled, have led to a significant change in

³³ Holderness, dual class

³⁴ describe increasing number of papers describing the influence of ISS and other advisory services. Not relevant to our inquiry.

corporate governance. In particular, the institutions' business model and their corresponding expertise define and limit the role they play in corporate governance. In the next section, we develop how these limits result in a general undervaluation by the market of governance rights, which in turn has framed a role for activist investors. As governance intermediaries or governance arbitrageurs, activist shareholders can, in the right circumstances, serve to reduce the market's undervaluation of governance rights to the advantage of all shareholders.

A. Retirement Savings and the Rise of Institutional Ownership

In our view, post-World War II policy decisions concerning how retirement security would be provided were a major, if at the time entirely unrecognized cause of the rise of the U.S. system of agency capitalism.³⁵ Three were of particular significance: the initial decision to rely primarily on privately funded pensions rather than expanding social security; the enactment of the Employee Retirement and Security Act (ERISA) in 1974; and the later shift in employer provided pension plans from defined benefit to defined contribution plans.³⁶

³⁵ Peter Drucker recognized the development early on, but was rather too optimistic (or, more accurately, pessimistic) about how active pension funds would be in corporate governance. See Peter Drucker, *The Unseen Revolution: How Pension Fund Socialism Came to America* (1976).

³⁶ The rise of institutional owners is also intertwined with the modern understandings of the value of portfolio diversification. Beginning with the mathematics of mean-variance optimization,³⁶ investors came to appreciate that holding a diverse array of stocks could reduce risk while not reducing expected returns, thereby maximizing expected utility. In theory a significant amount of risk reduction could be achieved even while holding a relatively small number of stocks but risk maximum reduction was easiest to achieve by holding the broadest array of stocks. Indeed the principal of risk reduction through diversification was not limited to stocks, certainly not stocks traded on a single national exchange in a globalizing economy, and would counsel portfolios of a broad range of risky assets. Because of economies of scope and scale, large financial intermediaries had comparative advantage in assembling risk-reducing portfolios. Thus like pension funds, individual investors decided to save through financial intermediaries that made equity investments.

The immediate post-war period saw a hotly contested debate over how to finance retirement security in the United States: stated simply, would retirement support come primarily through private pension funds, or through an expansion of the government social security program?³⁷ Retirement assets that went into private pension funds would then be invested in the capital market, as compared to taxes paid into the social security trust. Reliance on private pension plans carried the day; substantial tax incentives encouraged workers and employers to use such funds as the major source of their retirement savings.

The focus on private provision of retirement security was augmented by the 1974 passage of the Employment Retirement and Security Act (ERISA), which resulted in a further increase in funds available to the capital market. Responding to abuses in the management and funding of private pension funds, Congress enacted legislation that requires companies to set up special entities to hold pension resources that would be governed by trustees having fiduciary duties solely to their beneficiaries. Most important, ERISA requires the defined benefit plans fund currently the actuarially-determined annual payments necessary to fund future retirement obligations. This requirement resulted from discovery that many corporations had allowed a substantial build up of unfunded past service costs. Pension funds covering public employees, although not covered by ERISA, followed suit. The result was an enormous concentration of funds that would be invested in the capital markets. From 1980 to 1990, pension fund assets increased from \$871 billion to \$3,023 trillion in 1990.³⁸

³⁷ See, e.g., William Graebner, *A History of Retirement* 215-241 (1980).

³⁸ Conference Board, *supra* note ___, at Table 12.

The impact of this increase in real assets held by retirement funds appears clearly from comparison with the typical unfunded German pension fund whose commitment to make retirement payments is simply a promise not backed by dedicated funds. In effect, an unfunded pension fund invests all of its assets in the company's unsecured debt.³⁹ Although plainly unintentional, the U.S. requirement that promised of future retirement payments be backed by real assets both generated and concentrated very large amounts of funds that would be invested in the capital market by a class of fiduciaries on behalf of future retirees.⁴⁰

The shift away from defined benefit retirement plans to defined contributions plans also expanded the role of intermediaries at the center of an agency capitalism regime. Again, the motivation for the switch was past service costs. The annual amount that an employer has to deposit in a defined benefit plan depends importantly on the investment return the fund can be expected to earn. A higher assumed return results in smaller current payments. A defined benefit plan commits the company to provide employees a specified retirement payment, typically a percentage of their salary measured over a specified period. This arrangement places all of the investment risk on the company – if overly optimistic predicted investment returns prove too high so that the fund has too few assets to make expected retirement payments, the company must make up the shortfall. Consistent with that allocation of risk, the trustees of the pension funds, who are appointed by the company, control the fund's investment decisions.

³⁹ The European Union is currently considering a proposal that would require balance sheet disclosure of unfunded liabilities of employer liabilities under defined benefit pension plans. See Paul J. Davies. Fears Grow of £600 Billion Company Pension Bill, *Economist*, January 3, 2012; EIOPA, Response to Call for Advice on the Relevance of Directive 2003/41/EC: 2nd Consultation.

⁴⁰ Add discussion of vote as fund asset..

A defined contribution plan shifts the investment risk from the retirement fund sponsor to the employee, thereby preventing the employer from getting in trouble as a result of the unfortunate alignment of incentives between optimistic predictions of investment returns and a lower current payment to the pension fund. Under a defined contribution plan, the sponsor makes a specified annual contribution to the employee's account, which the employee then decides how to invest. The savings available on the employee's retirement then depends entirely on the success of the employee's investment decisions,⁴¹ with the result that employers (and their balance sheets) do not bear the liability for future investment performance. Most commonly, the employee is given a choice of investment options determined by the pension plan. Increasingly, these choices are largely mutual funds, reflecting the employees' need for investment management advice.

The result has been a significant shift from defined benefit pension plans to defined contribution pension plans. In 1990, defined contribution plans and IRAs totaled \$1.5 trillion and private defined benefit plans approximately \$1.6 trillion; by 2009, defined contribution plans and IRAs had grown to \$8.3 trillion while private defined benefit plans held \$2.1 trillion.⁴²

This increase and concentration of financial power had two important consequences. First, it created a source of funds that could be deployed to fund large

⁴¹ It was an odd policy choice to shift the investment risk from the employer who presumably was a more sophisticated investor (or had access to sophisticated investment advice) to employees who could be expected neither to be sophisticated themselves nor to have access to sophisticated investment advice.

⁴² 2011 Investment Company Institute Factbook pp. 101-02 and figure 7.2; Conference Board, *supra* note ___, at Table 12. This shift from defined benefit to defined contribution pension plans gaining strength in the U.K. See Norma Cohen, *Final-Salary Pensions being Closed Rapidly*, FT, Dec. 15, 2011.

investments and still allow investors to retain a diversified portfolio.⁴³ For example, mutual funds in 2009 held approximately 49.4 percent (\$4.1 trillion) of defined contribution plans and IRA assets, of which approximately 45 percent (\$1.78 trillion) was invested in U.S. equities.⁴⁴ Second, decision making over these concentrated funds was centralized in a small number of individuals and institutions that were obligated to consider only the best interests of the future retirees. Again using mutual funds as an example, the three largest U.S. mutual fund groups in 2009 controlled approximately 34 percent,⁴⁵ the ten largest controlled approximately 48 percent, and the largest 25 controlled approximately 72 percent, of total assets invested in mutual funds.⁴⁶

B. The Reconcentration of Ownership

The peculiar role of institutional investors in the reconcentration of ownership of U.S. public corporations can be seen most easily from the governance role played by mutual funds, both because of their size and similarity, and because of the extensive information that is available concerning their governance activities. Three characteristics are most telling, one with respect to power, one with respect to reticence and one with respect to responsiveness. First, mutual funds are potentially powerful: they hold a very large percentage of U.S. equities. Over recent years, mutual funds held just under 30

⁴³ This growth was facilitated by a 1979 ruling by the Department of Labor, the government agency charged with overseeing pension fund investments, that the suitability of a particular investment would be judged not in isolation, but as part of the pension fund's entire portfolio. CFR § 2550.404a-1. The official commentary accompanying the regulation effectively endorsed the portfolio approach: "The Department is of the opinion that (1) generally the relative riskiness of a specific investment or investment course of action does not render such investment or course of action either *per se* imprudent or *per se* imprudent, and (2) the prudence of an investment decision should not be judged without regard to the role that the proposed investment plays within the entire portfolio." 44 Fed. Reg. 37,221 at 37,222 (June 26, 1979). Since prudence would be determined at the portfolio level, pension funds could make individually risky investments like limited partnership interests in the private equity funds involved in leveraged takeovers.

⁴⁴ 2010 Investment Company Institute Fact Book.

⁴⁵ Steven J. Choi, Jill E. Fisch & Marcel Kahan, Voting Through Agents: How Mutual Funds Vote on Director Elections, working paper 2011, available at www.ssrn.com

⁴⁶ cite

percent of the outstanding stock of publicly traded U.S. corporations.⁴⁷ Given the concentration in the mutual fund industry,⁴⁸ 10 mutual fund families hold the voting rights for some 15 percent of outstanding U.S. equities. Thus, by any measure, mutual funds have the power to be a force in the governance of large U.S. corporations.

Second, mutual funds are at least on the surface anything but proactive. For example, during the 2007 to 2009 proxy seasons, the proxy statements of Russell 3000 corporations contained 20,414 proposals to be voted upon by shareholders. Of these, shareholders proposed 1,882 (9.2 % of all proposals), the remainder of which were proposed by management. In turn, mutual funds proposed only 84 (4.5% of all shareholder proposals). The last step in this analysis is the character of the proposals mutual fund did make: 67 (80% of all mutual fund proposals) concerned social and environmental issues,⁴⁹ presumably proposed by so-called socially responsible funds. Thus, over the 2007 through 2009 proxy seasons, mutual funds offered only 17 (0.9%) shareholder proposals addressed at corporate governance or performance issues. To be sure, mutual funds may be proactive in less visible ways, quietly persuading portfolio companies to take desired actions with the threat of making a shareholder proposal in the background; however, the magnitude of that effort given the limited voluntary action by companies on such matters as requiring a shareholder vote to adopt a poison pill, at least suggests that mutual funds are reluctant to undertake active engagement.

Third, while mutual funds are not proactive, they are not entirely passive: they very frequently oppose management on core corporate governance issues. The most

⁴⁷ cites

⁴⁸ See TAN __ supra.

⁴⁹ Investment Company Institute, Trends in Proxy Voting by Registered Investment Companies 2007-09, Figures 1 and 6.

extreme example concerns voting on anti-takeover matters – poison pills and staggered boards – and illustrate the extent to which mutual funds vote against management recommendations when the issue is presented to them. Over the 2003-2005 proxy seasons, mutual funds voted in favor of shareholder proposals to require a shareholder vote before adopting a poison pill almost 80 percent of the time, and in favor of proposals to declassify the board of directors 44 percent of the time.⁵⁰ Mutual funds willingness to vote against management increased over time. For the 2003-2008 period mutual fund voting in favor of proposals to declassify the board increased to over 80 percent, and with respect to proposals to require shareholder for a poison pill, to over 90 percent.⁵¹

C. The Puzzle of What to do with Institutional Investors.

The reconcentration of ownership of U.S. equities has resulted in conflicting views of the corresponding governance structure. On the one hand, concentration of ownership holds out the possibility that the institutions will, like Pinocchio, come to act like real boys – like real owners and actively supervise the performance of professional management. This view is reflected in current discussions in, for example, the European Union,⁵² the UK⁵³ and Israel⁵⁴ concerning how institutions can, and can be made to, play a more proactive role in corporate governance. On the other hand, institutions have continually declined to play this role; despite the urging of academics and regulators, they

⁵⁰ Angela Morgan, Annette Paulson, Jack Wolf & Tina York, Mutual Funds as Monitors: Evidence from Proxy Voting (2009), available at <http://ssrn.com/abstract=1431072>

⁵¹ James Coates, Alan Palmiter & Randall Thomas, ISS Recommendations and Mutual Fund Voting, 55 Villanova L. Rev. __, __ (201_). Add discussion of evidence that responsive voice proceeds exit (selling the shares).

⁵² Cite to Green Paper and academic response

⁵³ UK reports

⁵⁴ Recommendations of the Committee on Enhancing Competitiveness, available at <http://www.mof.gov.il/lists/list26/attachments/291/2011-1111.pdf> (translation available from the authors).

remain stubbornly responsive but not proactive.⁵⁵ Capital market development has concentrated governance rights in fewer hands, who conversely appear to have little interest or capacity to play an active stewardship role in the governance of portfolio companies. In the next section, we consider how the combination of agency capitalism and the limitations of institutional competence and incentives result in an undervaluation of governance rights.

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

The story thus far has been that the mechanisms of risk transfer and the resulting distribution of ownership change is driven by fundamental changes in capital markets or political economy and that complementary corporate governance innovation is a critical element of the governance agenda. In the United States, institutional investors collectively have become the majoritarian owners of most large public firms. This is because of two sets of factors: public and private decisions over how best to mobilize and protect retirement savings; and private decisions in favor of a particular organizational form for wealth management.

In theory such institutional ownership should mitigate the managerial agency cost problems of the Berle-Means corporation. Fewer owners, larger positions, more sophistication -- the combination should spontaneously generate more activism. Reality has fallen short, as demonstrated by Section II's account of institutions' relative

⁵⁵ For example, some 21 years ago, institutions were urged to help nominate a minority of directors who were both independent of management and dependent on shareholders. Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stanford Law Review 863 (1991). The proposal still attracts comment, but not action. See Harvard Business Review article; Ronald J. Gilson & Reinier Kraakman, The Directors' Guild, N.Y. Times, June 8, 2009.

passivity: mutual funds and other for profit investment managers are almost uniformly reticent – very rarely proactive, but responsive to others’ proposals; public funds are more likely to be proactive, but largely limited to governance matters rather than performance. One way to frame the question is to ask why institutions place so little value on the vote that despite their majority holdings they choose to be largely responsive to the initiatives of others? More engaged firm-specific voting could reduce managerial slack at specific firms, and perhaps more grandly, improve performance across an entire portfolio, and, in theory, enhance social wealth by improving resource allocation throughout the economy.

What accounts for the missed gains? Another form of agency costs, we think, rooted in the institution’s desire to deliver competitively superior performance for their beneficiaries (pension funds) or clients (mutual funds) while minimizing costs. These pressures will lead institutions to focus externally and internally on relative performance of diversified portfolios. Such performance metrics do not readily accommodate governance activism even though it would be in the beneficiaries (shareholders) interests to generate value in this way.

Take first the case of mutual funds and other private wealth managers. Fundamental analysis, which identifies poor governance that affects performance, may highlight a private trading opportunity; however, efforts to improve governance allow competitors to share in the benefits, thereby producing no competitive advantage to the proactive investment manager. The result is that investment managers have no private incentive to proactively address governance and performance problems, and therefore do

not develop the expertise to engage in that activity,⁵⁶ even if such activity would benefit their beneficiaries. This gap between the clients' and the fund's interests represents a particular kind of agency cost that is of particular concern because it locks in another agency cost: managerial slack at the portfolio companies. Together these are the "agency costs of agency capitalism."

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

Our claim is that the agency costs of agency capitalism will result in the chronic undervaluation of governance rights. Effective governance requires firm-specific investigation and firm-specific activism, both of which are costly and will be under-supplied by institutional investors. *First*, the logic of diversification cuts against governance activity. (i) No single stock accounts (or in the case of a mutual funds, can account) for a significant portion of either the portfolio of the fund or the outstanding

⁵⁶ Investment companies are further constrained by the the limit to the sharees they can hold in a portfolio company. For example, pass-through taxation is available to mutual funds only if they do not hold more than ten percent of the voting securities of a portfolio company. In this respect it is important to note that this restriction applies to individual mutual funds, rather than to entire fund families like, for example, Fidelity or Vanguard. From this point, however, things get complicated (or, perhaps, interesting). The Investment Company Act of 1940 does not recognize the existence of fund families, so the board of directors of a mutual fund owes duties only to the shareholders of a particular fund, undiluted by the interests of other funds within the fund family. This disconnect between the law and the organization of the industry has gone largely unexamined.

stock of the portfolio company, so even highly successful governance intervention (a 10 percent stock price improvement) will not have a strong effect on portfolio returns.⁵⁷ This “no effect” problem is particularly evident in the maximally diversified portfolio of the indexed investor, but it will be an inhibitory factor for all diversified investors. (ii) The success of governance intervention is probabilistic, both in attaining an objective (board turnover, e.g.) and in a positive effect on the company’s performance. Yet the costs incurred will for sure reduce returns. A favorable benefit-cost calculation will almost invariably point to de minimis governance expenditures for the diversified investor.⁵⁸ (iii) Even if the governance intervention is successful and cost-justified, it may degrade relative performance. Take first an index fund. The governance gains will be enjoyed by all other indexers, except that the activist fund will have incurred costs that lower its net relative performance. Take second an actively managed fund. In order to benefit relatively, it must overweight a company it has identified as poorly governed. If it succeeds, it will earn some positive returns (net of costs) that may give it some edge relative to *some* of its competitors (especially those who underweighted the stock), but diversification limits the relative gains. On the other hand, if the governance initiative fails, it may be facing losses on its overweight holdings in a company it has credibly identified as poorly governed. These losses come on top of the costs for the campaign. Not a very promising calculus.

Second, the institutions’ internal monitoring mechanisms, based on benchmarking or performance relative to peers, cut against governance. Keep in mind that this

⁵⁷ For example, imagine a governance intervention that increases the value of the portfolio company by 10 percent; the fund owns 5 percent of the company’s stock, and that ownership position is a large one for the fund, 3 percent of the fund’s assets.

⁵⁸ On the cost constraints and other disincentives to institutional investor activism, see Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* (2007).

is not the result of institutions misunderstanding what investors think is good for them. For profit institutions like mutual funds have learned that investors follow relative performance and direct assets accordingly. Pension funds also follow relative performance in selecting and monitoring agents. Such relative performance evaluation falls out of contemporary portfolio theory. Factors that ramify market wide – for example, the recent financial crisis to pick an extreme example of a general phenomenon -- affect a portfolio “systematically.” Such risks are not readily diversifiable, if at all. So the performance question is comparative: given the state of the economy, how does this portfolio compare to “unmanaged” portfolios in the same “space.” A portfolio manager can outperform by omitting or underweighting (relative to market capitalization) a stock from his/her otherwise diversified portfolio. This has implications for governance activism. (i) The process by which the portfolio manager acquires and uses information is not governance focused. The portfolio manager’s mission is to determine how the current stock price matches his/her best estimate of the future stock price; that judgment determines a buy/sell/hold decision. Information comes in continuously; the comparative evaluation occurs continuously. A diagnostic thought process –what sort of intervention would improve performance and the governance activism entailments – is simply different. (ii) Assume the portfolio manager decides that a portfolio company is underperforming. The most assured way to grab the value of that insight is by selling the stock rather than incurring the costs and speculative future benefits of a governance intervention. That is, the fact of poor governance at a portfolio company may be an element in comparative evaluation, but the indicated action is not “intervene” but “sell.”

Third, the compensation structure has a complicated relationship to governance activism. For mutual funds, the 1940 Act limits incentive-based compensation at the firm level.⁵⁹ It would be impossible to reward the fund with an incentive-based fee tied to the returns from a particular kind of investment management activity. On the other hand, superior relative performance is the major driver of a fund's profitability. Superior performance draws new assets that can be charged a fixed fee (no incentives) yet the funds relatively fixed investment costs mean that the fund's profits are sharply increasing in fund size.⁶⁰ Two things follow: There is no special incentive for governance activism, meaning that no reason exists to devote internal resources to governance activism as opposed to other ways that portfolio performance might be improved. *But there is also a powerful incentive to engage in governance activism if it delivered returns that would improve the relative performance of the fund.* The dearth of this activity suggests that while potential gains from governance activism may well exist – there is ample evidence of managerial slack – the set up of the institutional investor makes it poorly equipped to pursue these gains.

Fourth, evaluation alternatives to benchmarking, based on “absolute” returns, may push portfolio managers even further away from the granular evaluation that maps onto governance activism. This style of investment focuses on asset allocation and regards equities as merely one among many asset classes that a portfolio manager might draw from and invites macro rather than micro analysis. In environments of high macro-

⁵⁹ 1940 Act provisions on fees. The funds can of course use incentive compensation as part of internal monitoring but governance will be disfavored in that structure.

⁶⁰ That is, the decision costs for a particular portfolio investment decision are mostly fixed. Size determines the assets over which those costs will be distributed. As assets increase, costs as a percentage of assets and as a percentage of the management fee paid by the investor will decrease. The firm's profit margins increase in size and so does its profitability.

economic uncertainty, this strategy may contribute to high correlation among stock price movements. The observed high correlations of the post-financial crisis period⁶¹ also undercut the business case for institutional governance activism. If firm-specific performance is submerged in general market movement, this will lower the expected returns to activism.

Institutional investors, then, present a problem for corporate governance. This efficient risk-managing form gives rise to significant problems in the efficient assignment of governance rights. For institutional owners who are not seeking private benefits of control, governance rights ordinarily have very low value; institutions are skilled at managing portfolios, not managing companies. Moreover, the institutions' performance, and hence their success in attracting funds, is evaluated by the performance of their portfolios, measured in comparative terms. In light of the mismatch between skills and incentives with respect to active company management, as opposed to portfolio management, governance rights will be chronically undervalued. And the same mismatch results in the pattern of institutional behavior we observe: institutions are not proactive, but when an issue is framed to them, they will act in their beneficiaries' interests. In short, institutional investors are rationally reticent, not passive.

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

⁶¹ Fox, Fox & Gilson.

But the same frictions create an arbitrage opportunity. Instead of pushing institutional investors to take on a role for which they have shown little appetite and may well be unsuited, we should instead expect specialization. Institutions specialize in managing risk, adding to and taking advantage of increasing capital market completeness. But in so doing they may leave a governance gap, an embedded shortfall in the monitoring of managerial agency costs. Addressing these agency costs of agency capitalism plausibly requires a new set of actors to complement the diversified investing and portfolio optimization that institutional investors now engage in. Such actors would develop the skills to identify governance shortfalls with significant valuation consequences, acquire a position in a company with governance-related underperformance, and then present to reticent institutions their value proposition. Once the issue is framed and presented, the undervaluation of governance rights is reduced: the institutions will vote in favor of the specialized actors perspective if the issue is framed in a compelling way. From this perspective, the overall obligation to beneficial owners is split between the portfolio management undertaken by institutional investors, and the active monitoring of portfolio company strategy and execution undertaken by activist investors. Pursuit of this specialized strategy may be better than trying to mandate that flat-footed mammals learn how to fly.

The clearest example of such specialization in addressing both sides of the agency capital triangle is the case of activist investors/governance entrepreneurs. They are not control entrepreneurs, in the sense that they are not motivated by the pursuit of the private benefits of control and therefore do not typically seek to acquire control. Rather they are governance entrepreneurs, in sense that they monitor companies to identify strategic

opportunities, and then present to institutional investors a choice. In giving the institutions this choice, the activists increase the value of governance rights.⁶² Activist investors frame and seek to force governance/performance changes, but they are successful only if they can attract broad support from institutional investors who are capable of assessing alternative strategies presented to them, rather than formulating the strategies themselves. In effect, activists must make their case to sophisticated but non-proactive governance rights holders owners. Such a reactive role is a more plausible model for institutional investor engagement, reflecting both their expertise and incentives.⁶³ This interaction can mitigate the agency costs of agency capitalism by reducing managerial slack through a mechanism that complements the dominant role of institutional ownership.

But this of course means that we need an adequate supply of shareholder activists, and so the focus shifts to the returns to activist shareholders: they must be high enough when the activists are right to provide a sufficient return to their activities in light of the fact that they typically will not capture a large share of the value they create. Recent work by Nicholay Gantchev sheds light on the costs of hedge fund activism and its returns. A campaign that culminates in a proxy contest costs nearly \$11 million on

⁶² For a survey of evidence showing valuation creation for target shareholders by public hedge fund activism as well as evidence showing similar gains through private hedge fund activism in Europe, see Marco Becht, Julian Franks & Jeremy Grant, *Hedge Fund Activism in Europe*, May 2010, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1616340.

⁶³ Some might object that this sort of specialization overly empowers the proxy advisory services, especially ISS, because of the extent to which institutions have de facto outsourced shareholder voting decisions, a strategy that economizes on governance costs. But sharp critics of the general role of ISS regard the institutions as engaging in decision-making in “votes with clear economic significance (such as mergers or election contests.” See Charles Nathan et al, *The Parallel Universes of Institutional Investing and Institutional Voting*, Latham & Watkins Corporate Governance Commentary (March 2010), available at http://www.lw.com/upload/pubContent/_pdf/pub3446_1.pdf. Recent evidence suggests that ISS’ influence may well be overstated, See Choi, Fisch, Kahan, *The Power of Proxy Advisors: Myth or Reality?* 59 *Emory LJ* 869 (2010), especially with respect to voting by large mutual fund families, Choi, Fisch, Kahan, *Voting Through Agents: How Mutual Funds Vote on Director Elections* (2011).

average, he estimates.⁶⁴ When costs are taken in to account, hedge fund returns are cut by approximately two-thirds on average.⁶⁵ These benefit-cost considerations become important when considering the regulatory framework within which activism operates.

In our analysis, the specialization of institutional investors in portfolio management, including assessing proposals presented by activist shareholders, and the specialization of activist shareholders in the active monitoring of management performance and strategy that institutional investors have declined to provide (despite academic and regulatory entreaties), are symbiotic, a result of the evolution of conditions in the capital market. The rise of institutional investors and the corresponding reconcentration of ownership both results in the undervaluation of governance rights and the potential for governance entrepreneurs to arbitrage that valuation differential. Yet this is not a classic arbitrage opportunity because a payoff depends upon the credibility of the activist with the institutional majoritarian shareholders. The average activist block is

⁶⁴ Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, Oct. 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1646471. He models hedge fund activism as a sequential process, and attaches costs to the each stage, beginning with demand negotiations (\$2.94 million on average); requesting board representation (\$1.83 million on average); waging a proxy contest (\$5.94 million for the average campaign). Total average per campaign is \$10.71 million. Of the 1164 campaigns he tracked in the 2000-2007 period, only 7 percent result in a proxy contest. But approximately 57 percent of these proxy contests result in activist success (meaning, to attain the ultimate stated objective, not necessarily a board seat). In cases where the activist demands board representation (the second stage; representing less than 20 percent of the sample), the success rate is approximately 39 percent. The lowest cost intervention, a “demand” for negotiation, has the lowest succeeds rate, approximately seven percent.

Gantchev also agrees with prior literature that reports evidence inconsistent with hedge fund “short termism.” The average duration of an activist campaign is 15 months. The variation around that average skews to the right, however; the 75th percentile for a campaign with specific demands is 26 months; the 25th percentile is 6 months. The average Initial ownership stake at the beginning of a campaign is 8 percent, which increases only to 9 percent over the course of the campaign; apparently the size of the activist’s ownership stake does not affect the probability of success (where success is defined in terms of initial demand outcomes).

⁶⁵ Much like the case with venture capitalism, skill in identifying situations where activism can both produce returns and succeed, is not randomly distributed. The top quartile of activists earn most of the returns. It is also likely that more successful activists will take on large firms. Success brings more resources, which means capacity to acquire “activism” blocks in bigger firms. Activism costs do not increase much in firm size, so assuming available resources to make the block acquisition, larger firms should be targeted by the more successful activists. But the returns are not evenly distributed: the top quartile of activists earn most of the returns.

roughly 8 percent, far less than control.⁶⁶ When the activist succeeds, what is the source of the success? It is not likely to be the activist's dazzlement of management with the astuteness of its strategic and operating proposals. In cases where management adopts some or all of the activist's proposals short of a proxy contest, management presumably believes that the activist has been persuasive with the majoritarian institutional owners of the firm. In cases where the activist pursues a proxy contest, the vote is a plebiscite that requires majoritarian shareholder approval of the activist's proposals. In short, governance markets are made more complete through an interactions in which activists propose and institutional investors dispose.

Recent empirical work is consistent with this account. Gantchev models the sequential process of governance activism and describes the frequency of each stage. Activism begins with the filing of a 13D that discloses the activist's greater than 5 percent ownership stake and its intentions and objectives; next comes the "demand negotiation" stage, in which the activist undertakes to force a negotiation with target management; then a "board representation" stage, in which the activist begins the process of recruiting director nominees; a threat of a proxy contest and then the actual contest itself. Of particular interest is the declining incidence of each stage and the increasing success rate. For example, of the initial 13D filings by hedge fund activists, only approximately 30 percent go to the next stage, demand negotiations. This pattern is consistent the interaction we posit. After public posting of a bond (the ownership stake) to establish its credibility, the activist undertakes a non-public campaign to elicit a

⁶⁶ Brav et al; Klein; Gantchev.

favorable institutional response.⁶⁷ Subsequent actions reveal the outcome of such efforts. With approbation, the activist proceeds; without, it withdraws, realizing that the chances for success are low. The relatively low fraction of initial interventions that proceed to the next stage suggests a high burden of persuasion for institutional support.

Gantchev also shows that the success rate (as measured in terms of initial demands) increases as the activist persists. Presumably this is because the activist evaluates the likelihood of success at each stage in deciding whether to continue, and the target makes the same assessment as it comes to know of institutional sympathy for the activist's proposals at each stage.

In short, the agency costs of agency capitalism arises in significant part from specialization and, in turn, specialization may be part of the cure. Institutional investors specialize in portfolio selection and performance; activist shareholders specialize in framing alternatives to existing company strategies and thereby making governance rights valuable to institutional investors. In effect, capital markets break up the ownership bundle; the legal regime needs to foster conditions in which the bundle can be reassembled through the engagement of diverse actors. We now turn to present regulatory initiatives that would skew the balance against the control of the agency costs we have identified.

IV. The Implications of the Regulatory Regime

The sustainability of the collaboration between institutional investors and activist owners depends on the regulatory regime that governs the activists' accumulation of

⁶⁷ See also Becht, Franks, Mayer & Rossi, Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund, 22 Rev. Fin Stud. 3093 (2008) (suggesting that shareholder activism is predominantly executed through private interventions both with target management and with other institutions. Sometimes the best auctions are silent; so are activism campaigns).

shares. The activist incurs costs: the financing costs of its equity position; idiosyncratic risk-bearing in connection with holding an undiversified position; the costs of the activism campaign itself. It needs to cover these costs and earn a favorable risk-adjusted return in order to engage in the undertaking.

The cost-recovery and the profits must come on the returns on the activist's equity position. Think of the alternative sources of cost recovery. A contract with institutional owners to cover expenses and/or share gains would entangle the institutions in the regulatory regime that covers share accumulations, an unattractive scenario. The target is an improbable source of cost recovery. Precisely because its campaign is not to obtain a board majority, the activist is highly unlikely to benefit from a friendly board's decision that such costs were a reimbursable business expense.⁶⁸ Some future shareholder bylaw calling for reimbursement of proxy contest expenses, newly permitted under Delaware law,⁶⁹ is highly speculative. Thus the activist's return depends on stock price appreciation, gains that are shared with other shareholders as well.

In a "success" case, the activist's return is a function of the size of its block and cost of its equity position relative to the post-success stock price. Well-developed evidence shows that the target's stock price immediately appreciates upon disclosure of the activist's block, that this appreciation increases in the activist's reputation for successful engagement, and that the appreciation anticipates a very large fraction of the gains associated with a successful activism campaign.⁷⁰ These dynamics make the regulatory choices over the timing of disclosure critical. They set the context to

⁶⁸ Compare *Rosenfeld v. Fairfield Engine*.

⁶⁹ DGCL § 113.

⁷⁰ Eg, Brav et al; Klein & Zur; going back further to include potential control entrepreneurs, Mikkelsen & Ruback, *An Empirical Analysis of the Interfirm Equity Process*, 14 *J. Fin Econ.* 523 (1985); Holderness & Sheehan, *Raiders or Saviors? The Evidence on Six Controversial Investors*, 14 *J. Fin. Econ.* 555 (1985).

understand the current regulatory initiatives in both the US and the EU with respect to the timing of disclosure of the activists' initial positions and whether equity derivatives can be used to expand economic exposure.

Reducing the ownership threshold for disclosure, shortening the period for disclosure following threshold-crossing, and limiting the use of equity derivative will all have the result of reducing the returns to activist shareholders. This is because they will reduce the economic stake that an activist shareholder can accumulate before disclosing its holding. Since these "toehold" acquisitions are the major source of the activist's return, the effect is to reduce the returns to activism. It's not simply that smaller blocks will undermine the activist's credibility and thus effectiveness. Rather and more important smaller blocks mean reduced returns. The activist sector will shrink, fewer firms will be identified for activism, and the activists will reduce costly campaign efforts. The result will be greater undervaluation of voting rights, as a result of reducing the attraction of arbitraging the difference in the value of governance rights to a reticent institutional investors and to an activist shareholder.

The UK and the EU have moved far down this road, with an ownership disclosure threshold of 3 percent and a two day disclosure requirement in the UK, and [comparable proposals] for the EU.⁷¹ From our perspective, there is considerable irony. The UK in its Stewardship Code and the EU in comparable measures are looking for greater institutional investor engagement. We see shareholder activism as addressing an agency cost of institutional ownership by creating a new channel for institutional voice. Because institutional investors ultimately have decision rights over the success of an

⁷¹ More detail on status of current proposals.

activist's campaign, activism potentiates institutional governance. So in shutting down activist investors, the UK and the EU are also sidelining the institutions.

The SEC has received recent importuning to follow the UK and various other countries in shortening the disclosure window and to broaden the definition of beneficial share ownership to cover purely economic positions generated by derivative trades.⁷² The SEC has signaled that its current position – a 10 days disclosure period and a more restrictive definition of beneficial ownership – may be reconsidered.⁷³ Because we write as American legal academics, we will address those proposals with more specificity; however, some of our policy proposals may have carryover value for other jurisdictions.

Part of what animates the proponents of a tighter window is the concern that activists can accumulate ownership positions in the 10 day window far in excess of the 5 percent threshold. There are anecdotes to this effect, although the evidence is that activists on average take blocks under 10 percent. The objections to more aggressively exploiting the 10 day window are two. First, the public shareholders unknowingly selling to the activist are disadvantaged, because they are selling at a price that excludes the potential benefits of the activist's initiative. Second, the activists may be able to accumulate a control position or at least a position of strong influence a) without paying a control premium or b) for reasons that threaten majoritarian shareholder interests. We think these are weak arguments or point to problems that could be readily addressed in the US setting.

⁷² Wachtell Lipton Rosen & Katz Petition for Rule Making Under Section 13 of the Securities Exchange Act of 1934, March 7, 2011.

⁷³ SEC Release No. 34-64087 (March 17, 2011).

The first objection fails on the stating of it. A shareholder's decision to sell results either from liquidity needs or the shareholder's reservation price for the security in question. Any asymmetry of information involved in the transaction arises from the activist's private information about its own intentions, which may include a forecast as to the likely target firm response. Wherein is the selling shareholder's entitlement to share? This becomes even clearer when the question is examined from the ex ante shareholder perspective, a familiar move. Assume shareholders are diversified (or have the opportunity to diversify) and that whether one is a selling shareholder or a holding shareholder is unbiased. Immediate disclosure will constrain stakes building, thereby reducing the returns to activism, and thus the occasions for activism and thus the net gains from activism across a portfolio of firms. Shareholders ex ante would presumably prefer a rule that increased their average wealth even if in a particular case, they lost a gains-producing opportunity. The shareholders can't have it both ways: inclusion in all occasions of gain-sharing; the benefits of more occasions for gain-sharing.

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

The second objection, the concern about the race to acquire control, near-control, or at least overwhelming influence, in the 10-day window, we take more seriously, but

with a caveat. In the decades of various forms of shareholder activism, the instances of significant block-building in the 10 day window are relatively few. In part this is because rapid significant accumulation becomes known to market intermediaries and is impounded in the price,⁷⁴ thus undercutting the economic rationale for accumulation, but also because the activist's idiosyncratic risks are increasing in investment size.

Remember that a genuine governance entrepreneur, not a control-seeker, must persuade majoritarian shareholders. Failing that, the campaign itself will fail, leaving the activist with large potential losses.

For genuine concerns about a control shift there is a remedy: the poison pill, a private ordering solution to this risk. We would hardly endorse the "just say no" version of the pill seemingly blessed by the Delaware courts,⁷⁵ but a time-limited pill authorized by shareholders rather than unilaterally adopted by management, a form of "chewable pill," will address this potential problem.⁷⁶ A threshold of 15 or 20 percent would accommodate activism without opening the way to the accumulation of a control block.

One way to read the current campaign to compel quicker disclosure is as an effort to get the SEC to impose a low threshold pill at a time when institutional investors are successfully pressuring boards to turn away from poison pills. In the not-so-distant past, almost all firms had pills, either adopted or subject to adoption at a moment's notice, a virtual pill. Facing shareholder pressure, more boards have let pills lapse, or have not adopted them, even when a control battle may be brewing. Moreover, although the rare

⁷⁴ Gilson & Kraakman, MOME I.

⁷⁵ See Unitrin; cf. Chandler's opinion in *Airgas* in which he claims that the pill is "just say no with reasons."

⁷⁶ In this form, the pill would be a contractual version of the chancery Court's preferred position with respect to the pill announced initially in *Interco* and reaffirmed more recently in *Airgas*.

circumstance may validate a low threshold (5 percent) pill,⁷⁷ higher triggers are much more prevalent,⁷⁸ reflecting assumptions about judicial permissiveness. Shortening the disclosure period would go far to capping the activist's ownership stake, not because it's legally forbidden to acquire more, but the economics militate against it. Here's the beauty of SEC action from the perspective of those advocating lower and quicker disclosure triggers: The rule is the SEC's not the board's; it's imposed across all firms, so not subject to firm-specific independent director or shareholder resistance; and it purports to be improving shareholder welfare, unmotivated by possible managerial agency costs. The SEC would be adopting a pill directed at activist shareholders at precisely the moment that boards, increasingly, will not adopt one -- a genuine coup for those who prefer more protection for management from its shareholders.

The second policy question relates to whether economic exposure generated through derivatives should count within the definition of beneficial ownership for determining the disclosure threshold. The easiest way to achieve this is a "cash-settled" "total return swap," in which the party taking the long side of the swap gets exactly the return of the equivalent equity position without actually holding or obtaining the shares. The swap is a bet about the movement of the stock price. When the swap is unwound, the parties settle up. Stock appreciation results in a cash payment of the gains to the activist; a stock price decline requires the activist to pay out the losses on the deemed position to the counterparty. In theory this should be unobjectionable as policy matter, in four separate respects. First, the activist is doubling down on its investment without gaining additional voting leverage to force its adoption. This reduces the risk of

⁷⁷ Selectica; cite Edelman & Thomas.

⁷⁸ Recent Shark Repellant data from Bebchuk & Jackson.

opportunistic behavior by the activist or other forms of private benefit extraction, because the bet increases while decision rights remain in disinterested hands. The separation of cash flow rights from control rights go in the direction that tilts against the activist's narrow self-interest. Second, to the institutional shareholders who ultimately decide in the firm-specific case, the activist's taking a greater economic stake based solely on the performance of the stock is a credible signal of a high quality proposal. Third, for the activist, the synthetic stock position increases its returns from its firm-specific investment and thus encourages the investment in the first place. Fourth, for shareholders generally, the opportunity for higher returns by the activist through proposals that are screened by disinterested institutional decision-makers will increase the occasions of high quality shareholder activism, thereby generally reducing the agency costs of agency capitalism.

As developed in the literature⁷⁹ and one important case,⁸⁰ a major concern is that a total return swap in practice will convey voting rights as well as the economic interest, and therefore undercuts the policy behind the 5 percent ownership disclosure trigger. Moreover, assembling this trans-threshold stake can occur in a relatively low visibility way that will not activate the self-checking mechanism of block-building through market purchases. How is this? Because the "short" swap counterpart(ies) will hedge their position by going "long" the stock, that is, through stock purchases. And because of their client relationship with the activist, the counterparties will not be unbiased in their behavior: they will vote in favor of the activist's proposal. Moreover, the stock is available for acquisition whenever the activist chooses. The activist has control over the

⁷⁹ Hu & Black articles on "empty voting" and "morphable voting."

⁸⁰ CSX.

unwinding of the swap. When unwound, the counterpart(ies) want to reverse their hedge, the sooner the better, and the activist stands ready to buy the blocks.

This is a “possibility theorem.” Counterparties claim not to behave in this way. Nevertheless the SEC is called to arms to avoid this scenario through an amendment of the 13d rules to include even purely economic stock positions as through cash-settled swaps and other derivatives within the scope of beneficial ownership.

We have two responses. First, in the post-Dodd-Frank world, counterparties may come to lose their hypothesized power to deliver votes and shares. Equity derivatives may come to be traded on exchanges, or the process of central clearing may interpose a central clearing party between the sides to the trade. In other words, hedging may come to be effected quite differently, in a way that drastically reduces the possibility of evasion. The SEC should wait to see how that plays out before deciding how to define beneficial ownership.

Second, another possibility is simply to define beneficial ownership to exclude a total return swap that has been “sterilized” through a mirrored voting on any proposal or proxy contest mounted by the activist counterparty. In a sterilized swap, the counterpart(ies) are obliged to cast their votes to mimic the voting behavior of the disinterested shareholders. This proposal preserves the advantages of letting activists double down, while still protecting the policy behind 13d of restraining the possibility of sudden control shifts.

V. Conclusion

We have described an embedded monitoring shortfall in the dominant form of shareownership in the United States and other places as well. Institutions are highly effective vehicle for financial intermediation and risk-bearing. Their effectiveness may derive in part from the specialization that also gives rise to what we have called the agency costs of agency capitalism. Rather than insist that institutions remodel themselves, we have suggested that the limits of specialization may be best addressed by fostering the development of a complementary set of specialists, in this case activist shareholders, a species of hedge funds. On the governance dimension, institutional investors are not so much rationally passive as rationally reticent. The interaction between shareholder activists and institutional investors – one proposing, the other disposing -- gives value to the institutions' low-powered governance capacities, in effect operating to arbitrage the undervaluation of governance rights in the hands of reticent institutional investors. Governance markets thus become more complete. The net result is better monitoring and, perhaps, lower agency costs in the real economy.

To be sure, there is a risk that both institutional investors and activist investors may be myopic, to the end of increasing the value of a speculative option.⁸¹ But there is a corresponding risk that company managers may be hyperopic, to increase the value of their option by extending its length, especially if it is then out of the money. No governance structure will perfectly distinguish between those alternatives in part because both sides may have come to hold their conflicting views in good faith. In the end, we do best by allowing activist shareholders to bet their assets that they can persuade

⁸¹ See Bolton & Samama 2010.

sophisticated institutional investors that they are right in their assessment of portfolio company strategy.