The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights

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ABSTRACT

Equity ownership in the United States no longer reflects the dispersed share ownership of the canonical Berle-Means firm. Instead, we observe the reconcentration of ownership in the hands of institutional investment intermediaries, which gives rise to what we call "the agency costs of agency capitalism." This ownership change has occurred because of (i) political decisions to privatize the provision of retirement savings and to require funding of such provision and (ii) capital market developments that favor investment intermediaries offering low cost diversified investment vehicles. A new set of agency costs arise because in addition to divergence between the interests of record owners and the firm's managers, there is divergence between the interests of record owners – the institutional investors – and the beneficial owners of those institutional stakes. The business model of key investment intermediaries like mutual funds, which focus on increasing assets under management through superior relative performance, undermines their incentive and competence to engage in active monitoring of portfolio company performance. Such investors will be "rationally reticent" – willing to respond to governance proposals but not to propose them. We posit that shareholder activists should be seen as playing a specialized capital market role of setting up intervention proposals for resolution by institutional investors. The effect is to potentiate institutional investor voice, to increase the value of the vote, and thereby to reduce the agency costs we have identified. We therefore argue against recent proposed regulatory changes that would undercut shareholder activists' economic incentives by making it harder to assemble a meaningful toe-hold position in a potential target.

Keywords: agency capitalism, agency costs, activist investors, hedge funds, governance, mutual funds

JEL: G12, G23, G34, K22

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The canonical account of U.S. corporate governance, which stresses the tension between dispersed shareholders and company managers in large public firms, has become factually obsolete and now provides a misleading framework for contemporary corporate governance theorizing.[1] In this account, framed by Adolph Berle and Gardiner Means 80 years ago, shareholders individually own too few shares to monitor management's performance and confront coordination costs that make collective monitoring difficult.[2] But as we shall see, the Berle-Means premise of dispersed share ownership is wrong. In 2011, for example, institutional investors owned over 70 percent of the outstanding stock of the 1000 largest U.S. public corporations.[3]

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

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

Some jurisdictions, including United Kingdom[5] and the European Union[6], have sought to bridge this gap by advocating a new set of governance obligations – those of

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[1] For example, Brian Cheffins & Steven Bank, Is Berle and Means a Myth? 83 Bus. Hist. Rev. 443 (12009)(questioning Berle & Means thesis).

[2] Adolph A. Berle & Gardiner Means, The Modern Corporation and Private Property (1933).

[3] See Section II infra. See IRRC Institute, controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review (Oct. 2012)(providing empirical evidence of significant block holdings in U.S. public corporations); Clifford Holderness, The Myth of Diffuse Ownership in the United States, 22 Rev. Fin. Stud. (2009) (same).

[4] See Section III infra.

[5] See Financial Reporting Council, The UK Stewardship Code (Sept. 2012); The Kay Review of UK Equity Markets and Long-Term Decision Making (July 2012), available at http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-finalreport.pdf.

[6] European Union, Green Paper on Corporate Governance, Brussels, 5.4.2011

"stewardship" or "sustainable engagement" -- on institutional owners generally. From this perspective, the task is to "fix" the existing governance model to improve the operation of the capital market. We present a very different view. We show that the disinterest of these institutions in serving as active monitors of portfolio companies is an endogenous response to the particular agency relationships that arise from reconcentrated record ownership in investment intermediaries. . In turn, the appearance of activist shareholders such as hedge funds, who acquire a significant but non-controlling stake in a corporation and then try to alter the company's business strategy initially through persuasion but sometimes through a follow-on proxy contest, should be seen as an endogenous response to the monitoring shortfall that follows from ownership reconcentration in intermediary institutions.

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

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

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

COM(2011) 164 final; European Parliament, Report on Corporate Governance in Financial Institutions, A7-0074/2011, (2010/2303(INI)). Based on the consultation process around these prior reports, the European Commission recently published its 2013 "Action Plan" for European company law and corporate governance that will include an "initiative … on the disclosure of voting and engagement policies as well as voting records by institutional investors." European Commission Action Plan: European company law and corporate governance, COM(2012) 740/2, at 8 (Provisional text, Dec. 12, 2012).

one of agency capitalism characterized by concentrated but reticent intermediaries. This shift illustrates that corporate governance is bound up with the way capital markets support the transfer of risk to investors. Changes in the available mechanisms of risk transfer drive ownership changes; corporate governance institutions then adapt to insure an allocation of governance rights that facilitate the available risk transfer techniques. Thus, 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.

Contemporary objections to the role of activist investors largely ignore how activist investors are the product of the changes in U.S. equity ownership, and that they operate to revalue governance rights, whose value depreciated as they came to be held by institutions in whose business model governance rights were at best peripheral.[7] Stated simply, the availability of low cost diversification under the aegis of institutional investors, combined with the corresponding institutional investor business model, creates the agency cost of agency capitalism. A corporate governance structure that was suited to a Berle- Means ownership distribution must evolve in response to the change in ownership distribution.

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

Reflecting the authors' expertise, our discussion focuses largely on the evolution of United States ownership patterns and governance structures. However, we note that the analysis should prove useful in assessing developments in other countries. In particular, the efforts in jurisdictions as different as the European Union, the United Kingdom and Israel seek to harness institutional investors as "stewards," that is, as active monitors of long-term company performance.[8] These efforts, it will be apparent, ignore that the structure of agency capitalism gives intermediary institutional investors little incentive to play this role; as a result, the institutions largely lack the competence to undertake it.

Part I illustrates the direction of causation between capital market innovation and corporate governance by rehearsing examples of how changes in the capital market give rise to responsive changes in governance. Part II then takes up the evolution of agency capitalism in response to developments in the capital market, stressing the impact of changes in the financing of retirement security. Part III in turn 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, more specifically, as governance rights

[7] E.g., Adam O. Emmerich et al., Fair Markets and Fair Dislcosure: Some Thoughts and the Law and Economics of Blockholder Disclosure, ad the Use and Abuse of Shareholder Power (forthcoming Harv. Bus. L. Rev 2012). Compare, e.g., Lucian A. Bebchuck & Robert A. Jackson, The Law and Economics of Blockholder Disclosure, 2 Harv. Bus. L. Rev. 1 (2012).

[8] E.g., Kay Report, supra note 5; UK Stewardship Code, supra note 5; 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)(Israel).

arbitrageurs). Finally, Part IV considers the existing regulatory environment, including current reform proposals, in light of their effect on the supply of activist shareholders, with particular emphasis on proposals in the U.S. (and actions already taken in the U.K. and E.U. member states) to eliminate most of the timing gap between an activist investor's acquisition of the disclosure triggering percentage of a company's shares and its obligations to publicly disclose its shareholdings. 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. The Direction of Causation: From Capital Markets to Governance

Changes in the capital market drive the efficient structure of corporate governance, not the other way around. Companies need risk capital to take advantage of new opportunities and to capture economies of scale and scope. Public investors who can diversify their shareholdings are the cheapest risk bearers. Fama and Jensen made the point explicitly thirty years ago: "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."[9] 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 Adolph Berle and Gardiner Means some eighty years ago is simply the reciprocal of the benefits of specialization.[10]

The laser-like focus of corporate governance reformers on minimizing agency costs, starting at least with Jensen and Meckling's classic 1976 article,[11] is premised on the proposition that diversified shareholders are the cheapest risk bearers conditional on effectively addressing agency costs.[12] Put differently, the ability to diversify gives rise both to a demand for governance and, in turn, to its supply.[13] Thus, when innovation in the

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

[10] The text reframes somewhat the point Berle and Means actually were making. The separation of ownership and control, however efficient, in their view resulted in corporations run by managers and accountable to no one. The agency problem served as a justification for New Deal efforts to empower regulators to hold managers accountable for their actions.

[11] 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).

[12] 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.

[13] This framing raises an example of the causation question given prominence by the Law and Finance literature, which argues that governance protection of shareholders was necessary for the emergence of diversified shareholders. We note that the historical evidence supports the direction of causation described in the text: from capital market to governance not from governance to capital market. For England, see

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

Consider the following examples. The development of junk bonds in the 1970s, in the first instance as a means of financing non-investment grade companies, 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.[14] 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.[15] 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 public companies were the object of a hostile takeover in the 1980s.[16] The next 30 years of corporate governance debate over the allocation of governance responsibilities for hostile takeovers then was driven by these capital market developments.[17]

The growth in the completeness of the debt market also gave rise to a strong claim concerning a new form of governance. In 1989, Michael Jensen argued that the leveraged buyout 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.[18]

In 2008, Ronald Gilson and Charles Whitehead made a similar connection between the completeness of the capital market and corporate governance. They argued that the development of risk management – the transfer of risk in slices rather than through all-purpose risk bearing by common stockholders[19] – could substitute for traditional common stock-based risk capital, with important implications for the governance structure that

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Brian Cheffins, Mergers and the Evolution of Patterns of Ownership and Control, 46 Bus. Hist. 256 (2006); and Julian Franks, Colin Mayer & Stefano Rossi, Spending Less Time with Family: The Decline of Family Ownership in the UK, in The History of Corporate Governance Around the World: Family business Group to Professional Managers 582 (2005). For Germany, see Julian Franks, Colin Mayer & Hans Wagner, The Origins of the German Corporation: Finance, Ownership and Control, 10 Rev. Fin. 537 (2006). For the U.S., see John C. Coffee, Jr. The Rise of Dispersed Ownership: The Role of Law and the States in the Separation of Ownership and Control, 111 Yale L.J. 1 (2001); and Mark J. Roe, Strong Managers, Weak Owner: The Political Roots of American Corporate Finance (1996).

[14] 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).

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

[16] See sources cited in note 15 supra.

[17] 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).

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

[19] "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).

supported risk transfer.[20] The reduction in the centrality of common stock as a result of the higher leverage that risk management allowed facilitates the reemergence of block positions and a change in control patterns.[21]

A final example of the link between capital market innovation and governance structure concerns the relationship between stock market informational efficiency and the role of independent directors. Jeffrey Gordon has shown that the capital market's evolving informational efficiency facilitated the greatly expanded role of independent directors in corporate governance. Independent directors provided 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 impounded the public information about a corporation's current and future performance allowed directors plausibly to discharge the function courts assigned them.[22] Again, the capital market's evolving capacity drove innovation in governance structures.

We offer these examples simply as evidence that corporate governance functions to support the transfer of risk to investors and is driven by the instruments financial innovation makes available through the capital market. 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 depend on capital market evolution. Frictions and anomalies arise because the capital market evolves at a faster rate than governance structures adapt; path dependent institutions move less quickly than markets, in no small part because adaptation negatively affects those favored by existing patterns.

A range of implications flows from the recognition that the efficient structure of corporate governance is driven by capital market evolution, whether as a result of financial innovation or of political economy.[23] These include, for example, (i) the risk that best practice codes (including those of institutional investors like CalPERS and the ISS guidelines), which are necessarily based on where the capital market has been rather than

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[20] 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 contributions that developed this analysis is merely illustrative and therefore somewhat arbitrary. Gilson and Whitehead, for example, drew explicitly on Myron Scholes' 1995 prediction that firms would come to substitute less costly derivatives for equity capital. Myron S. Scholes, The Future of Futures, in Risk Management: Problems and Solutions 348, 362-65 (William H. Beaver & George Parker eds., 1995).

[21] Gilson and Whitehead argue that the development of risk management techniques completed the capital market infrastructure necessary to support Jensen's argument that the LBO association could substitute for public ownership and could explain the phenomenon of one private equity firm selling a portfolio company to another private equity firm. Gilson & Whitehead, supra note 20.

[22] 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).

[23] Thus, for our purposes we need not address the right combination of financial innovation that that makes the capital market more complete and thereby increases 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).

where it is going, will result in the petrification of the governance process;[24] and (ii) the potential for ownership structures to move toward more concentrated ownership and block-holding, even in countries with strong shareholder protection, as the continued development of derivative markets permits risk transfer in ways that move equity in the direction of an incentive contract most efficiently held by managers.[25]

We focus in this article on an important current manifestation of this dynamic: the reconceptualization of the value of governance rights and the role of activist shareholders in the face of a capital market that has come to be dominated by institutional investors acting as investment intermediaries. In the next section we take up the reconcentration of shareholdings that gave rise to agency capitalism and then to activist shareholders.

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

In recent years, the centrality of the Berle-Means description of the distribution of U.S. stockholdings to the corporate governance debate has been attacked from two opposite directions. From one direction, critics who 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 the world, including both developed and developing countries, equity ownership of public corporations is characterized by controlling shareholders or blockholders.[26]

A more direct challenge comes from the opposite direction: the Berle-Means description of the distribution of U.S. equity ownership simply is no longer correct. In 1950, the Berle 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 all U.S. public equities, and 73 percent of the equity of the 1000 largest U.S. corporations.[27] Table 1 sets out the institutional ownership of different size cohorts of U.S. public corporations in 2009.

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[24] 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).

[25] Gilson & Whitehead, supra note 20. For example, if the firm can hedge the systematic risk associated with a critical input -- oil, for example – then managers can bear more firm specific risk, an arrangement that more closely ties their payoff to matters under their control.

[26] Ronald J. Gilson, Controlling Shareholders and Corporate Governances: Complicating the Comparative Taxonomy, 119 Harv. L.Rev. 1641 (2006), summarizes the literature. Holderness, supra note 3, provides more recent data. Mats Isaksson & Serdar Celik, Corporate Governance in Current Equity Markets 15, OECD Working Paper (Nov. 2012), show that the share of global capitalization of stock markets in countries with dispersed ownership has dropped by some 30 percent between 2000 and 2011.

[27] The Conference Board, 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition, Table 10 (2011). For a time series of institutional ownership between 195 and 2004, see Gordon, supra, note 23 at 1568 (Table 4, Fig. 5). . For similar observations, see, e.g., Stuart L. Gillian &

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%

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 represent effective control of many large U.S. corporations could fit around a boardroom table. For example, Table 2 sets out the percentage of the outstanding stock held in 2009 by the 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	37.0%
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)

Laura T. Starks, The Evolution of Shareholder Activism in the United States, 19 J. Applied Corp. Fin. 55 (2007).

To be sure, the enormous growth in institutional holdings of U.S. equities and the corresponding increase in ownership concentration are quite different than the control or block holdings observed elsewhere in the world. In their own way, U.S. institutions, like Berle-Means' diversified individual investors, are themselves passive with respect to much of corporate governance despite the fact that they confront much lower coordination and other collective action costs than those that sidelined individual investors. In this section, we will argue that the distribution of shareholdings in the U.S. remains unique, no longer because of its great breadth, 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.;[28] however, the central change in equity distribution has been for equity ownership to concentrate in intermediary institutions like pension funds and mutual funds, which are the record holder of equity on behalf of their beneficiaries, mutual fund shareholders or pension retirees.

In this section, we explore the impact on corporate governance of the changes in the capital markets that have led to a pattern of U.S. equity holdings that we call "agency capitalism." By this we mean that the beneficial owners of U.S. equities confront two agency relationships – between the portfolio company management and the institutional record holder, and then between the record holder and the beneficial owner. This relationship is depicted in Figure 1. While academics and the courts have explored the management-shareholder agency relationship in great depth, the institutional agency relationship has received far less attention.[29]

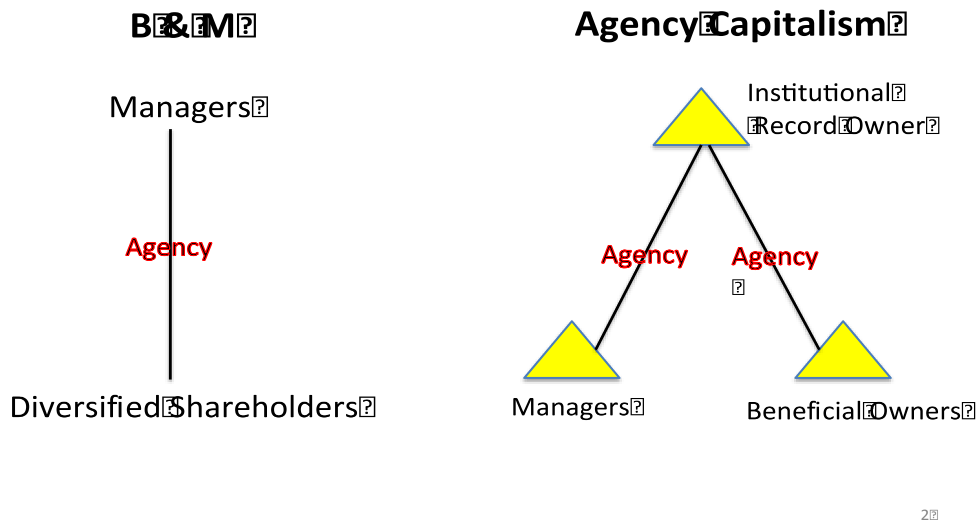
[28] See, e.g., Holderness, supra note 3.

[29] A developing literature examines the extent that recommendations by ISS and other advisory services influence mutual fund voting. See, e.g., Jie Cai, Jacqueline Garner & Ralph A. walking, Electing Directors, 64 J. Fin. 2389 (2009); Stephen Choi, Jill Fisch & Marcel Kahan, The Power of Proxy Advisors: Myth or Reality, 59 Emory L.J. 869 (2010); James Cotter, Alan Palmiter & Randall Thomas, ISS Recommendations and Mutual Fund Voting, 55 Villanova L. Rev. 1 (2010). All report measurable but limited influence. Assessing the influence of proxy advisors is beyond our ambition in this article. See also Stephen Choi, Jill Fisch & Marcel Kahan, Voting Through Agents: How Mutual Funds Vote on Director Elections, http://ssrn.com/abstract=1912772 (2011) (considering various ways that mutual funds economize on voting costs); Jennifer S. Taub, Able but not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholder Rights, 34 Iowa J. Corp. L. 843 (2009)

Another literature examines whether forcing institutional investors to reveal their governance decisions, at least as expressed through voting, changes behavior. E.g., Martijn Cremers & Roberta Romano Institutional Investors and Proxy Voting on Compensation Plans: The Impact of the 2003 Mutual Fund Disclosure Regulation, 13 Am. L. & Econ. Rev. 220 (2011); Burton Rothberg & Steven Lilien, Mutual Funds and Proxy Voting: New Evidence on Corporate Governance, 1 J. Bus. & Tech. L. 157 (2006); Angela Morgan, Annette Poulsen, Jack Wolf, and Tina Yang, Mutual funds as Monitors: Evidence from mutual fund voting , 17 J. Corp. Fin. 914 (2011).

Prior discussions of the two-sided agency relationship in a fashion similar to this article can be found in John C. Coffee, Liquidity vs. Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277 (1991), and Jill E. Fisch, Securities Intermediaries and the Separation of Ownership from Control, 33 Seattle L. Rev. 877 (2010).

Figure One – The Shape of Agency Capitalism



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

A. Retirement Savings and the Rise of Institutional Ownership

Post-World War II policy decisions concerning how retirement security would be provided were a major, if at the time unrecognized, cause of the rise of the U.S. system of agency capitalism.[30] Three were of particular significance: the initial decision to rely

[30] Peter Drucker recognized in the mid-1970s the increasing equity ownership by pension funds, but greatly overestimated how active pension funds would be in corporate governance. See Peter Drucker, The Unseen Revolution: How Pension Fund Socialism Came to America (1976). See generally See Jeffrey N. Gordon, Employees, Pensions, and the New Economic Order, 97 Colum. L. Rev. 1519, (1997); Martin Gelter, The Pension System and the Rise of Shareholder Primacy, forthcoming 43 Seton Hall L. Rev. (2013), http://ssrn.com/abstract=2079607, June 2012.

primarily on privately funded pensions rather than expanding social security; the enactment of the Employee Retirement and Security Act (ERISA) in 1974;[31] and the later shift in employer provided pension plans from defined benefit to defined contribution plans.[32]

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?[33] Retirement assets that went into private pension funds could then be invested in the capital market, including equities, as compared to taxes paid into the social security trust that have been invested in U.S. Treasuries. Reliance on private pension plans carried the day; substantial tax incentives encouraged workers and employers to look to such plans as the major source of their retirement savings despite some increase in social security benefit levels.

The impact on equity ownership of the private provision of retirement security was augmented by the 1974 passage of 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 pay future retirement obligations, and to pay down any prior unfunded past service costs over no more than 30 years.[34] 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.[35]

The impact of this increase in retirement fund assets appears clearly from comparison with, for example, the typical unfunded German pension fund whose commitment to make retirement payments is simply a promise not backed by dedicated

[31] See Gordon, supra note 30, at 1541-1544; Gelter, supra, note 30 at 16-17. See generally John Langbein, David Pratt & Susan Stabile, Pension and Employee Benefit Law (2010).

[32] The rise of institutional owners is also intertwined with the modern understandings of the value of portfolio diversification. This is discussed in Section II.B. infra.

[33] See, e.g., William Graebner, A History of Retirement 215-241 (1980) (tracing the legislative, economic and social factors that encouraged the development of private pension funds from WWII through the 1950s).; Alicia H. Munnell, Employer-Sponsored Plans: The Shift from Defined Benefits to Defined Contribution, in Oxford Handbook or Pensions and Retirement Income 359, 362 (Gordon L. Clark & Alicia H. Munnell, eds. 2006); Steven Sass, The Development of Employer Retirement Income Plans: From the Nineteenth Century to 1980, in Oxford Handbook or Pensions and Retirement Income 76, 78, 83 (Gordon L. Clark & Alicia H. Munnell, eds. 2006).

[34] I.R.C. § 411 (2000); ERISA § 203, 29 U.S.C. § 1053 (2000). Edward A. Zelinsky, The Defined Contribution Paradigm, 114 Yale L.J. 451 (2004), summarizes the special impact of ERISA on defined benefit plans.

[35]Conference Board, supra note 27, at Table 12.

assets.[36] In effect, an unfunded pension fund is fully invested in the company's unsecured debt.[37] Although plainly unintentional, the U.S. requirement for assets held in trust rather than a book entry to support promises of future retirement payments, 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.[38]

The shift away from defined benefit retirement plans to defined contribution 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 multiplied by the employee's years of employment with the plan sponsor.[39] This arrangement places all of the investment risk on the company – if overly optimistic predicted investment returns prove too high so that the fund has too few assets to make expected retirement payments, the company if solvent must make up the shortfall. Consistent with that allocation of risk, the trustees of the pension funds, who are appointed by the company, control the fund's investment decisions.

A defined contribution plan 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 (and therefore increased reported earnings). Under a defined contribution plan, the sponsor makes a specified annual contribution to the employee's account, which the employee then decides how to invest. The savings available on the employee's retirement then depends entirely on the success of the employee's investment decisions,[40] with the result that employers (and their balance

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[36]See, e.g., Bert Rürup. The German Pension system: Status Quo and Reform Options, in Social Security and Pension Reform 137 (M. Feldstein & Horst Siebert eds, 2002).

[37]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. U.S. accounting rules required this starting in 1985, with SFAS No. 87, , another factor that burdened the use of defined benefit plans. See . Robert M. Harper, Jr. & Jerry R. Strawser, The Effect of *SFAS 87* on Corporate Funding of Defined Benefit Pension Plans, 20(6) J. Bus. Fin. & Acct'g 815 (1993).

[38] This concentration of votes had an important role in hostile takeover fights. The Department of Labor, the agency charged with supervision of ERISA requirements, issued an opinion that the right to vote commons stock held by a pension fund was itself a fund asset, and that the vote was required to be cast in the sole interests of pension fund beneficiaries. Most directly. the DOL opinion restricted substantially the extent to which management could rely upon pension fund trustees to vote shares in favor of antitakeover positions or not to tender into a premium hostile bid.

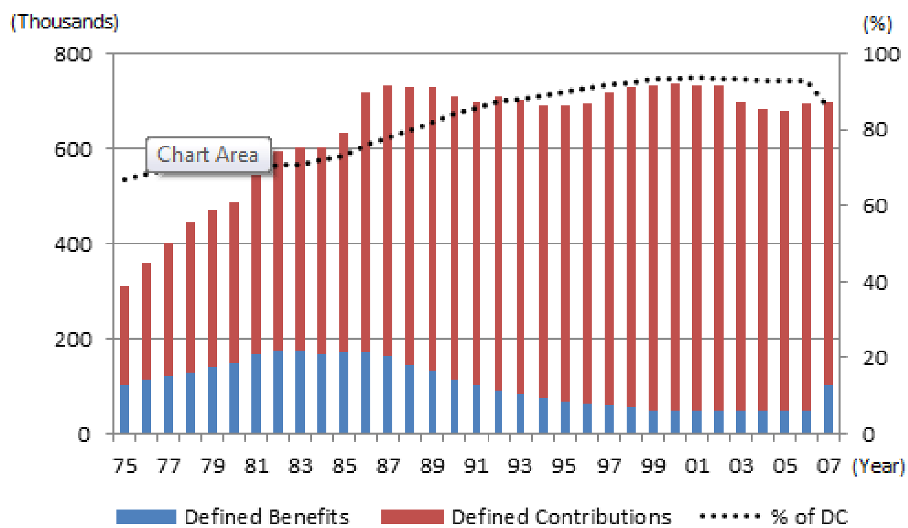
[39] see, e.g., Zelinsky, supra note 34 (explaining operation of defined benefit plan). Gordon, supra note 30, (same).

[40] Zelinsky, supra note 34, at 458-68,describes how the shift from a defined benefit to a defined contribution plan shifts to the employee the risk that investments will earn to little to support retirement, that contributions to the plan actually will be made, and that the employee will outlive his income. It was an odd policy choice to shift the investment risk from the employer, who presumably was a more a more sophisticated investor (or had access to sophisticated investment advice) and could secure economics of

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.[41]

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] Figure 2 shows the change in the number of defined benefit and defined contribution plans (as opposed to assets held) over the period 1975 through 2007. Figure 3 shows the change in the number of participants in each kind of plan. While the number of defined benefit plan participants has remained flat, the number of defined contribution plan participants has steadily risen over the same period.

Figure Two. Number of Private Sector Qualified Defined Benefit And Defined Contribution Plans, 1975-2007[43]



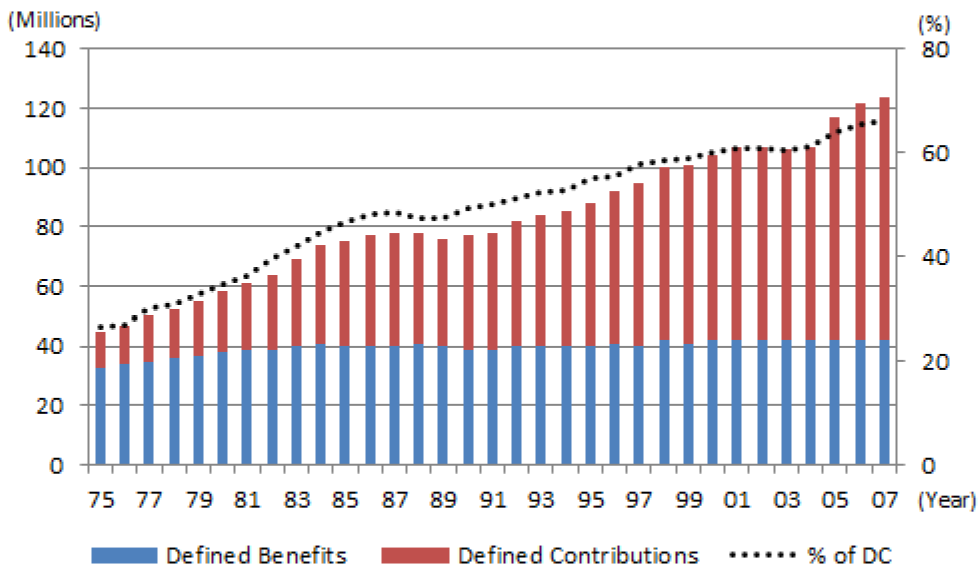
scale in managing that risk, to employees who could be expected neither to be sophisticated themselves nor to have access to the same quality of advice as would the employer. One of us has lamented the shift on distributional grounds as well. Defined benefit plan payouts were geared to an employee's final wage, which would be increasing in the firm's success and the employee's experience. Defined contribution plan payouts are less sensitive to final wages and are reduced by employees' investment conservatism. See Gordon, supra, note 31.

[41] Zelinsky, supra note 34, and Martin Gelter, supra note 30, summarize factors pushing employers to move from a defined benefit to a defined contribution plan.

[42] 2011 Investment Company Institute Factbook pp. 101-02 and figure 7.2; Conference Board, supra note 27, at Table 12. This shift from defined benefit to defined contribution pension plans is also gaining strength in the U.K. See Norma Cohen, Final-Salary Pensions being Closed Rapidly, FT, Dec. 15, 2011.

[43] Source: EBRI Data Book on Employee Benefits, Chapter 10 (Updated May 2011), table 10.2 a.

Figure Three. Number of Private Sector Qualified Defined Benefit and Defined Contribution Participants 1975-2007[44]



For our purposes, this increase and concentration of financial power had two important consequences. First, it created a source of funds that could be deployed to fund large investments and still allow investors to retain a diversified portfolio.[45] 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.[46] 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

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[44] Id., table 10.2b

[45] 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-l. 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. For general background on the new investment standard, see Jeffrey N. Gordon, The Puzzling Persistance of the Constrained Prudent Man Rule 62 N.Y.U. L. Rev. 52 (1987).

[46] 2010 Investment Company Institute Fact Book, supra note 27.

U.S. mutual fund groups in 2009 controlled approximately 37 percent,[47] the ten largest controlled approximately 48 percent, and the largest 25 controlled approximately 71 percent, of total assets invested in mutual funds.[48]

B. The Triumph of Portfolio Theory

The past 35 years has seen a sharp increase in US household ownership of equities; equity mutual funds have been the vehicle. As of 1977, approximately 20 percent of households owed equities, directly. The percentage of direct owners has remained stable, while the increase in mutual fund investing has increased the percentage of households that own equities directly or through mutual funds by 30 percent to 50 percent.[49] The increase in household mutual fund ownership has been significantly advanced by the portfolios theory of diversified investing. To be sure a large fraction of mutual fund owners have come to this form of investing through employer-sponsored defined contribution accounts (in 2011, 30 percent of all households) ; but a significant fraction own mutual funds even without that connection (31 percent of mutual fund holders; 13 percent of all households).[50] Moreover, most mutual fund holders (68 percent or 30 percent of all households) hold mutual funds both inside an employer account and outside.

What led to this investment pattern? As for greater equity investment, one important factor was the relative attractiveness of equity returns compared to returns on bank accounts, especially given the fixed interest rates that prevailed the 1980s.[51] But why did additional equity investment come through mutual fund investment during the period? Although mutual fund transaction fees declined, as reflected in the rise of no-load funds, so did the transaction costs of stock ownership, with the end of fixed commissions in 1975. A recent cross-country study of eight advanced economies observes that "direct stock ownership by households has largely been replaced by indirect stock ownership by financial institutions," and attributes this change to tax policies that favor such investing, for example,

[47] Choi, Fisch & Kahan, Voting Through Agents: How Mutual Funds Vote on Director Elections , supra, note 30.

[48] Investment Company Institute, Research Commentary: Competition in the Mutual Fund Business at 2, fig. 2 (2006).

[49] Gerald Davis, A New Finance Capitalism? Mutual Funds and Ownership Re-concentration in the United States, 5 Eur. Mngmnt Rev. 11, 15-16 (2008) (covering the 1977-2004 period). Current evidence from the Fed's Survey of Consumer Finances is consistent with this trend. As of the 2010 Survey, approximately 15 percent of all families directly held stock; 9 percent directly held "pooled investment vehicles," and 6 directly percent held "other managed assets." Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances, 98(2) FRB Bull. 1, 28 (Table 6), 34-35 (June 2012). Yet the percentage of families with indirect ownership of stocks was approximately 50 percent, primarily through tax-deferred retirement accounts, which heavily use mutual funds. Of the total *amount* of household equity holdings, only 31 percent was through direct stock ownership. The remainder took variously collectively managed forms: 21 percent direct through pooled investment vehicles, 6 percent through other managed vehicles, and 42 percent in tax deferred retirement accounts. Id. at 41-42, Tables 7.0, 7.1.

[50] ICI Factbook, at 86, Fig 1. 91.

[51] Davis, supra note 49.

tax-favored retirement accounts.[52] In the U.S. tax-favored treatment of defined contribution plans has surely led to such indirect ownership. Households' investment through 401(k) accounts, for example, is channeled into investment intermediaries. Yet as noted above, many investors own mutual funds outside of choice-constrained accounts. Indeed, individual mutual fund ownership is commonly less tax-efficient than direct equity investing. Mutual funds are "flow through" vehicles for tax purposes, and individuals are required to pay tax on net gains realized by the fund, even when the fund is selling stock to meet others' redemption requests.

A capital market innovation supplies the link: the application of Markowitz's Nobel-prize winning theorizing on the efficiency of mean-variance investing, giving rise to portfolio theory.[53] The lessons were: (i) diversification improves risk-adjusted returns; , (ii) the broader the portfolio, the greater the diversification; and (iii) since secondary markets in seasoned equities are highly efficient, research that adds value is expensive, and its fixed cost is best spread across large portfolios. All of this argues for investing through investment intermediaries that can assemble diversified portfolios as the low cost way to follow this strategy. Index investing is the limit[54] but the debate over whether households should exclusively investment through such lowest cost vehicles may obscure the major change, , which is that households increasingly invest through diversification-providing intermediaries – mutual funds.

C. *The Reconcentration of Ownership*

The peculiar position of institutional investors in the reconcentration of ownership of U.S. public corporations can be seen most easily from the governance role played by mutual funds, both because of their size and homogeneity, and because of the extensive information that is available concerning their governance activities. Three characteristics are most telling, one with respect to power, one with respect to reticence and one with respect to responsiveness. First, mutual funds are potentially powerful: they hold a large percentage of U.S. equities. Over recent years, mutual funds held approximately 25 percent of the outstanding stock of publicly traded U.S. corporations.[55] Given the concentration in the mutual fund industry,[56] 25 mutual fund families hold the voting rights for some18.75

[52] Kristian Rydqvist, Joshua Spizman & Ilya Strebulaev, The Evolution of Aggregate Stock Ownership, Center for Financial Studies W.P. 2011/18 (2010). www.econstor.eu/dspace/bitstream/10419/57351/1/66759728X.pdf.
[53] Harry M. Markowitz, Portfolio Selection: Efficient Diversification of Investments (1959); Portfolio Selection, 7 J. Fin. 77 (1952).
[54] See John H. Langbein & Richard A. Posner, Market Funds and Trust Investment Law, 1976 Am. Bar Foundation Research J. 1.
[55] 2012 ICI Factbook, 12, Fig 1.5.
[56] See supra text accompanying notes 47-48.

percent of outstanding U.S. equities.[57] Thus, by any measure, mutual funds have the power to be a significant force in the governance of large U.S. corporations.[58]

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. [59] Of these, shareholders proposed 1,882 (9.2 % of all proposals); the remainder 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 funds did make: 67 (80% of all mutual fund proposals) concerned social and environmental issues,[60] presumably proposed by so-called socially responsible funds. Thus, over the 2007 through 2009 proxy seasons, mutual funds offered only 17 (0.9%) of 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 strongly suggests that mutual funds are reluctant to undertake proactive engagement whether openly or behind the scenes.

Third, while mutual funds are not proactive, they are not passive in the Berle-Means sense: they very frequently oppose management on core corporate governance issues. The most extreme example concerns voting on 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 finds 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.[61] Mutual funds willingness to vote against management increased over time. For the 2003-2008 period mutual fund voting in favor of

[57] The calculation is based on the following two facts. The largest 25 mutual fund families represent 73 percent of mutual fund assets under management. 2012 Investment Company Institute Fact Book p. 225. In total mutual funds hold approximately 25 percent of U.S. domestic equities. Id. at 22.

[58] In fact, the discussion in the text likely quite significantly understates the voting power of the firms that advise mutual funds. The figures in the text reflect only the holdings of the retail mutual funds, likely because the most available source of data on mutual fund holdings come from the Investment Company Institute, whose data is limited to advisers registered as investment companies under the Investment Company Act of 1940. At the same time, the advisors to mutual funds also manage separate accounts for other institutional investors like pension funds. These represent a very large concentration of assets. For example, of the $3.673 trillion assets under management by BlackRock, the largest asset manager in the U.S., $1.045 trillion is in retail mutual funds and $1.483 trillion is in separate accounts managed for institutional investors. If overall mutual fund advisors manage in separate accounts as many assets as they do for mutual funds, and if the allocation to domestic equities is the same for separate accounts as it is for mutual funds, then the advisors control the voting of roughly twice the percentage of shares shown in the text. The breakdown of the character of BlackRock's assets under management comes from self-reported data provided by BlackRock to Evestment. See www.Evestment.com.

[59] Investment Company Institute, Trends in Proxy Voting by Registered Investment Companies 2007-09 (Nov. 2010), Figures 1 and 6.

[60] Id.

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

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.[62]

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

The reconcentration of ownership of U.S. equities in intermediary institutions has resulted in conflicting views of the corresponding governance structure. On the one hand, concentration of ownership holds out the possibility that the institutions will, like Pinocchio, come to act like real boys – like "real" owners (or stewards in the more polite vocabulary)[63] and actively supervise the performance of professional management. This view is reflected in current discussions in, for example, the European Union,[64] the UK[65] and Israel[66] concerning how institutions can, and might be made to, play a more proactive role in corporate governance. On the other hand, institutions have continually failed to play this role; despite the urging of academics and regulators, they remain stubbornly responsive but not proactive.[67] Capital market evolution thus has concentrated governance rights in fewer hands, who despite continual urging conversely appear to have little interest or capacity to play an active stewardship role in portfolio company governance. In the next section, we consider how the combination of agency capitalism and the complementary limitations of institutional intermediary competence and incentives result in an undervaluation of governance rights.

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

The analysis thus far has been that the mechanisms of risk transfer and the resulting change in the distribution of ownership is driven by the evolution of capital markets or political economy factors like pension reform; the need to develop complementary corporate governance innovation then follows. In the United States, institutional investors collectively have become the majority owners of most large public firms.[68] This is because of two sets of factors: public and private decisions over how best to mobilize and protect retirement

[62] Cotter, Palmiter & Thomas, supra note 29, at. To look at another measure: "withhold votes" for management's director nominees have somewhat increased over the 2007-09 period because of concerns about executive compensation, although the overall level of support (90 percent) is still high. See Inv. Co. Inst., Trends in Proxy Voting by Registered Investment Companies, 2007–2009 (Nov. 2010), at 12, 14.
[63] See UK Stewardship Code, supra note 5; Kay Report, supra note 5.
[64] See supra note 6.
[65] See supra note 5.
[66] 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).
[67] 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 Ronald J. Gilson & Reinier Kraakman, The Directors' Guild, N.Y. Times, June 8, 2009.

[68] See Table 1 supra.

savings; and private decisions in favor of a particular organizational form for investors achieving diversified 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 reduce coordination costs and spontaneously generate more active monitoring. Reality has fallen short, as demonstrated by Section II's account of institutions' peculiar form of passivity: mutual funds and other for profit investment managers are almost uniformly reticent – very rarely proactive, but responsive to others' proposals. Public funds are more likely to be proactive, but largely limited to governance matters rather than firm strategy or implementation.

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

What accounts for the missed gains? The answer, we think, is another form of agency costs, rooted in the institution's desire to deliver competitively superior performance for their beneficiaries (pension funds) or shareholders (mutual funds) while minimizing costs, part of the agency costs of agency capitalism. This competitive pressure will lead institutions to focus externally and internally on relative performance. Such performance metrics do not readily accommodate governance activism even though it would be in the beneficiaries' (shareholders') interests for the institutions to pursue value generation in this way.

Take first the case of mutual funds (including separate accounts managed by mutual fund advisers)[69] and other private wealth managers. Fundamental analysis, which identifies poor governance that affects performance, may highlight a private trading opportunity; however, efforts to improve strategy through governance efforts causes the benefits to be shared with competitors, thereby producing little competitive advantage to the proactive investment manager whose portfolio products and services are chosen in comparison to competitors offering similar products or services. The comparison is over whose growth portfolio produced better returns, not whether a value strategy would be better than a growth strategy. As a result, investment managers have little private incentive to proactively address strategy and performance problems at portfolio companies through governance action, and therefore do not develop the expertise to engage in that activity,[70] even if such

[69] See supra note 58.

[70] Investment companies are further constrained by the limit to the shares they can hold in a portfolio company. For example, pass-through taxation is available to mutual funds only if they do not hold more than 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.

activity would benefit their beneficiaries. This gap between the beneficiaries' and the fund's interests represent a particular kind of agency cost that is of special concern because it interacts with the more familiar species of agency cost: it locks in managerial slack at the portfolio companies. Together these are the "agency costs of agency capitalism."[71]

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

We can now turn to our central claim: that the agency costs of agency capitalism will result in the chronic undervaluation of governance rights. Effective use of governance rights requires firm-specific investigation and firm-specific activism, both of which are costly and will be 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 stock of the portfolio company, so even highly successful governance interventions (say a 10 percent stock price improvement) will have so small an effect on portfolio returns that the opportunity cost of the capital expended might well exceed the gains.[72] This "no (or negative) effect" relative performance 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 whether the objective is attained (e.g., board turnover or the sale of a division) and whether the performance effect will be positive. Yet the costs

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[71] The Kay Report, supra note 5 at 42 ("In the current market environment both analysis and engagement have something of the character of a public good – most of the benefits accrue to people who do not undertake them."), and Isaksson & Celik, supra note 27, at 31 ("[A] great majority of intermediary investors actually lack the incentives to exercise their ownership interests.") note the tension but do not address the role of activist investors.

[72] For description of mutual fund diversification/ anti-concentration rules, enforced through both the 1940 Investment Company Act and contemporaneous tax legislation, see See Mark J. Roe, Political Elements in the Creation of a Mutual Fund Industry, 139 U.Pa.Rev. 1469 (1991). Roe argues that these requirements arose from characteristic efforts throughout US history to limit the potential power of financial intermediaries. More recently, John Morley argues that mutual funds lobbied for these restrictions, to "brand" themselves as passive, low-risk investors. John Morley, Collective Branding and the Origins of Investment Management Regulation, 6 Va. L. & Bus. Rev. 341 (2012).

The impact of these diversification/anti-concentration rules is significant. 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, with the result that the fund gets .5 percent of the gain created. Even if the ownership position is a large one for the fund, say, 3 percent of the fund's assets, 99.5 percent of the benefit from the fund's actions goes to others while the fund pays 100 percent of the costs. In that circumstance, the fund may be far better off by spending the cost of the governance intervention on marketing. In some cases, governance intervention may serve as marketing. See Black Rock, Corporate Governance and Responsible Investment at BlackRock, Annual Review 2011, http://www2.blackrock.com/content/groups/global/documents/literature/1111157291.pdf.

incurred will, with certainty, reduce returns. A benefit-cost calculation typically will point to de minimis governance expenditures by the diversified intermediary institution.[73] (iii) Even if the governance intervention is successful and cost-justified, it still may degrade relative performance. Start with 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. Next take 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. This begins to sound like brief for the Wall Street Rule: if the issuer is badly governed, sell the stock and fire the portfolio manager.[74]

Second, the institution's internal mechanisms by which it monitors portfolio performance, based on bench-marking or performance relative to peers, cut against governance. Keep in mind that this is not the result of institutions' misunderstanding what investors actually want. For-profit institutions like mutual funds have learned that investors follow relative performance and direct assets accordingly. Pension funds also follow relative performance in selecting and monitoring portfolio managers, whether in-house or external. Such relative performance evaluation, falls out of contemporary portfolio theory.[75] 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 focused on identifying opportunities when governance action can improve company strategy. 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 governance intervention would improve performance – is simply a different inquiry. (ii) Assume the portfolio manager decides that a portfolio company is

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[73] 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, 155 U. Pa. L Rev. 1021 (2007), and, classically, Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. rev. 520 (1990).

[74] Robert Pozen, then a senior executive at Fidelity, made this point twenty years ago at a conference attended by the authors, whose focus was on encouraging institutional investor governance action. If Fidelity found itself invested in a company with bad governance, Pozen said, the portfolio manager had made a mistake. For Fidelity, the key was not to make the mistake in the first place.

[75] For a recent effort to incorporate the impact of fund flows as a result of relative performance on portfolio strategy, see Dimitri Vayanos & Paul Wooley, An Institutional Theory of Momentum and Reversal, , available at http://ssrn.com/abstract=1305671 (Aug, 2010).

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 for the institution, but not its beneficiary, may be to "sell" not "intervene."

Third, the institutions' compensation structures have a complicated relationship to governance activism. For mutual funds, the 1940 Act sharply limits the types of incentive-based compensation that shareholders can pay the fund's investment adviser – i.e., the incentive structure of the fees that Fidelity mutual funds pay to Fidelity.[76] It would be very difficult to reward the fund with an incentive-based fee tied directly or indirectly to the returns from a particular kind of investment management activity. On the other hand, superior relative performance is the major driver of a fund's profitability. Superior performance draws new assets that can be charged a fixed fee (no incentives), yet the funds' largely fixed investment costs mean that the fund's profits are sharply increasing in fund size.[77] 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 would be 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 institutional investor's business model makes it an unlikely candidate to pursue those gains.

Fourth, evaluation alternatives to benchmarking, based on "absolute" returns, may push portfolio managers even further away from the granular evaluation that maps onto 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; it invites macro rather than micro analysis. In environments of high macro-economic uncertainty, this strategy may contribute to high correlation among stock price movements. The observed high correlations of the post-financial crisis period[78] 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.

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. As in the standard

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[76] See Edwin J. Elton & Martin Gruber, Incentive Fees and Mutual Funds, 58 J. Fin. 779 (2003)(describing Investment Company Act limits on mutual funds incentive arrangements to a "fulcrum" fee that must reward good performance and penalize bad performance symmetrically).

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

[78] Edward Fox, Merritt Fox & Ronald J. Gilson, Economic Crises and Share Price Unpredictability: Reasons and Implications, working paper, Oct. 2012)(Very significant increase in firm specific volatility follow all financial crises in since early 20th century).

Berle - Means analysis, beneficial owners are rationally passive; governance rights are of little value to them. In turn, institutional owners who are not seeking private benefits of control are rationally reticent; they also will assign a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor's profitability and ability to attract assets depends. As a result, institutions can be expected to be skilled at managing portfolios, not at developing more profitable alternatives to a portfolio company's business strategy; strategic management is not the institution's business. The institutions' performance, and hence their success in attracting funds and earning profits, is evaluated by the performance of their portfolios, measured in comparative terms. In light of the mismatch between skills and incentives with respect to active company management, as opposed to portfolio management, governance rights will be chronically undervalued.[79]

Thus, we need to take seriously the governance environment created by the joint forces of capital market evolution and political economy, which at this moment can be described as "latent" activism (using Mancur Olson's terminology to refer to voters that are susceptible to organization because of well-defined common interests but are passive because of mobilization costs) and look for useful adaptations.[80] Costs, lack of expertise, and incentive conflicts reduce the value of governance rights in the hands of intermediary institutions.

But these same frictions in turn create an arbitrage opportunity. Instead of pushing institutional investors to take on a role for which they have shown little appetite and therefore are unlikely to have developed the additional skills that would be suited to an active governance role, we should instead expect specialization. Investment intermediaries specialize in managing risk, adding to and taking advantage of increasing capital market completeness. But this specialization, reinforced by the link between scale and profitability, may leave a governance gap, an embedded shortfall in the monitoring of managerial agency costs.

Addressing the governance gap – the agency costs of agency capitalism – plausibly requires a new set of actors to complement the diversified investing and portfolio optimization in which intermediary institutional investors now engage. Such actors would develop the skills to identify strategic and governance shortfalls with significant valuation consequences, to acquire a position in a company with governance-related underperformance, and then to present reticent institutions with their value proposition: a specified change in the portfolio company's strategy or structure.

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[79] We think this account of mutual funds' (and similar intermediaries') incentives provides a sounder basis for corporate governance theorizing than some recent models put forth in the finance literature. For a summary see Amil Dasgupta & Giogia Piacentino, The Wall Street Walk when Blockholders Compete For Flows (June 2012), available at http://ssrn.com/abstract=1848001.

Gerald Davis has similarly observed the reconcentration of share ownership yet the passivity of institutional owners. Gerald Davis, A New Finance Capitalism? Mutual Funds and Ownership Re-concentration in the United States, 5 Eur. Mngmnt Rev. 11 (2008). His explanation is somewhat different (conflicts of interest) and somewhat complementary (relatively short holding periods). Recent evidence on conflicts of interest is mixed. See Choi, Fisch & Kahan (2011), supra note 30. Relatively short holding periods is consistent with our account, in which institutional investor business model would lead to sales rather than governance activism at firms that institutions decide are mismanaged.

[80] Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Goods (1971) .

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. We see such specialized actors in the capital market – activist investors of various types – and indeed a complicated interaction between the actors and the institutions has arisen whose shape has been recently described in a comprehensive recent study by Nickolay Gantchev of 1164 activist campaigns over the 2000-2007 period.[81] What's interesting is that the activists achieve often achieve their stated objectives but not invariably, in approximately 29 percent of the cases.[82] As we elaborate below, an activist campaign is best seen as a multi-step process, the outcome of which critically depends on the extent to which the activist can garner significant institutional support for the proposed actions. The public campaign is a backdrop to the behind-the-scenes shareholder plebiscite. Shareholder activists make their strategic proffers; the outcomes suggest that the relevant institutional investor constituency is willing to consider and assess them.

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

This specialization addresses both sides of the agency capitalism triangle depicted in Figure One. Activist shareholders are not control seekers, in the sense that they are neither motivated by the pursuit of the private benefits of control, nor do they anticipate actually managing a portfolio company. Rather they are governance entrepreneurs, arbitraging the value of governance rights that become more valuable through their activity in monitoring companies to identify strategic opportunities, and then presenting them to institutional investors for their approval through a proxy fight should the portfolio company resist the proposal. By giving the institutions this choice, the activists increase the value of governance rights; the institutions' exercise of governance rights then become the mechanism by which value is created for beneficial owners.[83]

The point of tangency between these two specialists is that both activist and institutional shareholders must agree for a proposal to go forward: While activist investors frame and seek to force governance/performance changes, they are successful only if they can attract broad support from institutional investors who are capable of assessing alternative strategies presented to them, even if they will not formulate the strategies themselves. In effect, activists must make their case to sophisticated but non-proactive

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[81] Nickolay Gantchev, The Costs of Shareholder Activism: Evidence from a Sequential Decision Model, (forthcoming 2013 J. Fin. Econ), http://dx.doi.org/10.1016/j.jfineco.2012.09.007.

[82] Id. at 3,11, Table 3. (highest success in pursuing a sale (or privatization) of a target, restructuring of inefficient operations and additional disclosure; less successful in obtaining higher dividends (or repurchases), CEO removal, or executive compensation changes).

[83] For a survey of evidence showing value 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.

governance rights holders. Such a reactive role is a more plausible model for institutional investor engagement, reflecting both their expertise and incentives.[84] This interaction between intermediary institutions and shareholder activists, each with complementary specialized capacities thus can mitigate the agency costs of agency capitalism through a mechanism that complements the reconcentration of record ownership.

But this happy complementarity requires an adequate supply of shareholder activists, and so the focus shifts to the return to activist shareholders: it must be high enough when the activists are right – that is, when the intermediary institutions agree with the proffered strategy and the strategy in fact works – to warrant their effort.in light of the fact that the bulk of the gains from their effort will be captured by other shareholders, and that their efforts may not be successful.[85] Gantchev's recent work sheds light on the costs of hedge fund activism and its returns. A campaign that culminates in a proxy contest costs nearly $11 million on average, he estimates.[86] When costs are taken in to account, hedge fund returns are on average cut by approximately two-thirds.[87] These benefit-cost

[84] 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, supra note 29.

[85] A recent client letter from Wachtell, Lipton, Rosen & Katz, a leading proponent of restricting activist shareholders, recently: stated "[S]everal significant victories by boards of directors and corporations over activists could reduce hedge funds appetites for activism or alter their tactics or selection criteria. AOL, Forest Laboratories and Cracker Barrel all successfully defended against months long proxy fights. … Companies have succeeded in proxy fights by focusing on their business strategy, highlighting positive changes, whether financial or in corporate governance, and pointing out when the dissident had no long term business strategy." Wachtell, Lipton, Rosen & Katz, Mergers and Acquisitions – 2013, January 14, 2013.This is just the kind of constructive interplay that complementary specialization contemplates.

[86] Gantchev, supra note 81, at 14, Table 7A. 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 initial intervention, styled a "demand" for negotiation, has the lowest succeeds rate, approximately seven percent. Id. at11, Table 3B. 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. Id. at 12, 13, Table 4A. 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). Id. at 13, Table 5A.

[87] Id. at 16, (Table 8C).

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. Id. at 16, Table 8. It is also likely that more successful activists will take on large firms. Success brings more resources, which means capacity to acquire "activism" blocks in bigger firms. Activism costs do not 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 actively monitoring management performance and strategy and proposing alternatives, are complementary, a result of the evolution of conditions in the capital market. The rise of intermediary institutional investors and the corresponding reconcentration of ownership both results in the undervaluation of governance rights and the corresponding opportunity for activist shareholders to arbitrage that valuation differential. Yet this is not a classic arbitrage opportunity because the payoff depends upon both the credibility of the activist and the persuasiveness of its proposal with the controlling institutional shareholders.[88]

The average activist block is roughly 8 percent, far less than control.[89] When the activist nonetheless succeeds, what is the source of the success? It is not likely to be that the activist shareholder bedazzles management with the astuteness of its strategic and operating proposals. In cases where management adopts some or all of the activist's proposals without a proxy contest, management presumably believes that the activist can persuasively address the institutional investors who own a majority of the firm. In cases where the activist pursues a proxy contest, the vote is a plebiscite that requires shareholder approval of the activist's proposals. In short, governance markets are made more complete through interactions in which activists propose and institutional investors dispose.

Recent empirical work is consistent with this account. Gantchev models the sequential process of governance activism and describes the frequency of each stage. First, the activist shareholder assembles a toe-hold position, acquiring shares at a price as yet unaffected by the activist's plans. Public knowledge of the activist's efforts comes with the filing of a 13D that discloses the activist's greater than 5 percent ownership stake and its intentions and objectives.[90] Next comes the "demand negotiation" stage, in which the activist seeks to persuade target management to voluntarily adopt the activist's proposal. If this fails, then a "board representation" stage begins, in which the activist threatens a proxy contest and recruits director nominees. Should management still refuse to adopt the proposal, the final step is an actual contest. Of particular interest is the declining frequency of each stage and the increasing success rate at the later stages.[91] For example, of the initial 13D filings by hedge fund activists, only approximately 30 percent go to the negotiation

increase much in firm size, so assuming available resources to make the block acquisition, larger firms should be targeted by the more successful activists.

[88] This is consistent with empirical literature showing that activists are likely to target firms with significant institutional ownership, and, in evaluating otherwise equivalent firms, are more likely to target the firms with higher institutional ownership. See Gantchev, id. at 13, Table 6; Alon Brav et al. Hedge Fund Activism, Corporate Governance, and Firm Performance, 63 J. Fin. 1729, 1750, Table III.

[89] Gantchev, supra note 81, at 13, Table 5A. This is consistent with Alon Brav et al., supra note 88, at 1747, Table IIA (median initial ownership is 6.30%).

[90] The activist shareholder's pre-disclosure acquisition of a significant toe hold is critical to its business model. The timing of required disclosure thus directly affects the activist's expected returns. We consider current proposals to accelerate the disclosure requirement and thereby limit the activist's return by reducing the amount of pre-disclosure stock that can be acquired in the next section.

[91] Gantchev, supra note 81, at 11, Table 3B.

stage. This pattern is consistent with the interaction we posit. After public posting of a bond (the toe-hold investment) to establish its credibility and secure the chance of its return, the activist undertakes a non-public campaign to elicit a favorable institutional response.[92] 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.[93] 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 at each stage as it seeks out information about institutional sympathy for the activist's proposals.

There is a growing empirical literature that documents the impact on target company stock price of activist shareholder's efforts. Gantchev reports average (median) "raw" shareholder returns of approximately 39 percent (33 percent) over the average 19 month campaign period and average (median) annualized market adjusted returns of approximately 4 percent (4 percent). [94] Brav et al report average (median) raw target shareholder returns of 42 percent (20 percent) over the campaign period and annualized average (median) market adjusted returns of 20 percent (4 percent). [95] Klein and Zur report average target shareholder market-adjusted returns of approximately 22 percent over a one year post-initiation period.[96,97]

Our analysis shows that the agency costs of agency capitalism arise in significant part from the specialization of intermediary institutions in providing beneficial owners low cost diversification, at the cost of a business model that does not value governance rights. We then show that specialization by activist investors in arbitraging the value of governance rights – the difference between the value of institutions' governance rights before and after the intervention of an activist investor – may be part of the cure. Institutional investors

[92] 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).
[93] Gantchev, supra note 81, at 11, Table 3B.
[94] Gantchev, supra note 81, at 16, Table 8, 12, Table 4A.
[95] Alon Brav et al., supra note 88, at 1760,1761, Table 6A.
[96] April Klein & Emanuel Zur, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors, 64 J. Fin. 187, 188, 226 (2009) (although hedge fund targets experience higher returns upon 13D filing than other activists' targets, the reverse is true for subsequent gains; at yearend the totals are approximately the same).
[97] The existence of target shareholders gains from activist investor intervention is different from the debate over whether the interventions produce genuine economic gains vs. short-term price improvement. A recent paper that looks at plant-level census data shows that "a typical target firm improves its productive efficiency within two years after activism," a productivity effect that is concentrated in industries with elevated product market competition. Gains occur through both a "redeployment channel," deriving from better resource allocation, and a "discount rate" channel, deriving from the greater stability of returns. See Alon Brav, Wei Jiang & Hyunseob Kim, The Real Effects of Hedge Fund Activism: Productivity, Risk, and Product Market Competition, CES W.P. 12-14 (July 2012), available at http://ssrn.com/abstract=2022904.

specialize in portfolio selection and performance; activist shareholders specialize in framing alternatives to existing company strategies and thereby increasing the value of governance rights to institutional investors In effect, capital market evolution has broken up the ownership bundle, between rationally reticent institutional investors and potentially activist shareholders. To support effective governance, the legal regime needs to foster conditions in which the bundle can be reassembled through the complementary capacities and engagement of both.[98] 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 shareholders depends on the regulatory regime that governs the activists' accumulation of shares. The activist incurs costs: the research necessary to identify an opportunity to improve a target's business strategy; the financing and opportunity costs of its equity position; the idiosyncratic risk resulting from holding an undiversified position; and the costs of the activist campaign, from engagement with the target to the costs associated with a proxy contest, including legal counsel, proxy advisors, solicitation costs and the like. The activist needs to anticipate recovering these costs and earning a favorable risk-adjusted return before it will enter the business in the first place and engage with identified companies.

The cost-recovery and the profits come from the returns on the activist's toe-hold equity position secured before public disclosure of that position and the activist's plan. Think of the alternative sources of cost recovery. A contract with institutional owners to cover expenses and/or share gains both would incur significant coordination costs and would entangle the institutions in the regulatory regime that covers share accumulations, an unattractive scenario.[99] The target is also an improbable source of cost recovery. Precisely because the activist's campaign typically is not to elect a board majority, the activist cannot

[98] As an alternative mechanism, others have suggested pass-through voting by the holders of beneficial interests in investment intermediaries. E.g., Richard M. Buxbaum, Institutional Owners and Corporate Managers: A Comparative Perspective, 57 Brook. L. Rev. 1, 47-52 (1991) (pension fund beneficiaries); Jennifer S. Taub, Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights, 34 Iowa J. Corp. L. 843, 888-89 (2009) (mutual fund shareholders) Such suggestions seem highly likely to fail because of the original Berle-Means problem, the passivity of dispersed owners.

Gantchev & Jokikasthira propose an alternative hedge fund-institutional investor interaction, in which institutional exit reduces an issuer's stock price and also may signal an underperformance problem. This in turn may trigger an activist intervention. See Nickolay Gantchev & Chotibhak Jotikasthira, Hedge Fund Activists: Do They Take Cues from Institutional Exit?, Nov. 2012, available at . http://ssrn.com/abstract=2139482. From our perspective, even if the institutional investor's exit can be seen as a governance device, it requires a complementing action by an activist in order to be effective.

[99] Section 13 of the 1934 Securities and Exchange Act and Regulation 13D-G promulgated thereunder make it clear that any such agreement would render all parties to be members of a "group" that is deemed to have beneficial ownerships of the shares of all such parties. If the group owns more than 5 percent of an issuer's outstanding stock, group members have a filing obligation. See, e.g., Rule 13d-5(b). This will impose costs and liability risks on all parties who have entered into the agreement.

anticipate that a post-proxy fight friendly board would elect to reimburse its expenses.[100] An activist's pursuit of adoption of a shareholder bylaw calling for reimbursement of proxy contest expenses, newly permitted under Delaware law, [101] is both highly speculative and dilutes the activist's single minded campaign to increase the target's stock price and thus its credibility. The activist's return depends on stock price appreciation, gains that are shared pro rata with other shareholders as well.

In a "success" case, the activist's return is a function of the size of its block and the increase in the target's stock price as a result of the target's adoption of the proposal whether voluntarily or following a proxy contest. A great deal of empirical evidence shows that the target's stock price immediately appreciates upon disclosure of the activist's block depending importantly on the expectation that the activist has a substantive policy proposal. 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.[102] These dynamics make the regulatory choices over the timing of disclosure critical – the activist's business model depends on being able to secure a large enough equity position before required disclosure of that position drives up the price of the target's stock. Thus, the centrality of the disclosure regime sets the context to understand regulatory initiatives in the US and the EU to accelerate the disclosure of the activists' initial positions. These initiatives contain three elements: reducing the ownership threshold that triggers disclosure, shortening the period for disclosure following the ownership trigger being hit, and limiting the use of equity derivatives by including them in calculating the ownership amount.

Each of these elements will have the effect of reducing the returns to activist shareholders. This is because they will reduce the economic stake that an activist shareholder can accumulate before required disclosure of its holding drives up the price of the target company's stock. As noted previously, toe-hold acquisitions are the major source of the activist's return; these regulatory initiatives will reduce the returns to activism. It's not just that smaller blocks will undermine the activist's credibility and thus effectiveness. Rather and more important, reducing the size of the toeholds that activists can accumulate before disclosure reduces their returns. The likely outcome will be that the activist sector will shrink, fewer firms then will be identified as targets for strategic initiatives, and the activists will reduce costly campaign efforts. The result will be greater undervaluation of voting rights because of the reduced attraction of arbitraging the difference in the value of governance rights to reticent institutional investors and to an activist shareholder.[103]

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[100] Compare, e.g., Rosenfeld v. Fairfield Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955)

[101] Del.Gen. Corp. L. § 113.

[102] Eg, Brav et al., supra note 88; Klein & Zur, supra note 95; going back further to include potential control entrepreneurs: Mikkelson & 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).

[103] This can be understood as a particularized application of Grossman and Stiglitz demonstration that the capital market cannot be perfectly informationally efficient; arbitrageurs will no longer engage in the activity that impounds information into price if inefficiency does not allow an arbitrage profit. Sanford Grossman & Joseph Stiglitz, On the Impossibility of Informationally Efficient Markets, 74 Am. Econ. Rev. 393 (1980). Reducing the returns to activist investors similarly will reduce their efforts to move the value of the company toward its fundamental efficiency.

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 adopted in the UK[104] and comparable initiatives underway for other EU members.[105] From our perspective, there is considerable irony in this position. On the one hand, the UK in its Stewardship Code, the EU in comparable measures, and the Kay Report, all seek greater institutional investor engagement with portfolio companies.[106] In our view, this effort is likely to fail, since it conflicts with the institutions' business model. On the other hand, our analysis highlights shareholder activism as addressing an agency cost of institutional ownership – the undervaluation of governance rights that, if exercised, would benefit the beneficial owners -- by creating a new channel for otherwise reticent institutional voice. In effect, shareholder activism is what the stewardship movement desires but cannot achieve on its terms. Because institutional investors ultimately decide whether an activist's campaign will succeed, activism potentiates institutional governance by putting choices to the institutions. Reducing the size of a pre-disclosure stake that can be acquired by an activist shareholder has precisely the wrong effect: reducing the returns to activist shareholders will reduce the number of strategic initiatives by activist shareholders and ultimately results in reticent intermediary institutions continuing to undervalue governance rights. So in sidelining activist investors, the UK and the EU are also sidelining the institutions -- just those whose roles are simultaneously sought to be expanded into stewardship.

The SEC has received recent importuning to follow the UK and various other countries in shortening the disclosure window and broadening the definition of beneficial share ownership to cover purely economic positions generated by derivative trades.[107] As well, the SEC has signaled that its current position – a 10 days disclosure period and a more restrictive definition of beneficial ownership – may be reconsidered.[108] Because we write as American legal academics, we will address the proposals made to the SEC with more specificity; however, some of our policy proposals have carryover value for other jurisdictions.

Part of what animates the proponents of faster disclosure after the activist crosses the disclosure triggering threshold is the concern that activists can accumulate ownership positions far in excess of the five percent threshold during the current 10-day period before

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[104] For the U.K. see Chapter 5 of the Financial Services Authority's Disclosure Rules and Transparency

[105] For Germany (maximum four days lag), see Part 4 of the German Securities Trading Act. For France (four days), see AMF General Regulations, Art. 223-11; French Commercial Code, Art. R.233-1. For Italy (five day maximum), see Article 121 of the Regulation implementing Italian Legislative Decree No. 58 of 24 February 1998, concerning the discipline of issuers.

For discussion and critique analysis of actions and proposals throughout Europe to require disclosure of equity derivative positions, following the UK model, including a recent consultation by The Committee on European Securities Regulation (CESR) [now the European Securities Market Authority (ESMA)], see see Maiju Kettunen & Wolf-Georg Ringe, Disclosure Regulation of Cash-Settled Equity Derivatives – An Intentions-Based Approach (Oxford Leg. Res. Pap. 36/2011), available at http://ssrn.com/abstract=1844886.

[106] See supra text accompanying note 5.

[107] Wachtell Lipton Rosen & Katz Petition for Rule Making Under Section 13 of the Securities Exchange Act of 1934, March 7, 2011, available at http://www.sec.gov/rules/petitions/2011/petn4-624.pdf.

[108] SEC Release No. 34-64087 (March 17, 2011). TheDodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 11-203, 124 Stat. 1376 (sec. 766, adding sec. 13(o) to the 1934 Securities Exchange Act) specifically authorizes the SEC to reduce the trigger date for disclosure.

disclosure is required. There are anecdotes to this effect, although the evidence is that activists on average take blocks under 10 percent.[109] The objections to activists more aggressively exploiting the 10-day window are two. First, public shareholders who unknowingly sell to the activist are disadvantaged, because they are selling at a price that excludes the potential benefits of the activist's initiative. Second, the activists may be able to accumulate a control position or at least a position of strong influence without paying a control premium, or for reasons that threaten majoritarian shareholder interests. We think these are weak arguments or point to problems that are otherwise readily addressed in the US setting.

The first objection fails on the stating of it. A shareholder's decision to sell results either from liquidity needs or the shareholder's reservation price for the security in question. Any asymmetry of information involved in the transaction arises from the activist's private information about its own intentions, which may include a forecast as to the likely target firm response. Why does the selling shareholder have an entitlement to share in the value of information created by the analysis of other investors? The thin logic of an argument whose goal is to facilitate a free riding strategy becomes even clearer when the question is examined from the ex ante shareholder perspective, a familiar analytic approach. Assume 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 restrict the activist's opportunity to build a toe-hold stake, thereby reducing the returns to activism, and thus the occasions for activism and the net gains to other shareholders from the activist's revaluation of institutional shareholders' governance rights across a portfolio of firms. Shareholders ex ante would presumably prefer a rule that increased their average wealth even if in a particular case, they lost an opportunity to free ride on the activist's efforts. The shareholders can't have it both ways: a regulatory structure that gives shareholders the opportunity to free ride on knowledge of activists' strategies reduces the shareholders' opportunity to gain from the activist's strategic monitoring and presentation of strategic alternatives to reticent institutions

Shareholders would have the same view of the current SEC rule that allows institutional investors who do not seek to influence control to delay public disclosure of their accumulation of positions in a company until they have completed the acquisition.[110] For example, the SEC allowed Berkshire Hathaway to delay reporting its acquisition of a significant stake in IBM stock, because disclosure of the stake would have made it more

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[109] Gantchev's analysis of 1164 campaigns over the 2000-07 period shows that the activists' mean (median) stock ownership position at the outset of the campaign was 8.51% (7.0%). In the 75th percentile, initial ownership was still only 10%.In the 95th percentile, initial ownership was 16%. Gantchev, supra note 81, at Table 5A. Interestingly, the initial ownership for successful campaigns was, on average, less than for unsuccessful campaigns, 6.81% vs. 7.16%. Id. at Table 7B.

There is also evidence that assembling a larger block for many firms would move market prices in a way that would eat up activist investor gains, even without formal regulatory disclosure. See, e.g., remarks of Christopher R. Concannon, Virtu Financial, LLC, Columbia Program on the Law and Economics of Capital Markets, Nov. 29, 2012, available at http://www.law.columbia.edu/center_program/capital-markets/cap_mktsWorkshops2 (significant price impact from large, even medium, orders in present market; particular shortfall in liquidity for stock beyond the top 1000).

[110] See Sec. 13(f)(3) of the 1934 Securities Exchange Act, 15 U.S.C. §78m(f)(3) and Form 13F, Instructions for Confidential Treatment Requests.

costly for Berkshire Hathaway to acquire it in the first place. [111] Since shareholders as a group benefit from Berkshire Hathaway's accumulation, premature disclosure would hurt rather help.

To be sure, we understand that just this argument may have been part of the motivation for Congress' 1967 adoption of 13(d) of the Securities Exchange Act of 1934.[112] However, we know now more about how capital markets work than was known in 1967, and in all events, the issue is not the repeal of any disclosure regime governing share accumulations, but whether the SEC should extend the reach of the current regime, a decision that is in the SEC's discretion, rather than simply a blind application of Congressional intent in 1967. In this context, congressional intent does not have a 45-year long shadow.

We take the second objection -- that the activist may be seeking to acquire control, near-control, or at least overwhelming influence, in the 10-day window -- more seriously, but with a caveat. In the decades of various forms of shareholder activism since the adoption of the current disclosure regime, the instances of significant block-building in the 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,[113] 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, requires approval of its proffered strategy by sophisticated investors after having heard the target company's vigorous argument on the other side. Failing that, the campaign itself will fail, leaving the activist with large potential losses.[114]

And emphasizing the importance of changes in the capital market and corporate governance over the last 45 years, private ordering (with the not insubstantial assistance of the Delaware Supreme Court) already provides a response to the concern about secret control changes that deprive shareholders of a premium. The poison pill already provides a remedy that can effectively prohibit undisclosed accumulations.[115] We would hardly

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[111] Serena Ng, Erik Holm & Spencer E. Ante, Buffet Bets $10.7 billion in the Biggest Tech Foray, WSJ, Nov. 15, 2011, available at Online /WSJ,com/article/SB10001424052970204323904577037742077676990.html.

[112] This claim of legislative intent is vigorously presented by Adam O. Emmerich et. al., Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power, Columbia L. & Econ. W. P. No. 428, (August 27, 2012), available at http://ssrn.com/abstract=2138945, (forthcoming Harvard Business Law Review 2013).

[113] Ronald J. Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549 (1984).

[114] See Wachtell et. al, supra note 85.

[115] The standard "flip-in" "shareholder rights plan" establishes an ownership threshold (between 10 and 20 percent is common) the crossing of which will trigger massive dilution of the acquiror's position. See www.sharkrepellant.com for periodic updates on pill practices. A critical feature in most pills is that the definition of beneficial ownership either tracks the "acting in concert" provisions of the SEC's 13D-G regulations or broadens them. See Steven M. Davidoff, Netflix Poison Pill Has a Shareholder-Friendly Flavor, N.Y.Times, Nov. 6, 2012. The effect of such pill provisions is to make it difficult for significant shareholders to collaborate on an activist initiative. See, e.g., Stahl v. Apple Bancorp, 1990 WL 114222 (Del. Ch. Aug. 9, 1990) (upholding pill provisions that would include committee participation, forming a joint slarte, or expense sharing within the definition of acting in concert).) SharkRepellant.net reports that the largest fraction of recent pill adoptions have been in connection with activism and control issues.

endorse the "just say no" version of the pill seemingly blessed by the Delaware courts,[116] but a time-limited pill authorized by shareholders rather than unilaterally adopted by management, a form of "chewable pill," will address this potential problem.[117] 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 of shareholder accumulations is as an effort to persuade the SEC to impose the equivalent of a poison pill with a very low trigger at a time when institutional investors are successfully pressuring boards to turn away from poison pills. There is a history here. The genius of the poison pill was that shareholder approval was not necessary; all that was necessary was board approval.[118] In the not-so-distant past, almost all firms could be assumed to have pills, either already adopted or subject to adoption at a moment's notice, in effect a virtual pill. But in no small measure because institutional investors came to oppose pills when proposals to redeem them came to the shareholders, more boards have let pills lapse, or have not adopted them, even when a control battle may be brewing.[119]

Moreover, although the rare circumstance may validate a low threshold (5 percent) pill,[120] higher triggers are much more prevalent,[121] reflecting both expectations about unstated judicial limits and board reluctance to take an extreme position in the face of institutional investor opposition. Shortening the disclosure period would go far to capping the activist's ownership stake, not because of a legal prohibition to acquire more, but because the economics would militate against it. And it is at this point that the pro-management beauty of proposed SEC action to accelerate disclosure under the Williams Act emerges from the cloud of advocacy. From the perspective of those urging lower and quicker disclosure triggers at a time when neither the shareholders *nor* the board will adopt a pill trigger that is directed at activist shareholders, the proposed SEC rule change will impose it on all corporations without the approval of *either* shareholders or boards. Put differently, the SEC would be adopting a regulatory pill directed at activist shareholders at precisely the moment that boards, increasingly, will not adopt one -- a genuine coup for

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https://www.sharkrepellent.net/request?an=dt.getPage&st=undefined&pg=/pub/rs_20121127.html&2012_Poison_Pill_Impetus&rnd=369637 (visited Jan. 12, 2013).

116 See Unitrin v. American General Corp., 651 A.2d 1361 (Del. Sup. 1995); Air Products and Chemicals, Inc. v. Airgas, Inc, 16 A.3d 48 (Del. Ch. 2011) ; Ronald J. Gilson, Unocal Fifteen years Later (and What We Can Do About It), 26 Del. J. Corp. Law 491 (2001).

117 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 Capital City Assoc. v. Interco, 551 A.2d 787 (Del. Ch.1988). That preference was reaffirmed more recently in Air Products and Chemicals, Inc. v. Airgas, Inc, 16 A.3d 48 (Del. Ch. 2011) (Chandler, Ch.) .

118 See, e.g., Ronald J. Gilson & Reinier Kraakman, Takeovers in the Target's Boardroom: Burke versus Schumpeter, 60 Bus. Law. 1419 (2005).

119 Andrew L. Bab & Sean P. Neenan, Poison Pill in 2011, Conference Board, Director Notes (March 2011), available at http://www.conference-board.org/retrievefile.cfm?filename=TCB%20DN-V3N5-11.pdf&type=subsite.

120 Versata Enterprises v. Selectica, Inc., 5 A.2d 586 (2010); see Paul H. Edelman & Randall S. Thomas, Resetting the Trigger on the Poison Pill: Where Should the Delaware Courts Go Next?, 87 Ind. L. J. 1087 (2012).

121 See Bebchuk & Jackson, supra note 8 (results from recent survey).

those who prefer not only more protection for management from its shareholders, but now more protection from its board as well.[122]

The second policy question posed by the proposal to the SEC relates to whether, independent of the timing of disclosure, economic exposure generated through derivatives should count within the definition of beneficial ownership for determining the disclosure threshold. Here the issue is not the accumulation of shares with voting rights, but the acquisition of a purely economic interest; the technique provides economic returns to the activist shareholder on its activity without diluting the critical screen that the activist must survive to earn that return – the approval of the institutional shareholders.

The easiest way for the activist shareholder to achieve an economic interest divorced from voting rights that could influence the corporation's response to the proffered strategy is through a "cash-settled" "total return swap," in which the party taking the long side of the swap gets exactly the return of the equivalent equity position without actually holding or obtaining the shares. 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 opportunistic behavior by the activist or other forms of private benefit extraction, because the bet increases while decision rights do not. The separation of cash flow rights from control rights go in the direction that tilts against the activist's goals if they are defined as securing voting rights. Second, for the institutional shareholders who ultimately decide whether to support an activist's proposal, 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: it increases the size of the activist's bet on its proposal without influencing the corporation's decision whether to accept it. Third, for the activist, the synthetic stock position increases its returns from its toe-hold equity 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 literature[123] and one important case,[124] a major concern is that a total return swap in practice can convey voting rights in addition to an economic interest,

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[122] Emmerich et. al., supra note 112, cleverly but unpersuasively argue that board's reluctance to adopt pills is a reason for the SEC to act.

[123] Henry Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden Ownership , 79 Southern California Law Review 811-908 (2006); Henry Hu & Bernard Black, Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership , 13 Journal of Corporate Finance 343-367 (2007); Alon P. Brav & Richmond D. Mathews, Empty Voting and the Efficiency of Corporate Governance, 99(2) J. Fin. Econ. 289 (2011); Marcel Kahan & Edward B. Rock, 155 U.Pa. L. Rev. 1021,1075-77 (2007); Wolf-Georg Ringe, Hedge Funds and Risks-Decoupling – The Empty Voting Problem in the European Union, Oxford Leg. Stud. Res. P. 52/2012, available at http://ssrn.com/abstract=2135489 (forthcoming Seattle Univ. Law Review 2013); Michael C. Shouten, The Case for Mandatory Ownership Disclosure, 15 Stanf. J L. Bus. & Fin. 127 (2010)..

and thereby undercut the policy behind the five percent ownership disclosure trigger. Moreover, assembling this trans-threshold economic 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 argument is that counterparties will not be unbiased in their behavior: they will vote in favor of the activist's proposal in an effort to sustain relationships with their client. Moreover, the stock is available for acquisition whenever the activist chooses. The activist has control over the timing of the swap's unwinding. When unwound, the counterpart(ies) want to reverse their hedge, the sooner the better, and the activist stands ready to buy the blocks and the vote.

This is a "possibility theorem." Counterparties claim not to behave in this way and are especially sensitive after the federal district court's opinion in CSX Corp. v. Children's Investment Fund.[125] 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 and so further limit the size of the economic stake an activist can take in support of its strategy.

We have two responses. First, in the post-Dodd-Frank world, counterparties may come to lose their hypothesized behind-the-curtain power to deliver votes and shares. Equity derivatives may come to be traded on exchanges, or the process of central clearing may interpose a central clearing party between the sides to the trade.[126] In other words, hedging may come to be effected quite differently, in a way that drastically reduces the possibility of evasion. The SEC at least should wait to see how that plays out before defining beneficial ownership in a fashion that is dictated only by beliefs concerning the informal operation of the derivatives market and the relationship between transacting parties.

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

In the end, the case in favor of accelerating the disclosure of an activist shareholder's toe- hold stake is a claim that the legislative history that animated the

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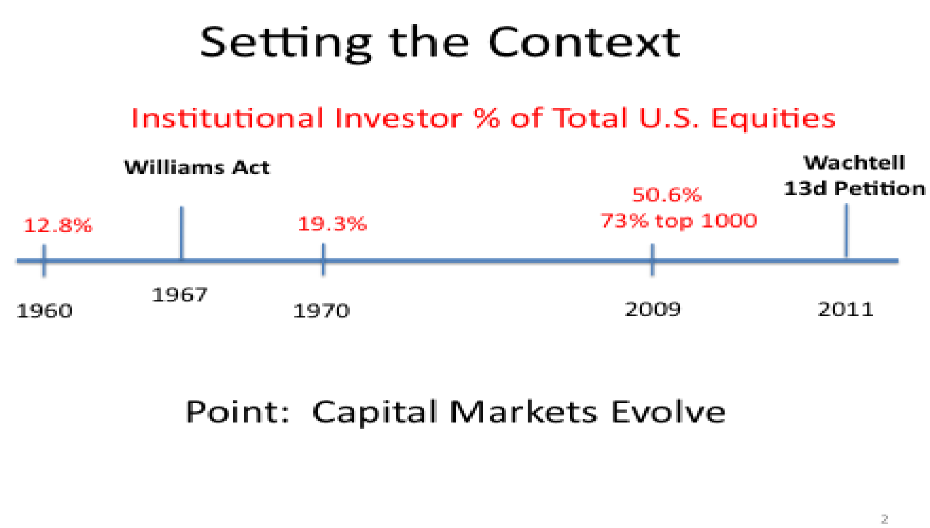
[124] CSX Corp. v. Children's Investment Fund Mngmnt (UK) LLP, 562 F. Supp.2d 511 (SDNY 2008), *aff'd,* 292 Fed. Appx. 133 (2d Cir. 2008) and *aff'd in part and remanded*, 654 F.3d 276 (2d Cir. 2011)

[125] Id.

[126] See Section 721(a)(21) of Dodd-Frank, supra note 107, 124 Stat 1667(amending the Commodities Exchange Act (7 U.S.C. 1a) to include an equity swap within the class of swaps for which presumptive clearing through a central clearing counterparty will be required). The SEC has recently finalized certain rules for security-based swaps, which include equity derivatives, in a release that provides useful background. See SEC Rel. No. 34-67286 (June 28, 2012), 77 FR 41601 (July 13, 2012): "Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies."

Williams Act and Section 13(d), based on the structure of the capital market 45 years ago, should dictate the SEC's exercise of its discretion now in the face of a radically different capital market and after the reconcentration of share ownership that has given us agency capitalism.[127] Figure Four illustrates the mismatch between this argument and current conditions.

Figure Four



In 1967 institutional investors collectively owned a relatively small percentage of U.S. equities. Stock ownership was still largely in the hands of individuals. The governance problem was that of Berle and Means: managers who were not accountable to widely dispersed shareholders. As we show in Part II, the evolution of the capital market over the last 45 years has reconcentrated ownership: institutional investors now own 73 percent of the largest 1000 U.S. corporations and the three largest mutual fund families own 18.5 percent of total U.S. public equities and direct the voting of a much larger percentage.[128] The result has been to shift governance concerns to those of agency capitalism: the devaluation of governance rights that results from those rights being held by investment intermediaries who rationally undervalue them. Activist shareholders then function as a response to concentrated institutional ownership and as a means to arbitrage the value of governance rights by creating the opportunity for reticent institutional record shareholders to act in their beneficiaries' interest. Nothing requires that the SEC ignore dramatic changes in the capital market over the last 45 years when evaluating the current Section 13(d) disclosure regime.

V. Conclusion

We have described an embedded monitoring shortfall in the dominant form of share ownership in the United States and other jurisdictions s as well. Intermediary institutional

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[127] Emmerich et. al., supra note 8, makes this long shadow legislative history argument as well as is possible.
[128] See supra note 57.

investors are highly effective vehicles for financial intermediation and risk-bearing. Their effectiveness derives in part from the specialization that also gives rise to what we have called the agency costs of agency capitalism. Rather than insist that institutions remodel themselves in a fashion that is inconsistent with their business model and therefore with little chance of success, we have suggested that the downside of specialization may be best addressed by fostering the development of a complementary set of specialists, in this case activist 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.[129] But there is a corresponding risk that company managers may be hyperopic, acting to increase the option value of their control by extending its length, especially if because of poor performance and strategy it is then out of the money. No governance structure will perfectly distinguish between those alternatives, in part because the conflicting views are not mutually exclusive and both sides may have come to hold those views in good faith. In the end, we do best by allowing activist shareholders to bet their assets that they can persuade sophisticated institutional investors that they are right in their assessment of portfolio company strategy.

[129] See, e.g., Patrick Bolton & Frederic Samama, L-Shares: Rewarding Long-Term Investors (2012) , available at http://ssrn.com/abstract=2188661(designing a security that would make investors more long-tern oriented).