SUPER HEDGE FUND

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ABSTRACT

Activist hedge funds revolutionized corporate America, generating both excitement and criticism alike. This article suggests that a novel market mechanism, a "super hedge fund," would maintain the benefits of hedge fund activism, while curbing its downsides. The super hedge fund would not really be a fund but, rather, a contractual arrangement among a broad group of institutional investors and a task force of financial experts. The task force would pool together the potency of the institutional shareholders in a sophisticated manner and then unleash its sting on target corporations. Unlike current hedge fund activism, the super hedge fund would not necessitate substantial financing or market transactions and, therefore, would be extremely efficient and very accessible. Importantly, the mechanisms of the super hedge fund would operate so as to ensure that the fund's incentives are closely aligned with the interests of the long-term shareholders of the targeted corporations. Hence, the new mechanism should respond to the claims of short-termism lodged at current hedge fund activism.

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I. INTRODUCTION

Activist hedge funds revolutionized corporate America but generated both excitement and criticism alike. This article suggests that a novel market mechanism, a "super hedge fund," would maintain the benefits of hedge fund activism, while curbing its downsides. The super hedge fund would not really be a fund but, rather, a contractual arrangement among a broad group of institutional investors and a task force of financial experts. The task force would pool together the potency of the institutional shareholders in a sophisticated manner and then unleash its sting on target corporations. Unlike current hedge fund activism, the super hedge fund would not necessitate substantial financing or market transactions and, therefore, would be extremely efficient and very accessible. Importantly, the mechanisms of the super hedge fund would operate so as to ensure that the fund's incentives are closely aligned with the interests of the long-term shareholders of the targeted corporations. Hence, the new mechanism should respond to the claims of short-termism lodged at current hedge fund activism.

At present, mutual funds, pension funds, and insurance companies own half of the market share in the United States. This enormous power remains quite dormant, however. Collective action problems, conflicts of interest, and a conservative fee structure all serve as barriers to activism. Yet, these obstacles notwithstanding, institutional investors are quite successful in flexing their muscles when a third party initiates action against corporate managers. For instance, since 1985, Institutional Shareholder Services and other proxy advisory firms have

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2 See infra notes 215-16, 239-44 and accompanying text.
3 See infra notes 249-50 and accompanying text.
4 See infra Part III.
5 See infra notes 59-67 and accompanying text.
6 See infra note 71 and accompanying text.
7 See infra notes 72-97 and accompanying text.
8 See infra note 104 and accompanying text.
helped transform American institutional shareholders from a passive group into a strong reactive force. More recently, hedge fund activists were able to rally institutional investors to promote certain operational goals at major U.S. companies. Hedge fund activism, however, is an extremely indirect mechanism for institutional investors to wield their power. It is a second-best solution that entails heavy transactional and agency costs.

The purpose of this article is to propose a more direct mechanism for institutional investors' activism. This new activism framework would seek to improve, at minimal costs, the performance of the companies in which institutional shareholders invest. The article begins by laying out this framework and then moves to a discussion of the forces that may impede its success as a solution.

Imagine that a parent organization, such as the Institutional Shareholder Services, gathers together teams of experts to form independent task forces for each market sector or a well-defined group of corporations. As explained below, this initial recruitment of experts for the task forces would become unnecessary once the task forces gained reputations in their own right. The parent organization would also draft a standard agreement. Each task force would sign as many of these agreements in parallel to one another, with as many institutional investors as possible, using the connections of the parent organization with institutional shareholders. The standard contract would initially provide for minimal financing for each task force, to be paid for by the members of the large group of institutional investors who sign agreements with the relevant task force. This initial financing would enable each task force, in accordance with the stipulations in the standard contract, to search for potential activism targets in the sector or group of firms within its expertise.

The standard contract would provide that once a task force has

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10 See infra notes 222-32 and accompanying text.
11 See infra note 294 and accompanying text.
12 See infra notes 24-26, 29-37 and accompanying text.
13 See infra Part III.
14 See infra Part V.
15 See infra notes 101-06 and accompanying text.
16 See infra Part III.
begun to zero in on a potential target, it would be authorized to make a "capital call"\textsuperscript{7} to cover the costs of actively engaging the target. Importantly, however, this considerable additional financing would be requested only from those institutional investors with shares in the corporate target, \textit{pro rata} to their holdings. Thus, the capital call\textsuperscript{8} provision in the contracts between the task force and all institutional investors that are not owners in the target would remain dormant. This funding structure is crucial in creating the task force's direct accountability as an activism agent to the institutional investors of the specific target in question. If a task force does not serve these investors well, it will soon find itself out of business. Moreover, to minimize the "free-riding risk,"\textsuperscript{9} the standard agreement would also include a provision that allows the task force to engage a target only if the aggregate holdings of the parties to the agreement top a certain threshold, roughly 25\%.

With this financing, the task force could then actively engage the corporate target and push it towards a certain goal. However, the task force would not hold a proxy\textsuperscript{20} from the institutional investors. In any action that requires the vote of the institutional investors, including proxy fights\textsuperscript{21} that the task force may initiate, the task force would only hold an advisory role in relation to the institutional shareholders. This way, institutional investors would be outsourcing the activist function to a team that is closely monitored by and tied to the interests of the institutional shareholders of the specific corporate targets.

There would be two major channels of monitoring in this proposed arrangement. First, the task force would be required to renew its contracts periodically with the institutional investors and, even within the period of validity, would have to ask for a financing reload\textsuperscript{22} to engage additional targets. Second, the standard contract may stipulate that certain actions require the consent of the relevant institutional shareholders. Thus, the task force would have to conduct its actions in a way that satisfies the institutional shareholders of the specific company in question. At the same time, with the promised financing from the institutional shareholders and its influential advisory role, the task force would be armed with significant powers and capabilities. Assuming enough institutional investors sign agreements with the task force, the power of the latter may exceed the power of any activist shareholder.

\textsuperscript{7}See infra notes 149-54 and accompanying text.
\textsuperscript{8}See infra notes 149-54 and accompanying text.
\textsuperscript{9}See infra notes 176-77 and accompanying text.
\textsuperscript{20}See infra note 155 and accompanying text.
\textsuperscript{21}See infra notes 155-57 and accompanying text.
\textsuperscript{22}See infra Part III (discussing the need to secure approval from investors for financing renews and other actions).
today. Ironically, however, the unmatched potency of the proposed mechanism may backfire and obstacles may surface to its actual realization. But before discussing those obstacles, it is important to first understand the advantages of the proposed framework over the current central manifestation of investor activism in the American market, i.e., hedge fund activism.23

Today, it is common practice for institutional investors to collaborate with hedge funds and benefit from their activism.24 Institutional investors are a major source of funding for hedge funds and often support their actions with their votes and voice.25 This, however, is not necessarily the optimal form of investor activism. To understand why, consider the following analogous situation: a condominium building is in urgent need of upgrading, but the unit holders fail to take concerted action. The wealthier unit holders therefore find an audacious third party and provide it with financing to purchase some of the units. This third party then uses its influence as an owner to improve the condominium management and ensure the necessary renovations. In the end, the third party activist sells its units to cash out, takes its profits, and moves on. While this third party will have improved the condominium property to the benefit of all unit holders, its involvement will have incurred huge transactional costs.

This article's proposed arrangement in the context of institutional investors seeks to cut out the middleman and the accompanying cumbersome procedure as well as employ a more direct agent at lower costs.26 Moreover, to continue the analogy, assume that the wealthy unit holders who funded the third party are actually condominium owners in another building but not necessarily unit holders in the building in question. This situation is comparable to the funding of a hedge fund by general institutional investors who do not necessarily have holdings in the specific target of activism.27 In the condominium example, such a funding structure reduces the incentives and ability of the unit holders (or the institutional investors in the hedge fund context) to monitor the agent28 and leaves much room for improvement. Only the condominium owners in the specific building in need of repair can make sure that the agent caters directly to the long-term welfare of their property. Under the current arrangement, the outcome is suboptimal, albeit preferable to a situation in which no agent of improvement is employed.

23 See infra notes 164-66 and accompanying text.
24 See infra notes 235-37 and accompanying text.
25 See infra notes 221, 234-35 and accompanying text.
26 See infra notes 249-54 and accompanying text.
27 See infra notes 250-51 and accompanying text.
28 See infra notes 68-80 and accompanying text.
In sum, there are certain flaws to the common market mechanism of hedge fund activism that make it less than optimal. First, the hedge fund business model entails huge transactional costs. Billions of dollars must be raised for an activist to buy a stake in the target, which is then followed by costly in-and-out market transactions. Second, hedge fund activism is not closely monitored, and an activist bears no long-term duties to the large shareholders of the corporate target. As a result, there is a need to fine-tune and improve the hedge fund's incentives to align them with those of the long-term shareholders of the target. Third, instead of retaining all gains from the enhancement of the value of the target (except for the activist's fees), the public and the institutional shareholders must share them with the wealthy individuals who commonly finance the hedge fund's operations and share profits. Fourth and lastly, as discussed below, activist hedge funds own only a minute slice of the market in comparison to the holdings of institutional investors. As a mechanism, then, hedge fund activism offers less of an opportunity to make an impact on the market than can be expected of a more direct mechanism of institutional shareholder activism.

The potential of the activism design suggested in this article is clear when compared to the current structure of hedge fund activism. The new mechanism would not require a third-party purchase of shares to engage a target, thereby saving considerable transaction costs and fees. This type of activism could quite easily extend to target the entire market, and in the absence of intermediate transactions, targeted managers would have no early warning of what is to come. Finally, and most importantly, the full force of institutional investors' power could be harnessed for the activism, which would be conducted under the

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29 See infra notes 246-50 and accompanying text.
30 See Ananth Madhavan, Implementation of Hedge Fund Strategies, HEDGE FUND STRATEGIES, Fall 2002, at 74 ("As many managers have learned, transaction costs can substantially reduce—and sometimes even eliminate—the notional or paper returns to an investment strategy.").
31 See Juliet Chung & David Benoit, Activist Investors Build Up Their War Chests, WALL ST. J. (Sept. 11, 2014), http://www.wsj.com/articles/daniel-loebs-third-point-raised-2-5-billion-in-two-weeks-1410458404 ("A number of the largest activists are raising billions of dollars, in an effort to take advantage of their increasing clout in boardrooms and above-average hedge-fund returns.").
32 See Andrew Carrothers, Friends or Foes? Activist Hedge Funds and Other Institutional Investors, MCMASTER UNIV. DEGROOTE SCH. BUS. (Sept. 24, 2013), archived at http://perma.cc/C84Y-HBFM ("[H]edge funds are subject to light regulation . . .").
33 See infra notes 236-38 and accompanying text.
34 See infra notes 250-51 and accompanying text.
35 See infra notes 60-63, 208-10 and accompanying text.
36 See infra notes 61-64, 209-11 and accompanying text.
37 See infra notes 253-54 and accompanying text.
38 See infra notes 249-54 and accompanying text.
39 See infra notes 249-54 and accompanying text.
watchful eye of those long-term shareholders of the specific target firm. Hence, it would be clear that the activism is directed at achieving long-term goals for the benefit of all shareholders. This is something that hedge fund activism cannot guarantee even if it does, on average, increase all shareholders' value.\(^{40}\)

Why, then, has such a framework not yet emerged on the market, and why is it not to be expected to easily emerge in the future? Some of the barriers lie in the existing regulation—including securities regulations—that imposes disclosure requirements on activist shareholders,\(^{41}\) which could spill over to the institutional investors in the proposed framework. A second barrier is the concern that the suggested mechanism could trigger existing shareholder rights plans, otherwise known as poison pills.\(^{42}\) But above all, the major impediment to the proposed mechanism is the political forces and common sentiments that initially weakened American institutional investors.\(^{43}\) A well-known argument holds that the dominant role played by corporate managers in the U.S. market is the result of regulation and political pressure that fragmented and weakened the financial sector.\(^{44}\) As a result, American institutional investors have failed to achieve the same prominence as their counterparts in highly developed economies overseas, such as in Germany and Japan.\(^{45}\) The very same forces would also operate against the solution offered in this article, even where there are no apparent obstacles to its implementation, which is hardly the case. Nevertheless, careful crafting of the new mechanism, especially in a way that maintains a mere advisory role for the task force in proxy fights, may evade part of these implementation obstacles.

The article continues as follows: Part II discusses the role played by institutional investors in the market today.\(^{46}\) These investors harbor a huge potential to influence the market, but this potential remains largely untapped.\(^{47}\) The discussion shows which kind of activism can be achieved by institutional investors and which kind is unlikely to

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\(^{40}\) See Bebchuk et al., supra note 1, at 1154-55; Lucian A. Bebchuk, The Myth That Insulating Boards Serves Long-Term Value, 113 Colum. L. Rev. 1637, 1671-73 (2013).

\(^{41}\) See infra notes 261-66 and accompanying text.

\(^{42}\) See infra notes 271-82 and accompanying text.

\(^{43}\) See infra notes 285-91 and accompanying text.

\(^{44}\) Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance, at xiv (1994) ("American politics repeatedly prevented financial intermediaries from becoming big enough to take influential big blocks of stock in the largest enterprises.").

\(^{45}\) Id. at 186 ("German and Japanese senior managers share power for better or worse with large financial intermediaries, which own and vote big blocks of stock and are active in corporate governance . . .").

\(^{46}\) See infra Part II.

\(^{47}\) See infra Part II.
materialize, followed by an analysis of the constraints faced by institutional investors that will set the stage for the solution proposed in the article. Part III lays out the framework of the proposed mechanism aimed at encouraging far-reaching and long-term activism driven by institutional shareholders. Among other things, the discussion gives consideration to certain concerns and challenges that could arise in implementing the proposed mechanism. Part IV compares the advantages and disadvantages of the mechanism to those of the activism currently led by hedge funds. Part V discusses the legal and political impediments to implementing the proposed solution.

II. AGENTS WATCHING AGENTS—AN UNFULFILLED PROMISE

Institutional investors are the sleeping giants of corporate America. In terms of size and potential impact, they wield immense power. This was not always the case. In 1965, American mutual funds held shares of U.S. corporations worth $36 billion; pension funds held shares of U.S. corporations worth $43 billion; and insurance companies held shares of U.S. corporations worth $21 billion. These holdings of the three groups of traditional institutional investors amounted to a relatively small fraction of the stock market: 5% for mutual funds, 6% for pension funds, and 3% for insurance companies. These figures, however, have grown rapidly and steadily since then.

48 See infra Part II.
49 See infra Part II.
50 See infra Part III.
51 See infra Part III.
52 See infra Part IV.
53 See infra Part V.
57 See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 1965 TO 1974 95 tbl.L.213 (2014) [hereinafter FEDERAL RESERVE 1965-1974], archived at http://perma.cc/A59B-JTDS (showing that the entire equity market of all U.S. public shares was worth less than $750 billion at the time). Shares of U.S. corporations not held by institutional investors were held directly by the public or by large shareholders, including controlling shareholders. See John C. Coates IV, Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?, 24 J. CORP. L. 837, 848 (1999) (discussing ownership patterns of U.S. corporations and revealing the presence of controlling shareholders in a large segment of the economy).
58 See FEDERAL RESERVE 1965-1974, supra note 57, at 95 tbl.L.213.
59 See Aguilar, supra note 56 (summarizing data to demonstrate the growth of institutional investors).
Today, and actually for quite some time, institutional investors hold a dominant position in the market. In 2012, mutual funds held shares worth $6.3 trillion, pension funds held $4.15 trillion, and insurance companies held $1.8 trillion of U.S. corporation shares. And while the equity market itself has grown tremendously over the years, with an aggregate market cap of more than $26 trillion for all public companies in 2012, these three groups of institutional investors combined account for an unprecedented 50% of the market. Within these groups, there are many single institutional investors that are very large and influential. For instance, in the commercial sector, the Vanguard Group runs assets worth $3 trillion, Fidelity Investments runs $1.98 trillion of the public money, and Prudential Financial holds assets worth $1.176 trillion. The largest public pension funds are also enormous. For example, Teachers Insurance and Annuity Association–College Retirement Equities Fund ("TIAA CREF") runs assets worth $851 billion, and California Public Employees' Retirement System ("CalPERS") runs $295.8 billion.

In a seminal paper published in 1990, Bernard Black identified this...
revolutionary ownership trend in U.S. markets that was already in full swing.\textsuperscript{68} He had a vision\textsuperscript{69} that institutional investors, who are themselves financial intermediaries investing public funds, would monitor corporate managers—agents watching agents.\textsuperscript{70} But this prediction did not fully materialize.\textsuperscript{71} Although institutional investors do play an important role in monitoring, their power is constrained by several factors. First and foremost is the problem of collective action.\textsuperscript{72}

Combined, institutional investors effectively control the market.\textsuperscript{73} In most firms—certainly the largest ones—institutional investors as a group hold a majority stake or dominant position.\textsuperscript{74} Because institutional investors have a preference for solid and stable investments,\textsuperscript{75} the ownership concentration in the largest corporations is amazingly high, with institutional shareholders owning on average more than 70\% of the stock.\textsuperscript{76} However, though this is true regarding the block of traditional

\textsuperscript{68}In 1995, for instance, mutual funds held stock valued at $1,070 billion (13\% of the equity market), pension funds held $1,970 billion (23\%), and insurance companies held $443 billion (5\%), altogether accounting for about 40\% of the stock market, whose aggregate value at the time was about $8,500 billion. \textit{See} Bd. of Governors of the Fed. Reserve Sys., Financial Accounts of the United States: Historical Annual Tables 1995-2004 tbl.L.213 (2014), archived at http://perma.cc/UX7N-RCM4.


\textsuperscript{70}See Black, \textit{Agents Watching Agents}, supra note 69, at 850 (explaining the two-tiered structure of agents monitoring agents).

\textsuperscript{71}See Ronald J. Gilson & Jeffrey N. Gordon, \textit{The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights}, 113 Colum. L. Rev. 863, 888 (2013) ("On the one hand, concentration of ownership holds out the possibility that the institutions will ... actively supervise the performance of professional management. ... 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."); Edward B. Rock, \textit{Oxford Handbook: Institutional Investors in Corporate Governance} § 6 (Univ. of Penn. Inst. for Law & Econ., Working Paper No. 14-37, 2015), archived at http://perma.cc/6C8F-YATF (discussing why institutional investors were unsuccessful in holding management accountable).

\textsuperscript{72}See Edward B. Rock, \textit{The Logic and (Uncertain) Significance of Institutional Shareholder Activism}, 79 Geo. L.J. 445, 454 n.29 (1991) (reviewing sources that have discussed the collective action problem in the corporate context).

\textsuperscript{73}See Edward S. Adams, \textit{Bridging the Gap Between Ownership and Control}, 34 J. Corp. L. 409, 424 (2009) (acknowledging that institutional investors are capable of changing the world of corporate governance).

\textsuperscript{74}See Aguilar, supra note 56 ("Simply stated, institutional investors are dominant market players . . . .").


\textsuperscript{76}See The Conference Bd., \textit{The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition} tbl.13 (2010), archived at
institutional investors, each individual investor rarely holds more than a small percentage of the stock of each company in which it has shares. Although some institutional investors are huge in terms of the magnitude of the assets they run, there are hundreds of different financial institutions invested in thousands of public companies. Thus, when monitoring is expensive, free riding thrives.

Free riding, however, is only one of two major barriers to
institutional investors' activism. The other obstacle is conflicts of interest. As the literature has identified, there are many sources of such conflicts that could interfere with the ability of institutional investors to function as effective monitors of public corporation management. The underlying problem stems from the fact that the institutional investors are themselves intermediaries who control the funds on behalf of their beneficiaries (the funds' members). Therefore, the institutional investors cannot be expected to strive to maximize the value of the assets under their management instead of their own interests. This potential conflict exposes money managers who run the institutional investor firms to pressure from interest groups, which could prevent them from intervening in the management of the corporations in which they invest. For instance, many institutional investors are affiliated with other financial institutions, such as investment banks that have strong ties in the business community, and might not want to unsettle their business partners by being too proactive. Since these institutional investors are not managing their own money, they may tend to easily follow the interests of their affiliates. In other contexts, the direct financial interests

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82 See Black, Shareholder Passivity, supra note 69, at 528 ("Free-rider problems work in tandem with the rational apathy of the free riders to discourage shareholder proposals from being made.").

83 See id. at 595-608 (discussing conflicts of interest in a variety of institutional investment settings).

84 See id.

85 See Rock, supra note 72, at 469.

86 See id. ("[Can] those managing the assets... be relied upon to act to maximize the value of the assets under their management[?] ").

87 See id. at 469 n.80 (quoting J. Kolman, The Proxy Pressures on Pension Managers, INSTITUTIONAL INVESTOR, July 1985, at 145):

In 1985, for example, Institutional Investor reported a number of instances in which corporate management successfully pressured investment managers to support shark repellent charter amendments:

A corporate pension administrator received a threat from one of the company's major customers: "Get your money manager to vote for our antitakeover proposals, or we'll stop buying your products."

See also Lucian A. Bebchuk & Žvika Neeman, Investor Protection and Interest Group Politics, 23 REV. FIN. STUD. 1089, 1090 (2010) ("[I]nstitutional investors... use funds received from individuals to invest in public companies, and [their] interests might overlap with those of 'outsider' shareholders in existing companies.").

88 Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. PA. L. REV. 1021, 1054 (2007) ("Many mutual fund management companies are affiliated with—and are, in effect, subsidiaries of and controlled by—another financial institution, such as an investment bank or an insurance company.").

89 See, e.g., Black, Shareholder Passivity, supra note 69, at 600 (discussing the tendency of banks to support the management of companies in pension portfolios which they oversee).
of the institutional investors could be harmed by their activism. If, for instance, private pension funds must maintain good ties with the management of the corporations they serve or seek to serve, and activism might impair these relations. Insurers might also be damaged by their own activism because it might trigger Director and Officer insurance policies that they market.

Finally, there is a third obstacle to institutional investor activism, which stems from the common fee structure of money managers, such as insurers, pension funds, and mutual funds. These money managers typically earn an annual fixed fee that amounts to a small fraction of the assets they run. This alone does not offer much of an incentive for active monitoring, since the institutional investor itself, unlike its member beneficiaries, would reap a very small proportion of the monitoring gains. Moreover, this fee structure includes limitations on the expenses that the money manager can recover from the beneficiaries’

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90 See id. at 596-97 ("The first prerequisite for a money manager, though, is money to manage. Existing corporate clients must be kept happy, new clients attracted. . . . The interesting case is when the plan's interests counsel an antimanager vote.").
91 Corporate management exercises influence over institutional investors in a number of ways:

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

Id. at 597.
92 Director and Officer insurance policies offer liability coverage for company directors and officers as protection from possible suits regarding the decisions and actions taken "within the scope of their regular duties." See, e.g., ALLIANZ GLOBAL CORP. & SPECIALTY, INTRODUCTION TO D&O INSURANCE 4 (2013), archived at http://perma.cc/45S7-GNV9.
93 See Kahan & Rock, supra note 88, at 1051:

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

94 See Kahan & Rock, supra note 88, at 1050-51 (discussing the cost of activism relative to the size of fees charged by most mutual funds).
funds. If some of the costs of shareholder activism cannot be deducted from the beneficiaries' accounts, they are borne directly by the money manager, which further chills incentives to actively monitor.

While these obstacles are considerable, experience has shown that institutional investors are still active to some degree. Institutional investors have been described as "rationally reticent" because they respond to proposals laid down for them but are unlikely to initiate change by themselves. To begin, institutional investors have proven that they can be active, albeit not proactive, in assisting a third-party proxy advisor. The best example of this is Institutional Shareholder Services ("ISS"), which advises institutional investors on how to vote on...
managerial proposals.\textsuperscript{102} Although ISS does not initiate any activity, it is quite effective in harnessing the power of institutional investors.\textsuperscript{103} ISS can work to thwart a proposal initiated by management, and it can also secure the backing of institutional investors to an activism campaign initiated by a third party, commonly a hedge fund.\textsuperscript{104} The fact that ISS, like its competitor, Glass Lewis,\textsuperscript{105} is funded by institutional investors and is able to sway the votes of many institutional investors despite the potential conflict of interest for such institutions is reassuring of the potential for activism.\textsuperscript{106}

Another highly important avenue of institutional investor involvement in shareholder activism is investment and backing of activist hedge funds.\textsuperscript{107} This type of activism, along with its advantages and disadvantages, is elaborated upon further in Part IV.\textsuperscript{108} But, at this stage, it suffices to note that in this framework of activism, quite like activism by way of the ISS, institutional investors are able to be active through a third party.\textsuperscript{109}

\textsuperscript{102}See id. at 7.

\textsuperscript{103}Voting data from five proxy seasons prior to 2010 show that mutual funds voted consistently with ISS recommendations on both management-submitted and shareholder-submitted proposals. See id. at 55. Press reports stated that ISS has the power to shift 20% to 30% of the shareholder votes, whereas some scholars show that an ISS recommendation shifts a lower, but still significant, percentage of shareholder votes. See Stephen Choi et al., The Power of Proxy Advisors: Myth or Reality?, 59 EMORY L.J. 869, 906 (2010); see also David F. Larcker et al., Conference Bd., The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions, DIRECTOR NOTES, Mar. 2012, at 1, 3, available at https://www.conference-board.org:

[A] negative recommendation from ISS, the largest proxy advisory firm, has been shown on average to influence between 13.6 percent and 20.6 percent of votes cast on management-sponsored proposals. During the 2011 proxy season, no company that received a positive recommendation from ISS failed its SOP vote, and 12.0 percent of companies that received a negative recommendation from ISS failed their SOP vote.

\textsuperscript{104}See Cotter et al., supra note 101, at 17 ("[F]unds are more likely to vote against management rather than exit when management's recommendations conflict with those of ISS.").

\textsuperscript{105}Glass Lewis is the second most influential proxy advisory firm. See CTR. ON EXEC. COMP., A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO: THE CASE FOR GREATER ACCOUNTABILITY AND OVERSIGHT 33-36 (2011), archived at http://perma.cc/3VMC-7F59.

\textsuperscript{106}See id. at 35-36 (discussing Glass Lewis' business model).

\textsuperscript{107}See infra Part IV.

\textsuperscript{108}See infra Part IV.

\textsuperscript{109}See Gilson & Gordon, supra note 71, at 867:

[T]he 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
Lastly, some institutional investors are quite active on their own, without any intermediary parties acting on their behalf.\textsuperscript{110} This is especially true of one class of traditional institutional investors: public pension funds.\textsuperscript{111} Some praise their activism, highlighting that they can act because they are not plagued by the same conflicts of interest that tie the hands of other institutional investors.\textsuperscript{112} Others are less enthusiastic, arguing that pension fund activism is ill advised, meant to please politicians and the public, and suffers from the fact that public pension funds are simply not driven by profit-maximizing goals.\textsuperscript{113} Regardless, even when institutional investors are active on their own, they usually intervene in broad corporate governance matters, which they come across in many corporations within their investment portfolios.\textsuperscript{114} They generally do not engage in operational or strategic activism that targets the business strategy and business-related decisions of a single company.\textsuperscript{115}

One case on point is California State Teachers' Retirement System ("CaISTRS"), which has declared that it will effectively engage companies in its portfolio.\textsuperscript{116} To further this goal, in 2013, CaISTRS published its inaugural corporate governance report to communicate its


\textsuperscript{111}See id. at 176.

\textsuperscript{112}See Black, \textit{Shareholder Passivity}, supra note 69, at 524 ("The public pension funds have the weakest promanager conflicts, but no institution is conflict free.").

\textsuperscript{113}See Kahan & Rock, supra note 88, at 1057-58 ("The problem for public pension funds, rather, is that they are political entities and, thus, subject to political constraints and conflicts of interest.... As should be evident, public pension fund trustees lack significant financial incentives to maximize fund performance."); see also Bus. Roundtable v. SEC, 647 F.3d 1144, 1152 (D.C. Cir. 2011):

\[\begin{quote}
[T]he Commission failed to respond to comments arguing that investors with a special interest, such as unions and state and local governments whose interests in jobs may well be greater than their interest in share value, can be expected to pursue self-interested objectives rather than the goal of maximizing shareholder value.... By ducking serious evaluation of the costs that could be imposed upon companies from use of the rule by shareholders representing special interests, particularly union and government pension funds, we think the Commission acted arbitrarily.
\end{quote}\]

\textsuperscript{114}But see Gilson & Gordon, supra note 71, at 893 (suggesting that having to monitor portfolio performance enables institutional investors to decide if intervening in a portfolio company's governance is desirable).

\textsuperscript{115}See id. at 899 ("[T]he 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.... ").

\textsuperscript{116}See CAL. STATE TEACHERS' RET. SYS., CORPORATE GOVERNANCE 2013 ANNUAL REPORT 3 (2013), archived at http://pcrma.cc/3UMY-A4TR.
agenda to the investment community. Specifically, CalSTRS stated that it would focus on four main themes: executive compensation, majority vote standards, diversity of corporate boards, and sustainability. Another good example is the backing granted by institutional investors to the adoption of managerial Share Ownership Plans ("SOPs"). CaLPERS, for instance, took a proactive approach and submitted numerous shareholder proposals, urging its portfolio companies to adopt stringent SOPs. In these examples of proactive engagement, public pension funds have tackled questions that they encounter again and again. They do not have to delve into the business activities of any single company in order to conduct such activism. The methods used by these funds in their activism are also limited and involve mostly public shaming and shareholders' precatory proposals. In other words, this is an inexpensive type of activism, and it does not cost much to develop the agenda or manifest it, nor does it need to be tailored to the business challenges and failures facing any single corporation. The most pressing and grave problems therefore elude this type of activism. Accordingly, some scholars conclude that the existing type of institutional investors' activism is mostly symbolic and not substantive.

In sum, it seems that some activism on behalf of institutional investors can be expected, but there are certain limitations. First, most

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117 See id.
118 See id. at 11-15.
120 A Stockholders' Proposal, pursuant to Section 14a-8 of the Securities and Exchange Act of 1934, pushed Dow Chemical to adopt a policy requiring that senior executives retain at least 75% of net after-tax shares acquired through equity compensation programs until two years following the termination of their employment. See Dow Chem. Co., Proxy Statement (Schedule 14A) (Mar. 31, 2010), archived at http://perma.cc/RJ6M-PY6R.
121 See, e.g., Joseph W. Yockey, On the Role and Regulation of Private Negotiations in Governance, 61 S.C. L. REV. 171, 198 (2009) (stating that one such issue is the high cost of activism and explaining that institutional investors seek ways to avoid the expenses of activism).
122 See id. at 186.
123 See 17 C.F.R. § 240.14a-8 (2014); Yockey, supra note 121, at 194.
124 See Yockey, supra note 121, at 198.
126 See id.
127 Another avenue by which institutional shareholders can influence management is exit (an old tactic known also as the "Wall Street Walk"). See, e.g., Amil Dasgupta & Giorgia Piacentino, The Wall Street Walk When Blockholders Compete for Flows 1 (June 2012)
institutional investors will not stick their necks out.\textsuperscript{128} The costs of such action—first and foremost, the reputation penalty involved—are prohibitive for most institutional investors to bear alone.\textsuperscript{129} However, if they were to act in concert with other institutional investors while guided by some third party, they could be quite potent and aggressive. In the absence of a mechanism facilitating such collective action, even the most aggressive pension funds, which can tackle general corporate governance problems, are unable to pursue any business agenda on a case-by-case basis.\textsuperscript{130}

Before this article moves on, the following high-profile story about shareholder activism is telling in this context. It is the story of a great victory for institutional investor activism and an illustration of its great potential, but also of the current limitations of such activism. The Shareholder Rights Project ("SRP"), a clinical program operating at Harvard Law School and directed by Professor Lucian Bebchuk,\textsuperscript{131} works on behalf of public pension funds and other organizations seeking to improve corporate governance at publicly traded companies.\textsuperscript{132} In 2013, SRP represented eight institutional investors with an aggregate value of assets exceeding $400 billion that serve over three million members.\textsuperscript{133}

SRP's work during the 2012 and 2013 proxy seasons focused on dismantling classified boards.\textsuperscript{134} It was tremendously successful and led to the declassification of eighty Standard and Poor's ("S&P") 500 and Fortune 500 companies.\textsuperscript{135} These eighty companies had an aggregate market capitalization exceeding $1 trillion, and, combined, they represent over 50% of the 126 S&P 500 companies that had classified

\footnotesize{(unpublished manuscript), archived at https://perma.cc/BX8B-NUQP. Shareholders—particularly blockholders—may induce good managerial behavior by exiting and pushing down stock prices when bad managerial actions are taken. See Anat R. Admati & Paul Pfleiderer, The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice, 22 REV. FIN. STUD. 2445, 2446 (2009); Alex Edmans, Blockholder Trading, Market Efficiency, and Managerial Myopia, 64 J. FIN. 2481, 2481-82 (2009); Alex Edmans & Gustavo Manso, Governance Through Trading and Intervention: A Theory of Multiple Blockholders, 24 REV. FIN. STUD. 2395, 2396 (2011).}

\textsuperscript{128}See Black, Agents Watching Agents, supra note 69, at 860.

\textsuperscript{129}See Black, Shareholder Passivity, supra note 69, at 523, 607.

\textsuperscript{130}See Yockey, supra note 121, at 186.


\textsuperscript{133}Id.

\textsuperscript{134}See id.

boards as of the beginning of 2012.136 A significant number of additional declassifications are expected due to commitments by companies to bring management proposals for board declassification to a vote.137

While many have hailed this significant change in corporate governance,138 there are also vocal critics of the SRP's work.139 These critics argue that dismantling classified boards is harmful to companies in the long run, particularly because it makes it significantly harder for a public company to fend off an opportunistic takeover bid.140 Critics also query using a major law school's clinical program as a forum for pursuing improved corporate governance,141 whereas proponents of the program actually hail this fact.142

The dismantling of staggered boards likely represents a major achievement for activism compared to the other so-called "achievements" of pension fund activism. Amazingly, proposals by SRP on behalf of their pension fund clients represented over 50% of all successful precatory proposals by public pension funds and over 20% of

136 Id.
137 Id.
138 See Gretchen Morgenson, New Momentum for Change in Corporate Board Elections, N.Y. TIMES (July 6, 2013), http://www.nytimes.com/2013/07/07/business/new-momentum-for-change-in-corporate-board-elections.html?ref=business\r\n=2&. William R. Atwood, Executive Director of the Illinois State Board of Investment, referred to the project, saying, "We're very pleased. We are about to get into our third proxy season with the project." Id. He added, "This is a noncontroversial, simple notion of governance that we feel duty bound to pursue." Id.
140 Lipton & Mirvis, SRP Is Wrong, supra note 139:
There is no persuasive evidence that declassifying boards enhance[s] stockholder value over the long-term, and it is our experience that the absence of a staggered board makes it significantly harder for a public company to fend off an inadequate, opportunistic takeover bid, and is harmful to companies that focus on long-term value creation.
141 See id. ("It is surprising that a major legal institution would countenance the formation of a clinical program to advance a narrow agenda that would exacerbate the short-term pressures under which American companies are forced to operate.").
The clinics teach lawyering skills, expose students to areas of legal practice, and provide hands-on, practical experience, which could be useful to them in their future careers. . . . The views advanced by the clinics represent those of the clients. . . . In all cases, however, it is generally understood that clinics do not speak for the law school and that any views expressed by a clinic should not be attributed to the law school where it operates.
all successful precatory proposals by any proponents in 2012-2013.143 If a single initiative can make up such a huge proportion of all successful initiatives, it would seem that shareholder activism in general, and pension fund activism in particular, are not such a powerful force. Moreover, as noted above, this type of shareholder activism cannot assist in matters relating to firm-specific business issues.144 It cannot demand answers from corporate managers for inefficiently refusing to pay dividends, perform efficient business divestiture, or wield the axe, if the corporation needs a change in leadership.145 The activism framework presented below in Part III is designed to deal with precisely these issues and affairs.146

III. A FRAMEWORK FOR LONG-TERM ACTIVISM

This Part lays out a general analytic framework for a new institution that would encourage long-term activism on the part of institutional investors.147 After introducing the proposed framework, this Part will discuss the incentives that will be generated by this mechanism and consider certain concerns that may arise with regard to its implementation.148 The basic premise is that a team of experts will be appointed for a given market segment and armed with certain rights and duties as stipulated in a standard agreement to be signed by each team and by as large a group of institutional investors as possible. A parent organization, such as ISS or a new institution, would draft this standard agreement and serve as a clearinghouse for the operation.

The standard agreement would provide crucial two-tier funding for the task force's activities. Tier-one funding would be quite minimal and used to support the task force before it engages in activism. At this stage, the task force would be observing the industry in an initial general search for targets. However, once the task force begins to zero in on a target, it would become entitled to call for additional and much more substantial tier-two funding.149 This capital call should be sufficient to

[144]See supra notes 114-26 and accompanying text.
[145]See supra notes 114-26 and accompanying text.
[146]See infra Part III.
[147]See infra Part III.
cover major possible expenses such as proxy fight costs, litigation, and public and investors relations campaigns. Most importantly, the source of funding for the two tiers would differ as follows: the low-tier funding would be provided by all institutional investors that have signed an agreement with the task force. The amount would be insignificant for each of the member institutions and possibly quite close to the retainer paid to third-party proxy advisory services. However, funding called for after the task force has zeroed in on a target would not come from all the institutional investors. Rather, the tier-two funding would be borne solely by the institutional investors that invest in the specific potential corporate target and pro-rata to their holdings in the target. This capital call to the direct investors of the target forges the link that is missing today between the institutional long-term shareholders of the target of the activism and the agent that executes the activism.

In addition to the crucial matter of funding, the standard agreement

For example, venture capital agreements commonly include a commitment from the limited partners that allows the general partners to call for additional funding when an investment is identified. See Bankman & Cole, supra, at 216. A similar procedure exists in other types of private equity funds, including leveraged buyout funds. See id. The act is commonly defined as a Capital Call or Draw Down and is defined as the act of a private equity fund "calling down" previously pledged capital from its limited partners in order to execute an investment. See id.

Activism costs could easily run into a few million dollars. See Adam Kommel, Proxy Fight Fees and Costs Now Collected by SharkRepellent: MacKenzie Partners and Carl Icahn Involved in Largest Fights, SHARKREPELLENT (Feb. 20, 2013), archived at https://pcrma.cc/R3FW-MDLV (presenting data on proxy solicitor fees and proxy fight costs).

The Wachtell, Lipton, Rosen & Katz law firm proposed a bylaw that would block the practice of compensation by activist shareholders of their proposed director nominees, which critics claim threatens the integrity of the boardroom. See Noam Noked, ISS Advises Against By-Law Restricting Shareholder Compensation of Board Nominees, HARV. L. SCH. ON CORP. GOVERNANCE & FIN. REG. (Dec. 27, 2013), archived at http://pcrma.cc/DA2T-LPFE. More than twenty-five companies have since adopted similar bylaws. See id. Recently, ISS stated that the adoption of restrictive director qualification bylaws without shareholder approval could be considered a material failure of governance; however, ISS added that bylaws precluding board service to those director nominees who fail to disclose third-party compensatory payments could provide greater transparency for shareholders and allow for better-informed voting decisions. See Director Qualification/Compensation Bylaw FAQs, INSTITUTIONAL S'HOLDER SERVS. (Jan. 13, 2014), archived at http://pcrma.cc/88QS-23XT.

See Kommel, supra note 150 ("For example, ... a $1 billion company ... might expect to pay about $210,000 to its proxy solicitor ... ").

See Bankman & Cole, supra note 149, at 216 (discussing the function of capital calls).

See Mark J. Roe, Corporate Short-Termism—In the Boardroom and in the Courtroom, 68 BUS. LAW. 977, 977 (2012) ("[T]he widely held view that short-term trading has increased dramatically in recent decades over-interpret[s], the data; the duration for holdings of many of the country's major stockholders, such as mutual funds run by Fidelity and Vanguard, and major pension funds, does not seem to have shortened.").
would also stipulate all other features of the relationship between the task force and the member institutions. The task force would be relatively free to identify the target and design an activism strategy; it would also be able to initiate and manage activist campaigns against the target company. To this end, the task force could use a variety of different tactics, fueled by the funding from its members, such as public relation campaigns and litigation against management. The task force could also initiate a proxy fight in which it would have an advisory role (but would not be given a proxy to engage in any action that requires the vote of the institutional investors). The task force advisory role would be a very influential factor that could direct and move the institutional shareholders to the desired activist goal and effectively pressure management.

A different model could include a requirement that a task force would hold a proxy to act on behalf of the member institutional investors that are shareholders in the corporate target. Thus, in its dealings with management, the task force would wield enormous leverage. Such proxy would assure the task force success when members hold close to 50% or more of a target's stock; in fact, in such cases, it is doubtful that a proxy would even take place in light of the task force's overwhelming power. This solution is problematic, however. It would worsen the legal and political barriers in implementing such a framework up to the point that it could not be applicable. See infra Part V. Specifically, institutional investors owe a fiduciary duty to their members, and therefore they could be barred from giving such broad proxy to the task force. See Luis A. Aguilar, Looking at Proxy Advisory Firms from the Investor's Perspective, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 17, 2013), archived at http://perma.cc/ZY63-UB57 ("Ultimately, voting rights belong to the shareholder and are an important aspect of the shareholder's investment."); see also Black, Agents Watching Agents, supra note 69, at 856:

Many money managers are fiduciaries who are required to act for the sole benefit of their beneficiaries. Corporate pension plans are governed by ERISA; public pension plans, bank trusts, and insurance company variable accounts are governed by the common law of trusts; and mutual funds are governed by state corporate law and the Investment Company Act of 1940.

Only a minority of the activist campaigns ends up in a proxy fight that is put to a shareholder vote, and in any case, activists do not hold a proxy from a large group of investors. Accordingly, it is not necessary that the task force acts as proxy on behalf of its institutional members, and its advisory role is sufficient to achieve the framework goals presented in this article. See CONFERENCE BD., PROXY VOTING ANALYTICS (2010-2014): EXECUTIVE SUMMARY 3 (2014):

[A] growing number of activist investors, especially hedge funds, have agitated for change without even filing a shareholder proposal, let alone waging a proxy fight. In fact, despite the increase in activism campaign announcements, there was a sensible decline in the number of campaigns related to shareholder meetings held in the first six months of 2014. . . .

These activism campaign announcements now serve to publicize the investor's view of the business strategy or organizational performance. It is a first step that may lead to the future filing of a proposal or the solicitation of proxies but that may also prove sufficient to persuade the company to seek dialogue and reach a compromise.

See also J.P. MORGAN, GUESS WHO'S COMING TO DINNER? SHAREHOLDER ACTIVISM AND IMPLICATIONS FOR INVESTORS 2 (2014):

Only around one quarter of activist events result in a threatened proxy fight. Furthermore, only 15% have gone "definitive" (when the activist files a
Given that part of the above tactics, such as litigation, can only be carried out by shareholders, the task force could buy a minimal amount of stock of the target company, or alternatively the task force could hold a proxy on behalf of one of the member institutional investors.

Put together, the task force would be equipped with immense capabilities and power. Some of these powers could be restrained in advance, and for that matter the standard agreement would stipulate which measures require preapproval by vote from the member institutions who own stock in the target firm. For instance, the agreement could require that any campaign to replace management or sell the corporate target in its entirety be preapproved by members.

Such preapproval requirements could be more rigorous than those currently faced by activist shareholders. Specifically, any initiative by an activist shareholder today that entails a proxy fight is in fact subject to approval from shareholders. Many other courses of action, however, such as pressure on management or litigation, do not require such preapproval. The task force contractual preapproval requirement mentioned above deviates from such structure and can be more restrictive. In addition to the examples above, the contract could, for instance, condition any litigation initiated by the task force on behalf of the member shareholders on their prior affirming vote.

The need to secure approval for certain steps would not, however, be the main reason why the task force would strive to serve the needs of the institutional investors. It would be only natural that the task force would want to reload its financing and engage additional targets. If the definitive proxy statement with the SEC) and only 10% were put to a shareholder vote. In other words, activists often achieve their objectives without going as far as a fight.

The task force does not create a fiduciary relationship; only shareholders are owed a fiduciary duty and may sue on behalf of the company. See Ronald A. Brown, Jr., Note, Claims of Aiding and Abetting a Director's Breach of Fiduciary Duty—Does Everybody Who Deals with a Delaware Director Owe Fiduciary Duties to that Director's Shareholders?, 15 DEL. J. CORP. L. 943, 945-46 (1990); see also Jones v. Harris Assocs. L.P., 559 U.S. 335, 339-40 (2010) (holding mutual fund shareholders are owed a fiduciary duty).

For example, Delaware and New York law permit a shareholder "to seek reimbursement of its expenses for proxy solicitation, subject to shareholder approval," which typically depends on the ultimate success of the solicitation. See An Introduction to the Proxy Solicitation Process, SEWARD & KISSEL LLP (June 5, 2009), archived at http://perma.cc/UYC2-AD84. Further, "[u]nder both Delaware and New York law, the company's incumbent management is entitled to reimbursement of reasonable expenses incurred in connection with the defense of a contested proxy contest." Id.

See id.


See supra notes 148-57 and accompanying text.

See supra notes 155-58 and accompanying text.
number of targets or level of funding provided for in the original agreement were exceeded, such a financing reload would require the signing of a new agreement (or perhaps a member vote for a number of initial funding reloads). In short, the task force must please its clients and show results. Pay-for-performance matrices\textsuperscript{161} could further bolster the incentives of the task force as a whole and the individual experts comprising it.

All in all, this mechanism would open up new horizons and avenues for shareholder activism that is long-term oriented.\textsuperscript{164} A powerful agent would search for potential targets in its designated market sector on behalf of institutional investors and then hit these targets with activism when necessary. Crucially, the wide scope of this activism, covering the entire market, would be realized with extremely low transactional costs. This activism would be effective without any need to buy a substantial amount of shares to achieve its goals, thereby eliminating any need to raise heavy funds to purchase shares. Moreover, with its strong backing, a successful outcome would be all but guaranteed. No less important is the fact that activism through the proposed mechanism would be closely monitored by the long-term investors of the target corporation. This does not happen when institutional investors invest in a hedge fund that initiates activism in a target with other institutional investors.\textsuperscript{165} The extreme potency of the mechanism, coupled with the close monitoring by the institutional investors, may bring about a dialogue between the task force and the targets' managements. The adversarial nature of hedge fund activism\textsuperscript{166} may therefore be replaced with a different activist voice that would be powerful without a need to be loud.

Yet, this new mechanism could face significant challenges that are important to understand. The first issue is whether some of the forces

\textsuperscript{161}See Peter Richardson & Steven Thomas, Using an Equity/Performance Matrix to Address Salary Compression/Inversion and Performance Pay Issues, 3 ADMIN. ISSUES J.: EDUC. PRAC. & RES. 20, 22 (2013), archived at http://perma.cc/MU29-ZRTA (explaining that a "pay-for-performance matrix" or "merit-based performance matrix" is a market-based compensation plan connecting compensation with employee performance).


\textsuperscript{165}See Martin Lipton, The Threat to Shareholders and the Economy from Activist Hedge Funds, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 14, 2015), archived at http://perma.cc/XCW9-XKJE (internal quotation marks omitted) ("[T]he increasing[] difficulty for directors to do anything other than reflect what is perceived to be in the immediate interests of their most influential, frequently short-term shareholders.").

\textsuperscript{166}See infra notes 191-96 and accompanying text.
that currently prevent institutional investors from being active would also prevent them from participating in the activism under the new mechanism. To begin, the conflict of interest that institutional investors face is often cited as an obstacle to activism. This obstacle, however, does not seem to be a major concern with the new framework. Institutions do not want to gain a reputation for being troublemakers. They are averse to initiating activism. But, being a part of a group that is led by an outside professional has no such reputational effect. Indeed, tellingly, institutional investors will often collaborate with hedge fund activism, either by investing as limited partners in the fund or by voting for its initiatives. This is indicative of the potential demand for this article's proposed mechanism. The passive nature of signing an early agreement with the task force, before investors know which target will later be engaged, dramatically alleviates the freezing effect of conflicts of interest. In other words, no one has to stand out as an activist for a new form of activism to take place.

The fear of standing out nevertheless warrants attention as a possible factor preventing participation. Institutional investors could fear that only a few institutions will sign an agreement with the task force, which would not only put the entire scheme at risk, but would also expose those that signed as activists. The solution is to include a provision in the standard agreement stipulating that a minimal number of parties to the scheme, say one hundred institutional investors, is a necessary condition for the contracts to take effect. This provision would

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167 See supra notes 78-92 and accompanying text.
168 See supra notes 78-92 and accompanying text.
169 See supra notes 78-92 and accompanying text.
170 See supra notes 78-92 and accompanying text.
171 See supra notes 78-92 and accompanying text.
172 See supra notes 78-92 and accompanying text.
173 See supra notes 78-92 and accompanying text.
174 See supra notes 78-92 and accompanying text.
176 See id.: "Activist Hedge Fund" has become an asset class in which institutional investors are making substantial investments. In addition, even where institutional investors are not themselves limited partners in the activist hedge fund, several now maintain open and regular lines of communication with activists, including sharing potential "hit lists" of possible targets.
177 Cf. Kahan & Rock, supra note 88, at 1022 (explaining that although hedge funds suffer from conflicts of interest, the incidents are isolated that major regulatory interventions are not warranted).
179 As a comparison, the Council of Institutional Investors, an association that advocates effective corporate governance and shareowners' rights, has more than 125 members. The organization is comprised of pension funds, other employee benefit funds, endowments, and foundations with combined assets that exceed $3 trillion. About Us: We're the Voice of Corporate Governance, Council of Institutional Investors, archived at http://perma.cc/D6EV-HCZA [hereinafter About CII] (last visited Aug. 22, 2013).
ease the reputational concern of potentially conflicted institutional investors.

This leads to the central challenge: the free-riding risk. Why should institutional investors invest in activism for the benefit of others rather than wait for others to invest? A partial resolution to this problem lies in the suggested threshold provision in the standard agreement. Requiring a large group of investors to sign an agreement with the task force would alleviate some of the free-riding concerns of those willing to sign. This, however, would only partially contend with the problem. Even if many institutional investors were to sign with the task force in general, it is still possible that the combined holdings of the relevant signees in a selected target would amount to only a small fraction of its stock. If they were to account, for instance, for only 5% of the target's stock, they could bear heavy activism costs, but 95% of the gains achieved would accrue to other shareholders of the target corporation. A possible solution is, again, a contractual stipulation that the task force is authorized to engage a target only if the aggregate holdings of investor members in the scheme top a certain threshold, say 25%.

Such a provision would generate at least three good outcomes. First, it would dramatically diminish members' concern that they will pay much but enjoy only a small portion of the benefits. Second, it would push more institutional investors to sign a contract with a task force. They would know that if they do not sign, they could find themselves invested in corporations that are not within the mandate of the task force and less likely to enjoy the direct gains of its activism. Moreover, the corporations in their portfolio would not be subject to the full disciplinary force of the activism. Third, this provision would prevent investors that signed an agreement from strategically over-fragmenting the holdings in their portfolios to evade part of the costs of the activism. Even absent such a provision, this tactic is a double-edged sword: it enables such investors to avoid paying a large sum of money after any single instance of activism, but consequently also means they cannot enjoy large chunks of the direct benefits of that same activism. Still, without the proposed provision, those who engage in over-

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176 See Romano, supra note 80, at 822 ("The prototypical free rider problem of corporate governance activities [is] . . . that only the activist bears the costs of activism while all of the firm's investors receive the benefits . . . ").

177 See id.

178 See Hannes, supra note 174, at 256-57.


180 Note, also, that the aggregate costs of activism for investors using such a tactic would not necessarily decline. Spreading their investments would mean they could pay less for individual activist initiatives, but would participate in (and pay for) activism more frequently. See Hannes, supra note 174, at 256-57.
fragmentation would be able to reap the full disciplinary effects of the activism. Thus, stipulating that the task force can target only corporations in which members hold a specified percentage of its shares would counter members' incentives to reduce their stakes in each portfolio corporation.

Finally, free-riding concerns are substantially exaggerated. Institutional investors that choose to opt out of a scheme that seems socially beneficial would suffer reputational loss.\(^\text{181}\) Since many of them are dependent on public investments, their public image can be crucial.\(^\text{182}\) This could explain why institutional investors often pay for third-party proxy advisory services, even though it is quite easy to learn what such services recommend without paying for them.\(^\text{183}\) The fact that institutional shareholders nevertheless pay for this public good is encouraging.\(^\text{184}\) True, the new mechanism could entail significantly higher costs, but the lion's share of these costs would arise only if there is a possibility of real gain. Regardless, institutional investors are so large that the cost is negligible for them,\(^\text{185}\) while the benefit is so significant that it could dramatically fortify the monitoring of the entire market. Overall, the generally passive character of the proposed mechanism seems to fit the needs and habits of the giant institutions that would be involved.

IV. LONG-TERM ACTIVISM VS. HEDGE FUND ACTIVISM

Shareholder operational or strategic activism refers to the involvement of shareholders in the management of a firm.\(^\text{186}\) The controlling or dominant shareholder in a corporation, when one exists, is practically always involved in the firm's management.\(^\text{187}\) In the last few years, active intervention of this type has been evident even in

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\(^{182}\) See id.

\(^{183}\) See David F. Larker et al., Outsourcing Shareholder Voting to Proxy Advisory Firms 3, 8, 10-11 (Stanford Graduate Sch. of Bus., Working Paper No. 2105, 2014), archived at http://perma.cc/UVF5-TWEY.

\(^{184}\) See Barry B. Burr, SEC Round Table Discusses Shift in Who Pays for Proxy-Voting Services, PENSIONS & INVS. (Dec. 5, 2013), archived at http://perma.cc/PPK8-C6LG.

\(^{185}\) See Larker et al., supra note 183, at 3.


\(^{187}\) See Rafael La Porta et al., Corporate Ownership Around the World, 54 J. FIN. 471, 474 (1999).
corporations with dispersed ownership. This is by and large the activity of activist hedge funds, whereas traditional institutional investors play a secondary role in this context.

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

189 "Activists generally acquire 5-10% of a target company's stock, but ... campaigns are increasingly mounted with less than 5%." See J.P.MORGAN, supra note 156, at 2; see also Alon Brav et al., Hedge Fund Activism: A Review, 4 FOUND. & TRENDS FIN. 185, 186, 202-05 (2010) (discussing activist hedge funds' investment in target firms).
190 See Brav et al., supra note 189, at 187 (describing hedge fund activists as a "new breed of shareholder activists").
191 See id. at 197-201 (discussing activist hedge funds' objectives). Companies are much more likely to face an activist campaign if they underperformed. See Adam Kommel, SharkRepellent Study Shows Underperformers Three Times More Likely to be Targeted by Activists Than Outperformers, SHARKREPELLENT.NET (Dec. 16, 2013), archived at https://perma.cc/2ZSR-8T2K:

Of the 1,123 activist targets with available three-year returns, 70.3% underperformed the Russell 3000 by at least 10 percentage points. In contrast, only 21.5% of activist targets outperformed by more than 10 percentage points, implying that significant underperformers are more than three times more likely to be targeted by activists than significant outperformers.

192 For instance, Greenlight Capital, a hedge fund with a stake in Apple, is currently battling Apple to return much of its $137 billion holdings in cash to shareholders. See Apple and Greenlight Capital: Einhorn 1, Apple 0, ECONOMIST (Feb. 22, 2013, 10:51 PM) [hereinafter Apple and Greenlight], archived at http://perma.cc/6PSV-FFWD. Greenlight filed a lawsuit seeking to block Apple's plan for a shareholder vote on a proposal that critics fear will make it harder for the company to issue preferred shares in the future. See id. Greenlight is "urging Apple to issue such shares with a perpetual 4% dividend." Id. The court sided with Greenlight, holding that Apple had unfairly bundled the stock proposal with other proposals into a single measure. See id. In addition, activist investor Icahn Partners has "amassed more than 4.7 million shares" of Apple's stock, amounting to "around 0.5% of Apple's shares." Dan Nakaso, Apple in the Sights of Activist Investor Carl Icahn, SAN JOSE MERCURY NEWS (Oct. 27, 2013), archived at http://perma.cc/WHY2-AUNS. In a letter to Apple's CEO, "Icahn urged Apple to pursue an unprecedented $150 billion stock buyback that he said would more than double the value of Apple stock ...." Id.

193 The case of Darden, a casual dining company with a portfolio of well-known restaurant chains, is illustrative of this point. See Avi Salzman, How to Profit from Today's Shareholder Activism, BARRON'S (Nov. 30, 2013), http://onlinel.barrons.com. Barington Capital, the activist hedge fund, is pushing Darden's management to split itself into two restaurant companies: one for its mature brands (Red Lobster and Olive Garden) and the other for the faster-growing, higher-end restaurants (Capital Grille, Yard House, and Eddie V's). See id. See also Letter from James A. Mitarotonda, CEO of Barington Capital Grp., L.P., to the Bd. of Dirs. of Darden Rests., Inc. (Sept. 23, 2013), archived at http://perma.cc/Z75G-8CQ8.

194 For instance, Research in Motion (BlackBerry's former name) was targeted by an activist campaign demanding the sale of the company. See Don Reisinger, Activist RIM Investor Calls for Sale. CEO Shake-up, CNET (Oct. 11, 2011, 9:52 AM), archived at http://perma.cc/PQ78-GQKQ.
Another typical and increasingly common objective of hedge fund activism is changes to the composition of the target's board of directors, including the installment of hedge fund representatives on the board. Proxy contests to replace incumbent directors went up from nine in the first half of 2009 to nineteen in the first half of 2012 and twenty-four in the first half of 2013. Whereas, in 2012, activists won only 43% of these battles to replace some or all of the directors; the win rate increased to 70% in 2013. There have been countless other activist initiatives, including intervention in more mundane matters such as changing the company's name or relocating its headquarters.

To be sure, activism of this sort is no longer a rare phenomenon. Since 2006, almost one in every six corporations in the S&P's 1500 index has been the target of activist campaigns. The numbers are rising sharply, with about ninety activist campaigns of targets that required over a $1 billion investment by the activists in 2013 alone—50% more than in 2012. No corporation is off limits for activist hedge funds, with companies like Apple, Microsoft, Dell, Sotheby's, and

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195For instance, in 2013, Bill Ackman, CEO of Pershing Square Capital Management, began a campaign to replace the Chairman and CEO of Procter & Gamble, which was eventually successful. See Chris Isidore, Ackman Wins, P&G Dumps CEO, CNN MONEY (May 24, 2013, 10:25 AM), archived at http://perma.cc/SJ7Z-986R.

196For example, "Hewlett-Packard . . . named Ralph V. Whitworth, the head of the hedge fund Relational Investors, to its board . . . ." Michael J. de la Merced, H.P. Gives Relational's Whitworth a Board Seat, N.Y. TIMES DEALBOOK (Nov. 17, 2011, 5:38 PM), archived at http://perma.cc/LWS6-VWHS. At the time, the hedge fund owned about a 1% stake in the company. See id. 


198Id.

199For example, Starboard Value has been urging Wausau Paper to change its name and move its headquarters to another state. See Lawrence Delevingne, More 'Value Investing Congress' Ideas, From Wills to Wausau, CNBC (Sept. 18, 2013), archived at http://perma.cc/G925-FX8U.

200See Salzman, supra note 193.

201CITI CORP. & INV. BANKING DIV., RISING TIDE OF GLOBAL SHAREHOLDER ACTIVISM 4 (2013) [hereinafter CITI, RISING TIDE].

202See Hirst, supra note 197.

203See Apple and Greenlight, supra note 192.

204With only a "0.8% stake in Microsoft," ValueAct Capital Management was successful in placing its president on Microsoft's board of directors in 2014, and it thus gained "the ability to discuss a range of significant business issues" with selected Microsoft directors and managers . . . ." Nathan Vardi, ValueAct Hedge Fund's Huge Microsoft Victory, FORBES (Sept. 3, 2013, 8:00 AM), archived at http://perma.cc/Q4NL-ZVG5.

205Dell fought off attempts by billionaire activist investor Carl Icahn to prevent the company from going private. See Michael J. de la Merced, Icahn Calls Off Fight Over Dell's Sale, N.Y. TIMES DEALBOOK (Sept. 9, 2013, 10:02 AM), archived at http://perma.cc/6U78-PRZU.
Procter & Gamble\textsuperscript{207} included among the targets. Toward the end of 2013, activist hedge funds were running approximately $89 billion of assets, a huge increase from $36 billion in 2009.\textsuperscript{208} In September 2013 alone, a net inflow of $7.2 billion was invested in activist hedge funds.\textsuperscript{209} As of the first half of 2014, activist hedge funds’ assets under management were estimated at $111 billion.\textsuperscript{210} The industry today includes more than one hundred activist hedge funds,\textsuperscript{211} with famous repeat players such as Carl Icahn’s fund ("Icahn Partners LP"),\textsuperscript{212} Ralph Whitworth’s Relational Investors,\textsuperscript{213} and many smaller hedge funds, each of which manages a few billion dollars.\textsuperscript{214} These numbers are far from surprising given the returns that activist hedge funds recently produced to their investors.\textsuperscript{215} Activist hedge funds have outperformed their non-activist peers and market indices, generating a 19.4\% compound annual growth rate since 2009, as compared to 7.5\% for all hedge funds and 12.3\% for S&P 500 companies.\textsuperscript{216}
Activists employ a variety of different tactics to achieve their goals.\textsuperscript{217} They can start with letters to management, followed by intensive media and public relations campaigns, and then turn to legal measures against management, up to and including a full-fledged proxy fight.\textsuperscript{218} The Elliot Management activist campaign targeting the Hess Corporation\textsuperscript{219} is illustrative of this course of action and shows why traditional institutional investors cannot be expected to perform this expensive, time-consuming task that draws so much fire from the business community.\textsuperscript{220} Traditional institutional investors seem to have found someone else to do the dirty work for them, but as discussed below, this mechanism entails vast transaction costs and, more importantly, is sub-optimally monitored.\textsuperscript{221}

The Hess Corporation is a well-known global energy company that operates in the gas and oil sectors.\textsuperscript{222} One of Hess's biggest shareholders, with a 4.5\% stake, is the Elliot Management hedge fund,\textsuperscript{223} run by billionaire Paul Singer.\textsuperscript{224} Elliot Management pushed for changes in the company's management and campaigned to replace the company's board.\textsuperscript{225} In response to the pressure, Hess announced steps intended to raise its stock price and agreed to certain changes, including separating the roles of Chairman of the Board and Chief Executive Officer, and supporting a proposal that directors stand for reelection every year rather

\begin{itemize}
\item\textsuperscript{217} See Brav et al., supra note 189, at 201-02 (discussing activist hedge funds' tactics).
\item\textsuperscript{218} See id.
\item\textsuperscript{219} See Michael J. de la Merced, How Elliot and Hess Settled a Bitter Proxy Battle, N.Y. TIMES DEALBOOK (May 16, 2013, 9:11 AM), archived at http://perma.cc/96HT-47SW (stating that the Hess Corporation is the biggest target of Elliot Management yet).
\item\textsuperscript{220} See Andrew Ross Sorkin, For Activist Investors, a Wide Reporting Window, N.Y. TIMES DEALBOOK (May 19, 2014, 9:42 PM), archived at http://perma.cc/T9DW-7EBJ (internal quotations omitted) ("Shareholder activism is extremely time-consuming, expensive and a drain on an investment firm's resources . . . .").
\item\textsuperscript{221} See Ronald Orol, Working on the A[activist]-Team, DEAL PIPELINE (Oct. 13, 2014, 3:24 PM), archived at http://perma.cc/PMR6-YFCL (explaining that passive funds partner with another company and leave it to the well-known party to do the "dirty work").
\item\textsuperscript{222} See Hess Operations, HESS CORP., archived at http://perma.cc/L5SM-XE97 (last visited Aug. 22, 2015) ("Hess Corporation is a leading global independent energy company engaged in the exploration and production of crude oil and natural gas.").
\item\textsuperscript{223} See de la Merced, supra note 219.
\item\textsuperscript{224} See id.
\item\textsuperscript{225} See id.
than every three years. Finally, "Hess agreed to give... Elliot... three board seats in exchange for the fund's support of the company's slate of five directors."227

Another illustrative example of the sophistication of hedge fund activism is the successful campaign led by Relational Investors that resulted in the breakup of the Timken Corporation into two independent companies.228 Relational Investors, an activist hedge fund that bought a 6.9% stake in the company, was the leading shareholder behind the campaign.229 After a short struggle, the shareholders approved a non-binding proposal, submitted by Relational Investors at the annual meeting, to split the company into two.230 A unique feature in Relational Investors' effort to gain the support of shareholders was setting up a website that included detailed presentations and supportive analyst reports.231 A few months after the vote, Timken's board agreed to spin off its steel business.232

There is no doubt that activist hedge fund investors are quite pleased with their achievements, although some spectacular failures have also been recorded.233 This explains why traditional institutional investors have recently supported activist hedge funds and are increasingly investing in them as a new type of legitimate asset class.234 In a sense, institutional investors' willingness to invest in activist hedge funds resembles their prior willingness to invest in leveraged buyout funds, which are a different avenue for corporate overhaul.235

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226 See id.
227 de la Meced, supra note 219.
228 See Nelson D. Schwartz, How Wall Street Bent Steel, N.Y. TIMES (Dec. 6, 2014), http://www.nytimes.com/2014/12/07/business/timken-bows-to-investors-and-splits-in-two.html?_r=0; see also Hirst, supra note 197 ("The Timken case is but one example of the leading and influential proxy advisory firms to institutional investors increasingly supporting activists.").
229 See Hirst, supra note 197; Schwartz, supra note 228.
230 See Hirst, supra note 197.
231 See id.
232 See id.
233 For example, Pershing Square, an activist hedge fund, was a major shareholder in Borders Group and tried to convince the Borders' board to merge with a rival company (Barnes & Noble). See Agustino Fontevectha, Borders Finally Throws In the Towel, Big Hit For Ackman and LeBow, FORBES (Feb. 16, 2011), archived at http://perma.cc/SWNN-7HAC. Borders eventually filed for bankruptcy. See id.
234 See Lipton, supra note 171 ("Activist Hedge Fund has become an asset class in which institutional investors are making substantial investments."); Rock, supra note 71, § 8 (discussing institutional investors and their involvement in activist hedge funds).

LBO firms can be seen as substitutes that developed partly due to institutional restrictions... The LBO firms obtain their equity and debt funding from the control-disabled, such as pension funds, insurers, and banks... Financial
interesting question is whether activist hedge funds do, in fact, improve shareholders' long-term welfare.\textsuperscript{236} Hedge funds normally hold on to the shares of the target corporation for a relatively short period, allowing for the possibility that the market returns they earn are myopic and no long-term value is achieved.\textsuperscript{237} Yet, although the scientific evidence on the long-term effects of hedge fund activism is scant, there is evidence that this activism indeed improves, on average, long-term shareholder value.\textsuperscript{238}

An empirical study conducted by Lucian Bebchuk, Alon Brav, and Wei Jiang examined about two thousand corporations that had been the targets of hedge fund activism campaigns.\textsuperscript{239} Their study showed that there is no evidence that interventions by activist hedge funds are costly to firms and their long-term shareholders.\textsuperscript{240} On the contrary, they found that in the five-year period following these interventions, operating performance improved.\textsuperscript{241} They also found that the initial positive stock price that followed these interventions correctly reflected their long-term consequences.\textsuperscript{242} Additionally, there was no evidence that the activist's institutions that could not take control directly have now found a way to weave around the regulations and prohibitions.

\textsuperscript{236} See Dionysia Katelouzou, Myths and Realities of Hedge Fund Activism: Some Empirical Evidence, 7 VA. L. \\& BUS. REV. 459, 476-78 (2013).
\textsuperscript{238} See Katelouzou, supra note 236, at 480-82 (explaining that even short term investors have an interest in the long-term welfare of the company, and activist hedge funds increase the value of the firms they target, which increases long-term shareholder value).
\textsuperscript{239} Bebchuk et al., supra note 1, at 1088-90. Similar results were found in Europe. See Wolfgang Bessler et al., The Returns to Hedge Fund Activism in Europe, 21 EUR. FIN. MGMT. 106, 106, 143 (2015) (finding that hedge fund activists in Germany increase shareholder value both in the short and long-term and that aggressive activism is initially associated with higher returns which are quickly reversed).
\textsuperscript{240} Moreover, in some cases, activists remain on as shareholders long enough to be considered long-term investors. See Ian D. Gow et al., Activist Directors: Determinants and Consequences 3, 23 (Harv. Bus. Sch., Working Paper No. 14-120, 2014) ("When they have board seats, activists remain as shareholders long enough to be considered long-term investors by conventional standards, with holding periods averaging three years.").
\textsuperscript{241} Bebchuk et al., supra note 1, at 1117: "During the five years following the intervention, we find no evidence supporting concerns that activist interventions are followed by short-term gains that come at the expense of subsequent long-term declines in operating performance. ... Indeed, in each of the years three, four, and five following the intervention, we find improvements that are statistically significant. Thus, overall, the evidence on firm performance does not support the myopic-activists claim.
\textsuperscript{242} Id. at 1155 ("We also find no evidence that the initial positive stock-price spike accompanying activist interventions fails to appreciate their long-term costs and therefore tends to be followed by negative abnormal returns in the long term; the data is consistent with
exit is followed by abnormal long-term negative returns.\textsuperscript{243} The findings contradict the assertion that hedge fund activism pushes for profitable short-term results at the expense of the long-term interests of the targets and long-term shareholders.\textsuperscript{244} The study drew much fire from opponents of hedge fund activism, who were disappointed by the findings.\textsuperscript{245}

Note, however, that even if these findings accurately reflect the overall long-term impact of hedge fund activism, it does not mean that this activism always increases long-term value.\textsuperscript{246} It only means that on average, it is successful in attaining its goals.\textsuperscript{247} The study also does not suggest that there is no better alternative, nor does it account for the huge transaction costs that are generated by hedge fund activism.\textsuperscript{248} This article, in contrast, explicitly maintains that hedge fund activism is a second-best solution from the perspective of institutional investors and their beneficiaries from the public. The claim here is that institutional investors would be best off cutting out the middlemen, to both improve results and save transaction fees.

To understand why hedge fund activism is an imperfect tool for the initial spike reflecting correctly the intervention's long-term consequences."). See also Marco Becht et al., The Returns to Hedge Fund Activism: An International Study 1-5 (Eur. Corp. Governance Inst., Working Paper No. 402/2014, 2014), archived at http://perma.cc/FJ9C-D6NA (analyzing 1,796 activist interventions and finding large abnormal returns to shareholder activism of between 4.5% and 7.5% percent across Asia, Europe, and North America).

\textsuperscript{243}See Bech, supra note 1, at 1155 ("Similarly, we find no evidence for pump-and-dump patterns in which the exit of an activist is followed by abnormal long-term negative returns.").

\textsuperscript{244}See Zhongzhi He et al., Hedge Fund Activism and Corporate Innovation 10 (Mar. 19, 2014) (unpublished manuscript), archived at http://perma.cc/NWC7-5WDZ: Our finding that activists improve innovative firms' innovation efficiency and deliver long-term returns to shareholders indicates that, although activists tend to have a short investment horizon, there is no evidence that they are pushed for myopic actions such as cutting R&D that hinders the long-run innovation ability. Instead, activist hedge funds focus on improving the innovation output and deliver positive long-term returns to the shareholders of innovative firms.

\textsuperscript{245}See Martin Lipton, The Bebchuk Syllogism, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 26, 2013), archived at http://perma.cc/X2V5-ENA7:
No empirical study, with imperfect proxies for value creation and flawed attempts to isolate the effects of activism over a long-term horizon influenced by varying economic, market and firm-specific conditions, is capable of measuring the damage done to American companies and the American economy by the short-term focus that dominates both investment strategy and business-management strategy today.

\textsuperscript{246}See Katelouzou, supra note 236, at 477-78.

\textsuperscript{247}See Alon Brav et al., Hedge Fund Activism, Corporate Governance, and Firm Performance, 63 J. Fin. 1729, 1741-42 (2008) (showing that between 27% and 60% of activist hedge funds are successful in achieving their goals).

\textsuperscript{248}See Lipton, supra note 245 (noting that the Bebchuk study does not suggest or shed light on any strategic alternatives).
these investors, consider the analogy that was initially developed in the Introduction: a condominium building has been neglected or even abused by the management company to the point that its value has significantly dropped. The unit holders fail to act and bring pressure on the management company due to collective action problems. The wealthy unit owners, however, are willing to provide a third party with huge funds and give it a free hand in using this money. This third party begins by purchasing some units in the building. It then uses the remaining funds in a campaign against the management company. Because the third party owns only a few units in the building, its chances of success are not obvious, and thus the management company puts up strong resistance to any change. This fight is bitter and costly, but eventually the management company relents, and the building undergoes renovations. A short while thereafter, the third party sells its condominium units for a large profit.

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

The same analogy can be useful to explain this article's proposed mechanism for institutional investor activism. Say a group of wealthy individuals each invest in many condominium units in a variety of different buildings. Some of the buildings are in urgent need of improved management. These wealthy owners appoint an expert to each geographic area, who is provided with initial funding to search in her area for a building in need of renovation. The wealthy unit owners commit to providing further, and much heavier, funding to the experts once they have decided which condo management to engage. The experts are authorized to target only properties in which the wealthy unit

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249 See supra Part I.
owners will hold enough units in the aggregate. Furthermore, the funding for the expert's engagement of the condominium management is not provided by all the wealthy individuals who signed an agreement with the expert but rather only by those with units in the targeted condominium building, pro rata to their holdings. The experts could then initiate a campaign to improve the condominium building and effectively pressure the management to yield to their demands. As a result, the condominium building will be significantly improved to the benefit of all unit owners there.

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

Finally, since the proposed activism scheme is based on existing holdings in the target corporation, all gains (but for the task force fees) are enjoyed only by those investors who were already shareholders in the target prior to its engagement, rather than having to be shared with all investors who finance the hedge fund's activism, as is the case under the prevailing model. And since institutional investor holdings dominate the market, the proposed mechanism would be highly accessible, and there would be no early warning to alert the target's management of the impending activism. This feature would produce a market-wide disciplinary force. In fact, the proposed mechanism would be so overwhelming that the management of target corporations might not even try to fight the activism, which, in turn, would reduce its costs even beyond what has been shown so far. This also means that we are more likely to see dialogues between the task force and the target's

251 Understanding why the expert is likely to be much more powerful than the strongest activist hedge fund lies in the striking difference between the size of the holdings of traditional institutional investors and that of hedge fund holdings: towards the end of 2013, activist hedge funds ran approximately $89 billion, whereas in 2012, mutual funds held shares worth $6,300 billion, pension funds held $4,150 billion, and insurance companies held $1,800 billion. See Federal Reserve 2005-2013, supra note 61, at 95 tbl.L.213.

252 See Kahan & Rock, supra note 88, at 1064-66, 1083-87 (discussing the short-term incentive structure in hedge fund activism).

management, and not a battle, which is typical for hedge fund activism. This is all for the better.

One major conundrum remains: why has this mechanism yet to evolve in the market, and why is it not expected to emerge spontaneously in the near future? This issue is discussed in the next and final Part of this article.

V. LEGAL AND POLITICAL BARRIERS TO IMPLEMENTATION

The proposed model for institutional activism could come up against certain challenges in implementation. One important challenge relates to coordination: the viability of this model rests on the participation of a very big group of large institutional investors. This means that a parent organization with preexisting strong ties to many institutional shareholders must be involved in order to recruit participants. This organization could also be helpful in formulating the standard agreement to be signed between the member institutional investors and the task forces. Finally, it could also be of assistance in recruiting the various task forces. The parent organization could be either an existing well-connected organization, such as ISS or the Council of Institutional Investors, or alternatively, a nonprofit organization put together expressly for this purpose. Coordinating the actions of many different institutional investors is a tricky task, but third-party proxy advisory firms have already proven that they are well geared for this. In 1985, the year that ISS was founded, its business model was quite visionary, likely raising many eyebrows; yet its success has been undeniable. The model proposed in this article can be seen as the natural next step.

Yet, it is not coordination itself that would be the central obstacle to implementing the proposed model, but the response of market and regulatory mechanisms to this coordination attempt. To begin, there

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255 See infra Part V.
256 See Black, Agents Watching Agents, supra note 69, at 830-49 (discussing generally the benefits of institutional investors).
257 The Institutional Shareholder Services executes nearly seven million proxy votes, representing 2.7 trillion shares, each year. See About ISS, supra note 9. The Council of Institutional Investors oversees combined assets worth $3 trillion. See About CII, supra note 175.
258 See id.
could be some regulatory hurdles that would have to be overcome.\textsuperscript{260} First, the scheme could rise to a possible antitrust concern. The antitrust authorities\textsuperscript{261} would thus have to clarify that the cooperation among the different institutional investors does not violate any antitrust requirements,\textsuperscript{262} and a similar clarification would be needed from the Securities and Exchange Commission ("SEC")\textsuperscript{263} as well. For instance, the SEC should clarify that the indirect cooperation between those who sign the agreement with the task force does not amount to holding their securities together and that the member institutional investors would still be considered passive investors.\textsuperscript{264} Otherwise, member institutions might fear that the scheme will trigger additional reporting requirements,\textsuperscript{265} and

\textsuperscript{260}Additional relevant regulation is already in the works. For example, concerns over the potential effect of proxy advisory firms on shareholders have already attracted regulators' attention. See Aguilar, supra note 155. Seemingly, the task forces could be covered by this expected regulation. See id. In addition, some proxy advisory firms are registered as investment advisers. See id. If the task forces would be similarly required to register as investment advisers, they would bear fiduciary duties to their clients, which would add more regulatory hurdles. See id.; see also Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 to -21 (2012).

\textsuperscript{261}The Federal Trade Commission ("FTC") is the primary authority for regulating and enforcing antitrust laws. See A Brief Overview of the Federal Trade Commission's Investigative and Law Enforcement Authority, FED. TRADE COMM'N (July 2008), archived at http://perma.cc/758G-4DDA.

\textsuperscript{262}The FTC could do so through its rulemaking authority because it is authorized to prescribe "rules which define with specificity acts or practices which are unfair or deceptive acts or practices in or affecting commerce." 15 U.S.C. § 57a (2012).

\textsuperscript{263}The SEC could do so through its authority to issue "policy statements" which clarify the Commission's position on a particular matter. See SEC Policy Statements, U.S. SEC. & EXCH. COMM'N, archived at http://perma.cc/3C4W-MFYC (last visited Aug. 22, 2015).

\textsuperscript{264}In a recent Compliance and Disclosure Interpretations ("C&DI")s", the SEC concluded that parties that do not have or share the power to vote or direct the vote of other parties' shares would not beneficially own such shares solely as a result of entering into an agreement. See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, U.S. SEC. & EXCH. COMM'N (Jan. 3, 2014) (citation omitted), archived at http://perma.cc/K4DY-QW4E:

In order for one party to the voting agreement to be treated as having or sharing beneficial ownership of securities held by any other party to the voting agreement, evidence beyond formation of the group under Rule 13d-5(b) would need to exist. . . . [I]f a voting agreement confers the power to vote securities pursuant to a bona fide irrevocable proxy, the person to whom voting power has been granted becomes a beneficial owner of the securities under Rule 13d-3. Conversely, parties that do not have or share the power to vote or direct the vote of other parties' shares would not beneficially own such shares solely as a result of entering into the voting agreement.

Since in the suggested framework the task force is not a proxy of the institutional investors and serves as an advisor, the task force agreement should not constitute as a group formation.

\textsuperscript{265}See 17 C.F.R. § 240.13d-101 to -102 (2014); see also Black, Shareholder Passivity, supra note 69, at 542-45:

SEC rules (13(d) Rules) require any person or "group" which beneficially owns more than 5% of a public company's stock to file a Schedule 13D containing disclosure about the person or group, its stock ownership, its plans with respect to the company, and various other matters.
other limitations that stem from securities regulation. A second hurdle would arise from the specific regulation that governs the activity of each type of traditional institutional investor—insurers, pension funds, and mutual funds. Given this regulation, two things should be clarified for the new framework to succeed. First, the relevant regulators or perhaps the courts should declare (at least implicitly) that none of the provisions in the standard agreement signed between the institutional investors and relevant task force (including the investors' consent to a capital call) in any way violates any fiduciary duty owed by the institutional investors to their members. Second, the institutional investors would have to be allowed under the relevant regulation to deduct the mechanism's costs from the members' fund and not have to deduct them from the management fees.

Regulatory hurdles would not be the only impediment to implementing the proposed scheme. The mechanism would also have to contend with resistance from management at portfolio companies, which would surely take action to frustrate this new mode of activism. Chief

Institutions who acquire a 5% stake without "the purpose . . . [or] effect of changing or influencing the control of the issuer" can file Schedule 13G instead of Schedule 13D. Schedule 13G calls for less information than Schedule 13D and does not need to be filed as promptly or amended as often.


270See Black, Agents Watching Agents, supra note 69, at 856-57 (discussing the fiduciary duties of institutional investors).
among the tools that could be resorted to is the notorious "poison pill," which operates to dilute the holdings of any shareholder that buys a stake beyond a certain threshold, commonly between 10% and 20%, without management's approval. Although poison pills have fallen out of favor, with only a few percent of the large companies still holding on to them, they could be reinstated when a hostile bidder emerges. However, recent experience shows that companies without poison pills tend not to put one in place when a hostile bid is made.

Poison pills are relevant in our context because they commonly apply the definition of a group set out in section 13(d) of the 1934 Securities Exchange Act. The conception of a group therein is quite vague, with Rule 13d-5 providing: "When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership . . . ." This definition, which has been incorporated into poison pills, is material to shareholder activism since "concerted conduct—but not parallel action—will trigger section 13(d)'s reporting obligations" and, therefore, also a poison pill.

Needless to say, no institutional investor would sign a task force


272 See Andrew L. Bab & Sean P. Neenan, Conference Bd., Poison Pills in 2011, DIRECTOR NOTES, Mar. 2011, at 1, 1-4, available at https://www.conference-board.org. In 2001, more than 2,200 corporations had poison pills in effect, whereas in 2011, there were fewer than 900 corporations with poison pills in effect. See id. Many large companies have allowed their in-force pills to expire. See id. As of 2011, there were only 291 companies with a market cap less than $100 million with poison pills. See id.


274 See Guhan Subramanian, Delaware's Choice, 39 DEL. J. CORP. L. 1, 5 (2014) ("88% of S&P 1500 companies do not currently have pills, and in recent years 59% of companies without pills have not put them in when a [hostile] bid is brought."); see also Joseph A. Grundfest, I Told You So, 39 DEL. J. CORP. L., 55, 58 n.14 (2014).

275 See Guhan Subramanian, supra note 88.
agreement if such an agreement could trigger a poison pill to the detriment of all shareholders that sign a similar agreement (assuming their aggregate holdings exceed the poison pill threshold at the target firm). Courts would most likely not affirm such an interpretation of a poison pill trigger, since it would compromise the sacred "shareholder franchise": shareholders' right to vote as they see fit. Nevertheless, the risk of triggering a poison pill is a concern that could significantly endanger the feasibility of implementation. An SEC clarification that a task force agreement does not create beneficial joint ownership for purposes of the federal securities regulations could alleviate the concern on the state poison pill level, as well.

In any case, the real potential foe of the proposed mechanism is neither the existing regulation nor the possibility of triggering a poison pill. Rather, the greatest threat to implementing this model is the political economy forces in the American market and the age-old sentiment against concentration of too much power in the hands of institutional investors. The proposed framework may tilt the current balance of power between managers and shareholders to such an extent as to spark backlash regulation. "[T]his traditional wariness of a concentration of power" is what engendered much of the legislation and regulation that prevented American financial institutions from becoming dominant shareholders initially. Thus, any attempt to reinstate their

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281See Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 n.2 (Del. Ch. 1988); Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights. This concern suffuses our law, manifesting itself in various settings. For example, the perceived importance of the franchise explains the cases that hold that a director's fiduciary duty requires disclosure to shareholders asked to authorize a transaction of all material information in the corporation's possession, even if the transaction is not a self-dealing one. Note, however, that a Delaware court recently concluded that a poison pill with two triggers, including a lower trigger for activist shareholders, is likely to be considered a proportionate response to the threat of collusive action by the hedge funds. See Third Point LLC, 2014 WL 1922029, at *1.
282See id.
284See Third Point LLC, 2014 WL 1922029, at *1.
285See Roe, supra note 44, at xiv.
286See Roe, supra note 235, at 11.
287See Roe, supra note 179, at 1471; A pattern can be seen in the history of American corporate finance. Institutions that can influence industry are restrained from growing too big. If they do grow anyway, their portfolios are forcibly fragmented. If the fragmented institutions attempt to link themselves together to control industry, law prohibits those links. For banks, insurance companies, pension funds, and
role as such, like the proposal in this article seeks to do, may well be met with new legal restrictions.

The design of the proposed activism framework tries to address and appease this threat, although it still remains as a potential barrier. First, each task force would have absolute autonomy from the parent organization and would be directed solely at a restricted set of potential targets within its area of expertise. This structure would alleviate the concern of too much market power resting in too few hands. Second, and more crucial, the task forces would have a strictly advisory role in proxy fights. They would conduct research and have full discretion as to which target to engage, but would not be given a proxy to engage in any action that requires the vote of the institutional investors funding their operation. Like activist hedge funds today, the task forces would have to convince the institutional shareholders to back their activism goals. Yet, unlike the hedge funds, they would not need to purchase a substantial stake in their targets, and their incentives would be closely linked to the interests of the target shareholders directly funding the activism. This advisory feature is likely to reduce the threat of a regulatory backlash as well as ease the fear of triggering poison pills.

To be sure, like any other initiative aimed at fortifying institutional investors' activism the proposal in this article would come under fire from corporate America. One of the many advantages of hedge fund activism is its relative ability to withstand regulatory constraints. The decentralized manner in which hedge fund activism works facilitates the mutual funds, the story is the same. Either separately or collectively, they have, perhaps wisely, been stymied from controlling or influencing industry after they have made their investments. What's more, there is a pattern of politics behind these prohibitions.

See also Roe, supra note 235, at 10-12:

[L]aw creates barriers to the institutions' taking big blocks. Banks, the institution with the most money, cannot own stock. Mutual funds generally cannot own control blocks of stock. Insurance companies can put only a fragment of their investment portfolio into the stock of any one company. Pension funds own stock, but they also face restrictions. More importantly, corporate managers control private pension funds, not the other way around.

. . . Politicians responded to that distrust by enacting rules restricting private accumulations of power by financial institutions.

288 See Roe, supra note 235, at 11.

289 If the task force does not have a proxy to vote on behalf of the institutional investors, this author believes that its operation will be unlikely to trigger a poison pill. After all, proxy advisory firms routinely advise scores of institutional investors on how to vote at shareholder meetings, including in proxy fights initiated by activist hedge funds, but the investors that fund this activity have never been accused of being a "group." Similarly, institutional investors that fund an activist hedge fund and also hold stock directly in the target do not automatically count their holdings together with other hedge fund investors. See id.

290 See Hirst, supra note 197.
evasion of such restraints, a feature that is not shared by the activism mechanism presented here.

VI. FINAL REMARKS

The ways in which institutional investors can theoretically manifest their voice can be stretched out on a continuum. At the one end, there is direct involvement of institutional investors in corporate activism. In practice, however, such direct activism is fairly rare. At the other end of the continuum is the extremely indirect manifestation of voice and participation in activism through hedge funds. Institutional investors who are the shareholders of a corporation that is targeted by a hedge fund activism campaign can vote for the activist in a proxy fight or otherwise voice their support for its campaign; they can also directly finance activist hedge funds. This article seeks to empower institutional investors and propose a new option for involvement in activism. It offers a middle ground. The proposed scheme outsources the function of activism from institutional investors to a third party. Although the involvement in activism remains somewhat indirect, it is much less so than in the context of shareholder participation in hedge fund activism.

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

Implementation of the new mechanism will face both new and

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291 See id.
292 See Gilson & Gordon, supra note 71, at 888.
293 See Roc, supra note 235, at 11.
294 See Roc, supra note 179, at 1471.
295 See Lipton, supra note 171.
296 See id.
297 See id.
298 See Rock, supra note 71, § 8.
299 See id. at § 4.
300 See id.
301 See id.
existing legal barriers. Careful crafting should prevent the mechanism from being too powerful and therefore face less resistance. In particular, the task force should not enjoy a proxy from member institutional investors, to vote on their behalf in the shareholders meetings of the target corporations. The task force would only enjoy an advisory role in this regard, albeit a powerful one. Relative to hedge fund activism, the new mechanism is also more likely to be less loud and less adversarial, given the nature of the sponsoring institutional investors. This feature would also prevent some of the possible opposition and backlash to its operation.

In conclusion, institutional investors have proven in recent years that they are able to pool their power and resources to dramatically impact the management of a portfolio company. To do so, they often need to resort to a third party to direct their activity. They therefore turn to third-party proxy advisors to negotiate with management and advise them on how to vote in shareholder meetings. They also fund or otherwise support activist hedge funds that initiate campaigns to pressure management. This article has suggested a new and innovative mode of operation: cutting out the middleman and replacing it with an agent that would enable institutional investors to influence management using their existing power. No wasteful fund raising or market transactions would be necessary, but rather an expert advisor would direct concerted action by the institutions that, in aggregate, dominate the market.

302 See Rock, supra note 71, § 4.
303 See Appel et al., supra note 100, at 29.
305 See id.
306 See id.