FOR INSTITUTIONAL INVESTORS, THE ALTERNATIVE OF "EXIT OR VOICE," OR "EMPOWERMENT OR ENGAGEMENT" IN THE UNITED STATES AND THE UNITED KINGDOM

Akio Otsuka†

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† Professor of Law, Dean of School of Business Sciences (2018-present), Chair of the J.D. Program of Law School (2013-2015), University of Tsukuba; LL.M. 1990, MBA 1991, Southern Methodist University; Ph.D. in law 2001, University of Tsukuba.

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I. INTRODUCTION

The corporate governance systems in the United States ("U.S.") and the United Kingdom ("U.K.") are similar in many respects. Both countries' markets have large capitalizations, dispersed ownership, liquidity, and active takeover activity. Another important similarity is the large equity stake of institutional investors, who own more than 50% of the publicly listed shares in each country.[1] Only 20% (10%) of large (medium) U.S. firms feature a blockholder with at least a 20% holding,[2] estimated as the threshold required to exercise control. In contrast, political and legal impediments exist in the U.S. to forming large stakes.[3]

Since the early 1990s, the argument has been that institutional investors should fill this agency gap by "monitoring" and "engaging"

1 For statistics on the United States, John van Reenen, Philippe Aghion & Luigi Zingales, *Innovation and Institutional Ownership*, VOXEU (Mar. 20, 2009), http://www.voxeu.org/article/innovation-and-institutional-ownership (stating that the OECD reported that institutional investors hold more than $32 trillion in publicly traded equities). For statistics on UK institutional ownership, see OFFICE FOR NAT'L STATISTICS, SHARE OWNERSHIP: A REPORT ON OWNERSHIP OF SHARES AS AT 31ST DECEMBER 2004 (2005). For statistics on U.S. institutional ownership, see Laura T. Starks, Professor, Univ. of Texas at Austin, Presentation to the FMA Doctoral Seminar: The Influence of Institutional Investors on Financial Markets Through Their Trading & Governance Monitoring (Oct. 17, 2007).

2 *See* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377 (2009); Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

3 Mark Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. FIN. ECON. 7 (1990).

portfolio companies on behalf of their beneficial owners. However, with the vast majority of equity interests held by intermediary institutions, such as mutual funds and pension funds, individual investors are now involved in two sets of agency relationships: between shareholders and corporate directors and between beneficial owners (shareholders) and recorded owners (intermediary institutions).[4]

Blockholders, such as intermediary institutions, may also aggravate rather than solve agency problems.[5] First, even if blockholders' actions maximize firm value ex post, their presence may reduce value ex ante: the threat of intervention by the blockholders may erode managerial initiative, and their mere presence may depress liquidity. Second, instead of maximizing firm value, blockholders may extract private benefits from the firm. Although blockholders may ease conflicts of interest between corporate managers and investors, conflicts of interest may exist between blockholders and minority shareholders.

In response to the 2008-2009 global financial crisis, the U.K. developed best practice codes urging corporate governance obligations of "stewardship" on institutional investors.[6] The argument for these governance obligations arose from a belief that institutional investor stewardship will foster the long-term success of companies "in such a way that the ultimate providers of capital also prosper."[7] In contrast, institutional intermediaries have proven to be ineffective as proactive corporate monitors because they lack an incentive and expertise for corporate stewardship.[8]

From the perspective of law and economics, this article analyzes whether activist institutional investors can assume and fulfill a useful role within corporate governance systems and, if possible, how they can act as a component in a corporate governance system. This article proceeds as follows. Part II of this article outlines the Berle–Means theory on corporations' separation of ownership from control and the advent of institutional investors from concentrations of investments. Part III

4 Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013) (illustrating a dual set of agency relationships).

5 Alex Edmans, *Blockholders and Corporate Governance*, 6 ANN. REV. FIN. ECON. 23 (2014).

6 *See* FIN. REPORTING COUNCIL, THE UK STEWARDSHIP CODE 4 (2012), https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf [hereinafter Stewardship Code].

7 *Id.* at 1.

8 *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 595-608 (1990) (providing examples of the ways in which money manager incentives and conflicts of interest affect voting and activism).

discusses institutional investors' choice between voice and exit. In classical models, blockholders exert corporate governance through direct intervention in a firm's operations, otherwise known as "voice." More recent models show that blockholders can govern through an alternative mechanism known as "exit" or selling their shares if the manager underperforms. In other words, blockholders disappointed with their investment returns follow the so-called "Wall Street Rule" and sell their shares rather than attempt to influence corporate managers; that is, they choose to exit over voice. Blockholders may improve governance through either active monitoring or passive selling, and both activities are expected to improve corporate governance.[9] "Conversely, blockholders may worsen governance by extracting private benefits of control or by pursuing objectives other than maximizing firm value."[10] Part IV explores shareholder empowerment in the U.S. and the U.K. and further discusses engagement. Parts V through VII provide a relatively detailed discussion regarding restrictions on shareholder activism; conflicts of interest and fiduciary duty; Regulation Fair Disclosure; and proxy advisors. Part VIII summarizes and concludes.

II. BERLE AND MEANS' MODEL TO BLOCKHOLDERS' ERA

A. The Berle–Means Corporation-Separation of Ownership from Control

Many publicly traded corporations have widely dispersed shareholders and, as a result, have no large shareholder. In their landmark book, *The Modern Corporation and Private Property*, Berle and Means found that many public corporations had dispersed ownerships where no single shareholder owned a large number of shares.[11] They observed the phenomenon as a "separation of ownership from control" (the "Berle–Means Corporation").[12] The Berle–Means Corporation assumes that a large number of dispersed shareholders collectively own shares in a large corporation.[13] Ownership usually implies control; however, because of

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

10 Edmans, *supra* note 5, at 23.

11 *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY (1932).

12 *Id.* at 6 ("The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear.").

13 *See* John C. Coffee Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 Nw. U. L. Rev. 641, 641 (1999).

dispersion of ownership in the shares of a public corporation, managers who control corporate assets, information, and the voting mechanisms have *de facto* control over the corporation, with little monitoring by shareholders because no dominant shareholder exists. In addition, shareholders of many public corporations are passive.[14]

The separation of ownership and control is beneficial when the managers operate the business in ways that benefit all shareholders. The "separation of ownership from control" is justified by the notion that managers serve as specialists who use their expertise to increase the value of the corporation, whereas shareholders are passive investors who are diversified, supply large amounts of capital, and seek gains from increases in the firm value.[15] In contrast, if managers unfairly self-deal or mismanage the business, shareholders may suffer substantial losses or insufficient gains. Much of the corporate governance in the U.S. focuses on reducing agency costs up to a maximum, that is, balancing the costs and benefits of this separation of ownership from control and, if necessary, utilizing different monitoring devices available to protect shareholders from losses resulting from such separation.

B. Emergence of Institutional Investors

For most of the twentieth century, the ownership of public corporations was primarily in the hands of private individuals. After the collapse of the banking system and the Great Depression of the 1930s, the Glass-Steagall Act[16] was enacted by the U.S. Congress. Congress recognized that certain abuses in the financial community contributed to the banking panic of the late 1920s and early 1930s and sought to rectify those abuses through preventative legislation that created a "wall" between investment and commercial banking activities.[17] In the early 1900s, American financial institutions were active participants in U.S. corporate governance, but the enactment of securities laws in the 1930s limited the power of financial intermediaries and, thus, their governance

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14 *See* ROBERT CHARLES CLARK, CORPORATE LAW 390-96 (1st ed. 1986) (explaining that smaller shareholders are rationally apathetic because of costs and free riding).

15 *See* Arthur R. Pinto, *Globalization and the Study of Corporate Governance*, 23 WIS. INT'L. L.J. 477 (2005) (providing explanations for the prevalence of separation of ownership from control including different legal systems, cultural differences, and history and politics).

16 The Glass-Steagall Act is the common name for the Banking Act of 1933. Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified in scattered sections of 12 & 18 U.S.C.).

17 The Glass-Steagall Act was one of several statutes enacted by Congress in the early 1930s to regulate financial markets. Other statutes included the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2012), Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78pp (2012), and Public Utility Holding Company Act of 1935, ch. 687, tit. 1, 49 Stat. 803 (1935) (repealed 2005).

role. In 1942, the U.S. Securities and Exchange Commission (the "SEC") promulgated the Shareholder Proposal Rule pursuant to its authority under Section 14(a) of the 1934 Securities Exchange Act. The Rule requires corporate management to include shareholder proposals in its proxy materials, at no cost to the proponent, for a vote at the annual shareholders' meeting.[18] Since that time, shareholder activists have used the proxy process and other approaches to pressure corporate boards and managers to effect change. In particular, during the mid-1980s, the involvement of large institutional investors increased dramatically with the advent of public pension fund activism.[19] Institutional investors as a whole increased their share of U.S. equity markets to 51.4% in 2000 and then to 61.2% in 2005.[20]

Since then, share ownership shifted, with the increased ownership by institutional investors consisting of private and public pension funds, insurance companies, foundations, endowments, universities, bank-managed trusts, mutual funds, and—more recently—private equity and hedge funds.[21] Whereas the Berle–Means Corporation of dispersed ownership continues, institutional investors, relative to individuals, often hold a larger number of shares representing a larger investment. If these institutions act collectively, they can influence their corporations.[22] However, the growth of institutional ownership does not mean that any one institution is likely to dominate the ownership of a corporation. A large number of these institutions exist, many of which are not interested in either increased activity or ownership because these active roles or influences would incur increased costs as well that might not necessarily produce benefits.[23]

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18 *See* 17 C.F.R. § 240.14a-8 (2018).

19 Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55 (2007).

20 Press Release, The Conference Board, U.S. Institutional Investors Continue to Boost Ownership of U.S. Corporations (Jan. 22, 2007), https://www.conference-board.org/utilities/pressDetail.cfm?press_ID=3046 [https://web.archive.org/web/20070205020337/https://www.conference-board.org/utilities/pressDetail.cfm?press_ID=3046].

21 NEW YORK STOCK EXCHANGE, FACT BOOK 1996 (1997). In 1950, 91% of equity was held by households. *See id.* In 1996, the figure was approximately 48%. *Id.* Pension funds held 22% of all equities. *Id.*

22 See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. REV. 811, 815-16 (1992).

23 Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation*, 61 VAND. L. REV. 299, 300 (2008).

III. EXIT/VOICE

A. In Hirschman

In his classic book, *Exit, Voice, and Loyalty*,[24] Hirschman observed that the mechanisms of exit and voice discipline an organization, under which mechanisms firms in decline learn of customer dissatisfaction in two ways: through "exit," when customers stop patronizing the firm, or through "voice," when customers express dissatisfaction to a person with authority at the firm.[25] For example, a dissatisfied employee might quit (exit) or complain (voice).[26] The exit mechanism corresponds to the economic approach as a disciplining force, whereas voice corresponds to the political or sociological approach.[27] Hirschman did not place one mechanism over the other but noted the interplay between exit and voice and introduced loyalty as an interposing mechanism that gives voice room to operate.[28]

Hirschman cast loyalty as a mitigation against hasty exits.[29] The notion of loyalty helped Hirschman explain why everyone does not simply take an easy exit option, and why some cling to a brand or an organization in the hope that voice will eventually put it on the right track. In relation to voice and exit, Hirschman argued that most organizations are dominated by one or the other mechanism.[30] If someone attempts to exit when exit is essentially closed, significant discipline will be incurred.[31] Voice then becomes the only option. According to Hirschman, loyalty moderates between the voice and the exit options.[32] Loyalty makes exit less likely and voice more effective.[33] To optimize organizations, a mix of both voice and exit is necessary.

B. Recent Discussion on Exit or Voice

As argued above, institutional investors have two active choices when they become dissatisfied with a portfolio firm: (i) they can engage

24 ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).

25 *Id.* at 4.

26 *Id.* at 3-4.

27 *Id.* at 15-16.

28 *Id.* at 1-4, 15-18, 77-80.

29 *Id.* at 78.

30 *Id.* at 120.

31 *Id.* at 96.

32 *Id.* at 76.

33 *Id.* at 77.

with management to attempt to institute change ("voice" or direct intervention); or (ii) they can leave the firm by selling shares ("exit" or "voting with their feet"). Subsequently, theoretical models have documented the governance benefits of collective actions by institutions through voice.[34] Recently, these theories have been complemented by models showing that the threat of exit can also discipline management.

1. Voice

Following the practice known as the "Wall Street Rule" is about exercising *voice* instead of selling shares and voting with their feet. Gantchev described hedge fund activism as a sequential process with three different stages: demand negotiations, board representation, and proxy fight.[35] Activism begins with an activist filing a regulatory form announcing the crossing of a specified ownership threshold and its intentions.[36] Then comes the demand negotiations stage in which the activist communicates its demands and negotiates directly with management.[37] If its demands are rejected, the activist requests board representation through which it threatens to launch a proxy fight and recruit director nominees.[38] If management still resists, then the activist moves to the final and most aggressive stage: the proxy fight.[39] Crucially, the activist lacking a controlling position in the target has to collect the support of other shareholders—mainly institutional investors. Another commentator describes as follows: after publicly announcing its presence, the activist will begin with a nonpublic campaign that seeks to convince institutional investors to support its demands.[40] Then, the activist will move to the next stage only after it positively assesses the likelihood of support from other institutional investors, and the last stage

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34 Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 Ohio St. L.J. 1009, 1016-17 (1994).

35 Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 613-14 (2013). Gantchev comprehensively studied 1,164 activist campaigns from 2000 to 2007. *See id.* Gilson and Gordon cited the Gantchev model in arguing their account. *See* Gilson & Gordon, *supra* note 4, at 900-01.

36 *See* Gantchev, *supra* note 35, at 613-14.

37 *Id.*

38 *Id.*

39 *Id.* at 614.

40 Gilson & Gordon, *supra* note 4, at 900; *see also* Alon Brav, Wei Jiang, Frank Partnoy & Randall S. Thomas, *Hedge Fund Activisim, Corporate Governance and Firm Performance*, 63 J. FIN. 1729, 1753 (2008) (arguing that activists tend to target companies with high institutional ownership).

(i.e., the proxy fight) is, in essence, an official decisive vote on the activist's proposals.[41]

An important channel of shareholder activism is voting at the annual shareholder meeting.[42] Some indicate that 53% of respondents have voted against management in their proxy votes as shareholders.[43] Further, proxy voting itself is important for regulatory and fiduciary reasons, and certain institutional investors are required (or voluntarily choose) to disclose their proxy votes as well as their voting policies.[44]

Voice theories reached different conclusions on whether stock liquidity hinders or helps intervention by a blockholder in management. Some argued that liquidity deters voice.[45] Voice intensity has a significant negative relationship to institutions' preferences for liquidity, suggesting that investors who care more about stock liquidity and hold more liquid stocks use voice less intensively. This suggestion implies that theories for which liquidity discourages voice are more strongly supported;[46] contrary to voice, liquidity either allows investors to cut and run or causes investors to use exit rather than voice. Similar to voice, the preferences of exit depends not only on block size, but also on liquidity. However, whereas voice theories have differing predictions, liquidity enhances exit.[47]

Even if a blockholder cannot exercise voice, he or she can still exert governance through the alternative channel of exit.[48] The blockholder typically induces the manager to exert greater effort, but can, in some cases, worsen the agency problem.[49] The blockholder might encourage the manager to invest in long-term projects. Given that the block size of a blockholder determines intervention incentives, the number of

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41 *See* Brav et al., *supra* note 40, at 1741, 1764 (management will also make the same assessment in deciding whether to accept or reject the activist's demands).

42 *See, e.g.*, Peter Iliev, Karl V. Lins, Darius P. Miller & Lukas Roth, *Shareholder Voting and Corporate Governance Around the World*, 28 REV. FIN. STUD. 2167 (2015).

43 McCahery et al., *supra* note 9, at 2913.

44 *See* Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (2012). Under Section 14(a) of the Securities Exchange Act of 1934, the SEC has the authority to regulate the proxy solicitation process. *See id.*

45 *See, e.g.*, John C. Coffee Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Amar Bhide, *The Hidden Costs of Stock Market Liquidity*, 34 J. FIN. ECON. 31 (1993).

46 *See* Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481 (2009).

47 Edmans, *supra* note 46, at 2647.

48 *See* Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2645 (2009); *see also* Edmans, *supra* note 46.

49 Admati & Pfleiderer, *supra* note 48.

blockholders affects the strength of voice by impacting block size.[50] Splitting a block between multiple investors weakens voice by exacerbating the free-rider problem and, as a result, each blockholder has less incentive to intervene.[51]

Coffee, regarding the liquidity, explains that an investor's choice to exercise voice reduces the liquidity of his or her share holdings.[52] Thus, an investor is faced with the choice of whether to exercise greater voice through monitoring activities or to retain the maximum amount of liquidity.[53] Coffee then observes that it is unlikely that investors voluntarily increase their monitoring activities at the expense of liquidity and suggests, as an explanation for recent increases in shareholder activism, that some institutional investors have already sacrificed the liquidity.[54] For those investors, because exit is no longer an available option, monitoring activities do not impose this additional cost upon them.

Some argue that institutional investors too rarely initiate activism through voice.[55] Others argue that investors prefer to engage behind the scenes to submit shareholder proposals. Only 16% of the respondents submitted shareholder proposals.[56] Two explanations for the infrequent use of shareholder proposals could be the rather low passage rate of proxy proposals[57] and the fact that proxy fights are extremely expensive. The overall observation that investors prefer private negotiations to public engagement is consistent with recent theoretical evidence, and if an activist's information becomes public, the activist loses its credibility and the ability to influence the management.[58]

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50 *See* Andrew Winton, *Limitation of Liability and the Ownership Structure of the Firm*, 48 J. FIN. 487 (1993); Thomas H. Noe, *Investor Activism and Financial Market Structure*, 15 REV. FIN. STUD. 289 (2002); Alex Edmans & Gustavo Manso, *Governance Through Trading and Intervention: A Theory of Multiple Blockholders*, 24 REV. FIN. STUD. 2395 (2011).

51 Edmans, *supra* note 5.

52 Coffee, *supra* note 45, at 1311.

53 *See, e.g.*, *id.* at 1287 (arguing that "any attempt by institutional investors in the United States to exercise control over corporate managements will entail a probable sacrifice of this liquidity, which may be an unacceptable cost to them").

54 *Id*. at 1288-89.

55 *See, e.g.*, Black, *supra* note 8, at 572-573.

56 McCahery et al., *supra* note 9.

57 Gillan & Starks, *supra* note 19, at 55-73.

58 *See* Doron Levit, *Soft Shareholder Activism*, 32 REV. FIN. STUD. (forthcoming 2019).

2. Exit

Although exit has been treated as an alternative to shareholder activism exercised through voice, recent research has recognized exit as another powerful governance mechanism.[59] Stock sales by dissatisfied blockholders hurt the manager with a substantial amount of his or her compensation tied to stock price performance.[60] because such sales lower stock prices. Exit theories argue that blockholders can govern even if they do not actively intervene. Some commentator indicated that liquidity impairs activism by facilitating exit,[61] whereas others describe exit as a governance mechanism and, therefore, view liquidity as beneficial to governance. This view occurs partly because liquidity encourages initial block acquisitions by allowing a blockholder to buy additional shares without affecting the price[62] and partly because it facilitates more trading by blockholders, consequently strengthening corporate governance through exit.[63] Indeed, according to research on activist hedge fund block acquisitions from 1995 to 2010, liquidity increases the likelihood of block acquisitions.[64]

Similarly, exit theories hypothesize that liquidity is central to the effectiveness of exit.[65] Liquidity increases the exit threat because it encourages blockholders to collect a firm's fundamental information; allows blockholders to trade more aggressively on that information; and leads to larger initial blocks.[66] In addition, this information can be incorporated into the stock price through trading. Exit is also considered more effective if a firm's managers have greater equity ownership; managers then experience a larger loss if the stock price is depressed

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59 *See, e.g.*, Admati & Pfleiderer, *supra* note 48, at 1; Edmans, *supra* note 46.

60 *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990) (detailing that the rise of pay-for-performance concept can be traced back to the 1980s and recognizing that equity-based compensation plays a forceful role in incentivizing managers to act in shareholders' interests).

61 *See* Coffee, *supra* note 45, at 1288-89 (arguing that liquidity impairs activism and voice by making it easier for institutional investors to immediately sell their shares and follow the "Wall Street Walk").

62 Ernst Maug, *Large Shareholders as Monitors: Is There a Tradeoff Between Liquidity and Control?*, 53 J. FIN. 65 (1998).

63 Alex Edmans, Vivian W. Fang & Emanuel Zur, *The Effect of Liquidity on Governance*, 26 REV. FIN. STUD. 1443, 1444 (2013).

64 *Id.* at 1457-60.

65 *See, e.g.*, Alicia J. Davis, *Market Efficiency and the Problem of Retail Flight*, 20 STAN. J.L. BUS. & FIN. 36, 42 (2014).

66 Edmans et al., *supra* note 63.

because of a blockholder's exit.[67] The exit threat is more effective if multiple informed blockholders hold shares in a firm because their trading then incorporates into the stock price more information on the fundamental firm value.[68]

Investors' block size is also important for the exit threat.[69] Exit theories hypothesize that block size has opposing effects.[70] For larger block sizes, an informed blockholder can sell more shares when collecting negative information about the managers, and the incentives to collect such information increase as well. Both effects imply that the exit threat increases with block size. However, if the block size becomes too large, selling the entire block, even if negative information is received, becomes more difficult because the price impact will be too substantial. Therefore, an optimal block size exists. In addition to block size, other factors identified by exit models are a management's equity incentives, the existence of other blockholders (who could also be threatening to sell), and investor flow concerns.[71] In sum, the exit threat is a substantial disciplinary governance mechanism.

Regarding corporate engagement (which is this article's topic) the investor horizon makes a difference and deeply matters for engagement. Engagements are primarily motivated by concerns over a firm's corporate governance or strategy rather than over short-term returns, whereas long-term investors have stronger incentives to voice and, in fact, intervene more intensively than short-term investors.[72] These findings support the view that interventions are not primarily conducted by short-term activists who intend to seek solely short-term gains.[73] Critics of hedge fund activism observe hedge funds as short-term speculators who squeeze a quick profit from the firm at the expense of long-term value.[74] Thus,

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67 *See* William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1878 (2018).

68 Edmans & Manso, *supra* note 50.

69 *See, e.g.*, Admati & Pfleiderer, *supra* note 48; Edmans & Manso, *supra* note 50.

70 Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 CORNELL L. REV. 849, 882-3 (2012).

71 McCahery et al., *supra* note 9, at 2918-20.

72 *See id.* at 2906.

73 Lucian Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1095-96 (2015).

74 *See* Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH.: F. CORP. GOVERNANCE & FIN. REG. (Feb. 26, 2013, 9:22 AM), https://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy.

the financial markets have been increasingly dominated by activist short-term investors in search of quick returns.[75]

Some commentators observed that firms with large passive investors might also have stronger incentives to engage because they find it more difficult to use exit as a governance mechanism.[76] Moreover, long-term investors use voice more intensively, possibly because their long-term horizon provides them with stronger incentives to monitor. This finding is inconsistent with the view that activism is primarily used by short-term-oriented investors but supports the other argument.[77]

IV. EMPOWERMENT OR ENGAGEMENT

A. The Perspective of Shareholder Empowerment

Shareholder activism refers to "any action(s) of any shareholder or shareholder group with the purpose of bringing about change within a public company *without trying to gain control*."[78] Shareholder activism exists in a "market for corporate influence."[79] Shareholder activists attempt to influence corporate decision-making without spending the resources necessary to gain control.[80] Two methods exist to enhance shareholder activism. First, shareholders will be empowered by statutory rules. Second, the structure through which shareholders—institutional investors—purport to influence corporate management will be directly or indirectly supported or enhanced by a soft law or similar.

1. Theoretical Dispute on Shareholder Empowerment

Corporate law provides numerous statutory default rules that, among others, provide the board of directors with final decision-making

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75 *See* Rebecca Darr & Judith Samuelson, *Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management*, ASPEN INST. 2-3 (Sept. 9, 2009), https://assets.aspeninstitute.org/content/uploads/files/content/docs/bsp/overcome_short_state0909 .pdf.

76 *See, e.g.*, Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 IOWA J. CORP. L. 493, 510-11 (2018).

77 *See* Darr & Samuelson, *supra* note 75, at 4.

78 Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 2014 BYU L. REV. 1015, 1017 (2015).

79 Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 58 (2011).

80 Gillan & Starks, *supra* note 19, at 55 ("Shareholder activists are often viewed as investors who, dissatisfied with some aspect of a company's management or operations, try to bring about change within the company without a change in control.").

authority at a corporation.[81] Under statutory corporate laws, the board of directors is the default center of authority for corporate decision making,[82] and the power to control corporate assets is vested in directors.[83] Corporate law concentrates decision-making authority in the board and executive officers because it recognizes that a centralized, hierarchical authority is essential for the successful management of a public company that can become extremely large.[84] Given that all board decisions are subject to fiduciary duties, board actions taken to oppress offensive shareholder activism may be a breach of directors' duties of care and loyalty.[85] However, corporate law does not provide a clear path for shareholder activists who want to correct boards' inefficiencies.[86]

2. Shareholder Empowerment

It is often argued that shareholders should be permitted to "set the rules" by allowing them to initiate fundamental decisions, such as charter amendments or reincorporations.[87] Shareholders currently cannot initiate charter amendments or reincorporations without a proposal by the board of directors.[88] Doubt about managerial compensation practices has led to the advocacy of "say on pay" in the form of an annual shareholder vote on compensation packages.[89] The Dodd-Frank Act now requires such a

81 Rose & Sharfman, *supra* note 78, at 1022 ("Corporate law provides a public company's board the exclusive authority to manage and execute the various forms of explicit and implicit contracts that encompass a firm's contractual makeup.").

82 *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2018) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

83 *See, e.g.*, *id.* § 141(c)(1).

84 Clark, *supra* note 14, at 801-16 (arguing that "facilitation of cooperation" allows for efficiently completing large tasks).

85 Bernard S. Sharfman, *A Theory of Shareholder Activism and Its Place in Corporate Law*, 82 TENN. L. REV. 791, 821 (2015).

86 *See, e.g.*, Rose & Sharfman, *supra* note 78, at 1028 (citing DEL. CODE ANN. tit. 8, § 109 (2018)); *see also* 17 C.F.R. § 240.14a-8(i) (2018).

87 Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 865-75 (2005) (providing data about precatory resolutions by activist shareholders to dismantle staggered boards).

88 *See* DEL. CODE ANN. tit. 8, § 242(b)(1) (2018); REVISED MODEL BUS. CORP. ACT § 10.03 (AM. BAR ASS'N 2016) (both requiring a board resolution prior to a stockholder vote for an amendment of the certificate).

89 *See* Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-in*, 46 HARV. J. ON LEGIS. 323 (2008).

vote every three years.[90] Advocates of such reforms argue that greater shareholder empowerment would induce management to act in the interests of shareholders and, as a result, reduce agency costs. Some commentators suggest that a tradeoff exists between reducing managerial agency costs resulting from shareholder empowerment and shareholders' severe informational disadvantage.[91] Given that shareholders do not have firm contractual rights but are left with residual cash flows in the firm, their position is most strongly at risk. Hence, they have the strongest incentive to monitor managers to maximize the total firm value, which consists of a firmed contractual amount and an infirmed residual amount.[92] Assuming that shareholder wealth maximization is the proper goal of corporate law, shareholder empowerment may be a solution to solving accountability issues, minimizing agency costs, and optimizing incentives for directors and executive officers.[93] Thus, the more pragmatic reason for shareholder empowerment is the relative ease of holding directors accountable to the clear objective of shareholder primacy.[94]

3. Objections to Shareholder Empowerment

As previously noted, shareholder empowerment might be indeed beneficial; however, in fact, the board of directors enjoys significant authority while control by shareholders is tightly curtailed.[95] Some objections have been made within the shareholder primacy framework: centralized management under the direction of a board of directors has a cost advantage over shareholder decision making because corporate decisions are complex, and a relatively small group of people with good information, capabilities, and incentives to manage the firm can

90 Dodd-Frank Wall Street Reform and Consumer Protection Act § 951, 15 U.S.C. § 78n-1 (2012) (introducing a new Section 14A of the Securities Exchange Act).

91 William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 691-705 (2010).

92 Armen A. Alchian & Harold Demsetz, *Production, Information Cost, and Economic Organization*, 62 AM. ECON. REV. 777, 781-83 (1972).

93 Martin Gelter, *Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light*, 7 N.Y.U. J.L. & BUS. 641 (2011).

94 *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 731 (2007) (arguing that looser accountability also hurts stakeholders with managers' loss of accountability to shareholders).

95 *See* DEL. CODE ANN. tit. 8, § 141(a) (2018) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

effectively make such complex decisions, whereas direct control by firms' owners is usually only workable in small enterprises.[96]

Some commentators pointed out that the interests of different groups of shareholders may strongly diverge, which is likely to create friction and inhibit decision making in corporations.[97] Short-term and long-term shareholders often have their own strongly divergent goals, which are particularly relevant given the increasing importance of activist short-term investors, such as hedge funds. If and when capital markets are not perfectly efficient and do not accurately reflect long-term firm value, some shareholders may be tempted to seek short-term profits by making decisions that are contrary to the firm's long-term interests, thus undermining sustainable development.[98] Diversified or undiversified shareholders are likely to have different risk preferences, and the interests of shareholders that have hedged their risks may be decoupled from the financial welfare of the corporation.[99] Generally, as a result, the emphasis on shareholder value has been criticized as producing managers with a short-term focus who are no longer able to take into account long-term firm development.[100] Some scholars argued that shareholders have good reasons to bind their hands, leave it to a group of experts with superior information, good capabilities, and incentives to avoid the mutual holdup of decision-making and generally yield better results than disputing among potentially diversified shareholders.[101]

4. Director Primacy

Proponents of the director primacy model argue that boards must be mostly free of shareholder interference to serve shareholder interests.[102] Bainbridge argued that shareholders alone, as opposed to other stakeholders, are the appropriate beneficiaries of director fiduciary

96 *See* Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 492 (1999) ("Boards of directors can be characterized as large, elite, and episodic decision-making groups that face complex tasks pertaining to strategic-issue processing.").

97 Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577-93 (2006).

98 *Id*. at 579–83.

99 *Id*. at 583–85, 590–92.

100 Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1283 (1992).

101 *E.g.*, John Armour, Henry Hansmann & Reinier Kraakman, *What Is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW 1, 13 (Reinier Kraakman et al. eds., 2d ed. 2009); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 792-93 (2007).

102 *See* Peter C. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667, 693-94 (2002).

duties.[103] According to the director primacy model, directors are ultimately responsible for shareholder wealth maximization, rather than promoting stakeholder interests,[104] and the interests of shareholders should prevail over those of other constituencies.[105] In addition, directors (rather than managers, shareholders, and stakeholders) are responsible for the overall control of the corporation.[106] He argued that the powers of the board of directors are original and undelegated, and that neither shareholders nor courts should weaken the board's decision-making authority.[107]

Bainbridge also described that a core tension exists between the board's authority and the responsible exercise of such authority; shareholder voting rights are one of the significant mechanisms that hold directors accountable.[108] An increase in shareholders' right to review board decisions might weaken the core of corporate governance, and shifting the decision-making power to shareholders is undesirable in itself in accordance with director primacy.[109]

Irrespective of which side one takes in this debate, it is difficult to deny that both have a point: the benefits of reducing the agency cost produced by unaccountable management must be weighed against the cost of shareholder involvement. Thus, a tradeoff seems to exist between managerial discretion on one side and accountability to shareholders on the other.[110]

5. My Proposal

I previously proposed that any corporate governance reform must focus primarily on promoting the long-term welfare of the corporation, balancing constituencies' interests, and ensuring accountability (or transparency).[111] In light of this goal, I have examined a proposal for corporate governance reforms, that is, the "enlightened shareholder

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103 Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 485 (2001).

104 *Id.* at 572.

105 *Id.* at 577-85.

106 *Id.* at 550.

107 STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 11-12 (2008).

108 Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. UNIV. L. REV. 547, 555-60 (2003).

109 *Id.* at 557-59.

110 *See, e.g.*, Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of the New Corporate Governance in Theory and Practice*, 34 DEL. J. CORP. L. 139, 161 (2009).

111 *See* Akio Otsuka, *Reforms of Corporate Governance: Competing Models and Emerging Trends in the United Kingdom and the European Union*, 14 S.C. J. INT'L. L. & BUS. 71 (2017).

value" ("ESV") approach and directors' reporting, which are currently accepted in the U.K. The core of the ESV principle is embodied in Section 172 of the U.K. Companies Act 2006. The Act attempts to reconcile shareholder primacy with other long-term and stakeholder concerns.[112] This legal duty requires directors to promote the long-term success of the corporation for the benefit of shareholders as a whole; however, in doing so, directors must consider the list of stakeholder interests described in Section 172(1) of the Act.[113] The "enlightened shareholder" is the yardstick for a hypothetical shareholder interested in the long-term well-being and performance of the corporation and its social and environmental impact,[114] referred to as the ESV approach[115] of corporate governance, which merges elements of the shareholder primacy and the stakeholder model. The Company Law Review ("CLR"), which worked on the Act, accepted the concept of the ESV as a fundamental principle in corporate governance.[116] However, I argue that directors are still responsible for the overall control over the corporation subject to the ESV approach.

According to some commentators, key differences between the dominant institutional investors in the U.K. (i.e., pension funds) and the U.S. (i.e., mutual funds), as well as the two countries' regulatory environments, make stakeholder-oriented corporate reform less likely in the U.S.[117] However, I do not believe that these differences are crucial to introducing the ESV approach to the U.S.[118]

B. U.S. and U.K. Shareholder Empowerment

1. General View

In both countries, institutional investors have traditionally been viewed as passive, with a policy of selling portfolio companies when

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112 *See also* Paul L. Davies, Cassel Professor of Commercial Law, London School of Economics and Political Science, W.E. Hearn Lecture at the University of Melbourne Law School: Enlightened Shareholder Value and the New Responsibilities of Directors (Oct. 4, 2005).

113 *See* Companies Act 2006, c. 46, § 172 (Eng.).

114 *See* Andrew Keay, *Moving towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado About Little*, 22 EUR. BUS. L. REV. 1, 40 (2011).

115 *See id.*; Daniel Attenborough, *The Company Law Reform Bill: An Analysis of Directors' Duties and the Objective of the Company*, 27 COMPANY L. 162, 165 (2006).

116 *See* Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's "Enlightened Shareholder Value Approach*, 29 SYDNEY L. REV. 577, 579 (2007).

117 Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 IOWA J. CORP. L. 59, 79-80 (2010).

118 Otsuka, *supra* note 111, at 101.

dissatisfied with their performance.[119] In 1950, U.S. institutions owned less than 10% of the equity in U.S. markets.[120] This number rose to higher than 50% in the early 1990s.[121] Similarly, U.K. pension funds and insurance companies owned 16% of U.K. shares in 1963 but 52% by 1990.[122] Shareholder empowerment in the U.S. and the U.K. is one of the most important issues in corporate governance today for monitoring managers and improving firm value.[123] One vital difference may relate to the probability of shareholder lawsuits against the board of directors. Some scholars indicated that the probability of a director of a U.K. public company being sued for breach of duty is virtually zero.[124] In the U.S., however, although the probability is still low, the board of directors must recognize the possibility, which influences its actions.[125]

2. United States

The equity market has become increasingly conscious of the prominent role of U.S. institutions in corporate governance. With their large positions in the securities market, it has become difficult and costly for institutions to exercise the Wall Street Rule. For instance, the investment objectives of certain institutions, such as index funds, might prohibit selling equities simply because a firm is underperforming. Further, U.S. policymakers encourage institutions to take a more active governance role, particularly in the area of proxy voting. For example, in 1988, the U.S. Department of Labor required pension funds to vote in accordance with the fiduciary duties of the Employee Retirement Income

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119 *See* Marc Goergen & Luc Renneboog, *Strong Managers and Passive Institutional Investors in the UK*, *in* THE CONTROL OF CORPORATE EUROPE 259, 262 (Fabrizio Barca & Marco Becht eds., 2d ed. 2002).

120 Starks, *supra* note 1.

121 *Id.*

122 OFFICE FOR NAT'L STATISTICS, *supra* note 1, at 9.

123 For historical perspective of U.S. shareholder activism, see generally 25 FOR 25: OBSERVATIONS ON THE PAST, PRESENT, AND FUTURE OF CORPORATE GOVERNANCE (Institutional Shareholder Services 2011), https://www.issgovernance.com/file/files/ISS_25for25.pdf [hereinafter 25 FOR 25]; Gillan & Starks, *supra* note 19 (discussing the role of activism in corporate governance).

124 Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN L. REV. 1055, 1093 (2006); John Armour, Bernard Black, Brian Cheffins & Richard Nolan, *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. EMPIRICAL LEGAL STUD. 687, 690 (2009).

125 Armour et al., *supra* note 124, at 692; Black et al., *supra* note 124, at 1092-93.

Security Act ("ERISA").[126] In 2003, the SEC mandated that mutual funds disclose proxy votes and voting policies.[127]

Shareholder proposals and board nominations are a substantial part of this empowerment and have become part of the policy debate and reform.[128] In the U.S., state laws govern shareholder rights and, as a result, the holding of shareholder meetings and what shareholders are allowed to vote on at these meetings.[129] State laws also generally permit shareholders with ownership between 5% and 10% to call a special meeting or use written consent to propose their actions.[130] However, corporations frequently use charter and bylaw provisions to limit this shareholder ability. Another significant feature in shareholder proposals is that U.S. laws specify a minimum of shares that must be presented in person or by proxy at a shareholder meeting to constitute a quorum.[131]

SEC Rule 14a-8, the so-called "Shareholder Proposal Rule," is a central tool for enhancing "shareholder democracy."[132] In brief, the Rule permits a qualifying shareholder[133] of a public corporation registered with the SEC to place proposals on the corporation's proxy statement and have those proposals voted on at the annual shareholder meeting, forcing the

126 Ralph V. Whitworth, *The Corporate Governance Movement: 25 Years Past and Hence*, *in* 25 FOR 25, *supra* note 123, at 3.

127 Angela Morgan, Annette Poulsen, Jack Wolf & Tina Yang, *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914, 915 (2011).

128 For arguments in favor of shareholder empowerment, see, e.g., Bebchuk, *supra* note 94; Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007). For arguments against shareholder empowerment, see, e.g., Bainbridge, *supra* note 103; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789 (2007); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006).

129 Shareholder Proposals, 72 Fed. Reg. 43,466, 43,467 (Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240).

130 *See* DEL. CODE ANN. tit. 8, § 228 (2018). Section 228 of the Delaware General Corporation Law provides that, absent a contrary provision in the certificate of incorporation, any action that may be taken at a shareholder meeting may be taken by a written consent of at least the minimum number of votes that would be necessary to take such action at the meeting in which all shares entitled to vote were present and voting. *See id.*

131 Deborah A. DeMott, *The Figure in the Landscape: A Comparative Sketch of Directors' Self-interested Transactions*, 62 LAW & CONTEMP. PROBS. 243, 249 (1999).

132 *See*, *e.g.*, Frank D. Emerson & Franklin D. Latcham, T*he SEC Proxy Proposal Rule: The Corporate Gadfly*, 19 U. CHI. L. REV. 807 (1952); Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97 (1988); Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503 (2006).

133 17 C.F.R. § 240.14a-8(b) (2018) (rule detailing that a shareholder is eligible to submit a proxy proposal if the shareholder has continuously held at least two thousand dollars in market value or at least one percent of the corporation's voting securities).

corporation to include a resolution and supporting statement in the proxy materials for its annual shareholder meeting.[134] Thus, a shareholder may submit a proposed course of action to other shareholders for a vote through the process governed by SEC Rule 14a-8.[135] However, 13 substantive bases for exclusion exist (e.g., matters relating to board election, the company's ordinary business operation, or personal grievance).[136] To submit proposals regarding substantive matters, shareholders must distribute their proxy materials and solicit votes at their expense, which proposals are binding and referred to as proxy fights.[137] To the contrary, shareholder proposals solicited using corporate proxy materials at corporate expense are precatory, and firms are not obligated to adopt the proposal even if passed by shareholders.[138]

3. United Kingdom

In the U.K., a series of corporate governance reports, including Cadbury (1992), Greenbury (1995), Hampel (1998), and Myners (2001) emphasized the governance role of institutions and the importance of voting.[139] The U.S. and U.K. own similar governance systems that have quite different rules regarding submitting a shareholder proposal or calling a shareholder meeting. This difference in the role of the board likely causes differing proxy rules.

In the UK, the 2006 Companies Act[140] governs proxy rules.[141] A General Meeting is called where the Board is obliged to call a General Meeting as a result of a requisition from shareholders. Shareholders representing at least 5% of the paid-up share capital can require the company to call a General Meeting.[142] Every notice of a General Meeting must contain, among others, a statement that every shareholder has a right to appoint a proxy under section 324 of the Act, and any statements provided by shareholders which the company is obliged to circulate

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134 For a more detailed overview of Rule 14a-8 and its various requirements, see STEPHEN M. BAINBRIDGE, CORPORATE LAW 294-302 (3d ed. 2015).

135 17 C.F.R. § 240.14a-8 (2018).

136 Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2018).

137 Bebchuk, *supra* note 87, at 838, 846.

138 Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 221-22 (2001)

139 *See* Chris Mallin, *Financial Institutions and Their Relations with Corporate Boards*, 7 CORP. GOVERNANCE: INT'L REV. 248, 248-55 (1999) (arguing the role of UK institutional investors and their relations with corporate boards).

140 *Id.*

141 *Id.* § 307.

142 Companies Act 2006, c. 46, § 303 (Eng.).

pursuant to sections 314 to 317 of the Act.[143] The Act makes some material changes to the proxy rules, including making firms, not shareholders, the bearer of the circulation costs.[144]

Special resolutions, generally required to amend the articles of association, require a 75% supermajority vote for approval.[145] In addition, UK investors may use ordinary shareholder resolutions—requiring a simple majority vote—to elect and remove directors.[146] Historically, shareholder meetings in the UK have low voter turnout, averaging about 20% in 1990 of eligible shareholders.[147] The 1998 Hampel Report explicitly noted that institutional shareholders have a responsibility to vote, and recent evidence indicated that the UK voting level has increased to 50%.[148] In comparison, in the U.S., where institutional voting is compulsory, voter turnout can easily reach 70–80%.[149]

To summarize, although UK proposal rules are more onerous on sponsors in terms of ownership requirements and solicitation costs, they confer UK shareholders with greater power because proposals are binding, and shareholders have the statutory right to call special meetings and to remove and elect directors through a simple majority vote. Many commentators, however, have expressed concern that institutional investors may be ill-suited to assume such power in view of their predominantly short-term business models.[150]

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143 *See, e.g.*, *id.* § 314(1) ("The members of a company may require the company to circulate, to members of the company entitled to receive notice of a general meeting, a statement of not more than 1,000 words with respect to—(a) a matter referred to in a proposed resolution to be dealt with at that meeting, or (b) other business to be dealt with at that meeting.").

144 *See id.* § 316(1) ("The expenses of the company in complying with section 315 need not be paid by the members who requested the circulation of the statement; if—(a) the meeting to which the requests relate is an annual general meeting of a public company, and (b) requests sufficient to require the company to circulate the statement are received before the end of the financial year preceding the meeting.").

145 *Id.* § 283.

146 *Id.* §§ 160, 168.

147 *See* Chris Mallin, *Institutional Investors and Voting Practices: An International Comparison*, 9 CORP. GOVERNANCE: INT'L REV. 118, 124 (2001) (comparing the voting systems in several countries, including the United Kingdom, the United States, Australia, and Germany).

148 *See id.* at 119, 124.

149 Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29, 40 (2002) (analyzing the institutional and regulatory environment governing shareholder voting).

150 *See* Coffee, *supra* note 45, at 1281 (asserting that monitoring by financial institutions could be limited to only improving their positions rather than those of shareholders).

C. Engagement

1. General

In the U.S., activist shareholders are arguably the capital market's endogenous response to the agency gap that results from the emergence of institutional intermediaries.[151] Typically, activist shareholders first acquire non-controlling stakes in corporations and then attempt to influence corporations' business strategies. Within this framework, activist shareholders are expected to play a certain monitoring role and exercise the substantial governance rights vested in institutional investors.[152] In this way, activist shareholders perform a form of stewardship function.[153]

2. Benefits of Engagement

As posited by Lisa M. Fairfax, "[s]hareholders' increased voice in corporate affairs makes their engagement a priority for several reasons."[154] Shareholder engagement provides corporations with the opportunity to explain their policies and strategies in a manner that could prevent misunderstandings.[155] Enhanced shareholder engagement enables corporations to educate their shareholders[156] and enables them to make more informed decisions.[157] When shareholders have a voice over a range of corporate governance decisions, this educational role is crucial. In the next stage, shareholder engagement may enable corporations to gain support for their policies and support the directors and officers who execute those policies.[158] When shareholders have an increased ability to

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151 *See*, e.g., Gilson & Gordon, *supra* note 4, at 867 (arguing that activist hedge funds offer a response to the shortfall in monitoring institutional intermediaries).

152 *See id.* (framing the role of activist shareholders—this approach stands in contrast to the raider-like takeover attempts of the 1980s).

153 *See id.* (describing how activists can perform a stewardship function).

154 Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. ILL. L. REV. 821, 832 (2013).

155 *See* LISA M. FAIRFAX, SHAREHOLDER DEMOCRACY: A PRIMER ON SHAREHOLDER ACTIVISM AND PARTICIPATION 124 (2011).

156 *See id.* at 115; Ira M. Millstein, Holly J. Gregory & Rebecca C. Grapsas, *Ten Thoughts for Ordering Governance Relationships in 2010*, WEIL, GOTSHAL & MANGES LLP 2 (May 2010), https://www.weil.com/~/media/files/pdfs/alert_ordering_governance_relationships_in_2010.pdf.

157 *See* Fairfax, *supra* note 155, at 123; *see also* Millstein et al., *supra* note 156, at 2.

158 *See* LATHAM & WATKINS LLP, DANGEROUS TALK? WHEN/HOW SHOULD DIRECTORS COMMUNICATE WITH SHAREHOLDERS? 2, http://www.directorsforum.org/resources/pdf/cdf_dangerous_talk_program_outline_3-18.pdf?ID=3.362 [https://www.yumpu.com/en/document/read/52351925/1-dangerous-talk-when-how-should-directors-communicate-with-/4].

reject corporate pay packages and unseat directors, such support is clearly important. According to recent proxy data, one crucial difference between corporations that have won shareholder support for their policies and those that have failed is corporations' willingness to engage directly with shareholders.[159]As a result, shareholder engagement may enable corporations to avoid costly confrontations with shareholders. Some governance experts argued that much of shareholder activism could be avoided with effective shareholder engagement.[160]

3. UK Brief History Leading to the Stewardship Code

The conclusions and recommendations of the Cadbury Report (1992) and the Hampel Report (1998) provided the foundation and starting point for most subsequent reports on institutional investor engagement and even for the current Stewardship Code.[161]

The ideals of institutional investor engagement continued to gain support in the UK in the early 2000s with the releases of the Myners Report, the Higgs Report, and guidance from the Institutional Shareholders' Committee.[162] After the global financial crisis of 2008–2009, the debate became active again. UK regulatory authorities accused institutional investors of apathetic monitoring, commonly referring to institutional investors as being "asleep."[163] Indeed, many commentators argued that institutional investors were part of the problem, not only by failing to intervene but also by actively pushing company management

159 *See* Jeremy L. Goldstein, *Say on Pay 2012*, HARV. L. SCH. F. ON CORPORATE GOVERNANCE & FIN. REG. (July 14, 2012), http://blogs.law.harvard.edu/corpgov/2012/ 07/14/say-on-pay-2012.

160 *See* LATHAM & WATKINS LLP, *supra* note 158, at 2-3 (quoting Millstein as asserting "almost every hot button governance issue can be addressed through constructive communication between boards and management with shareholders.").

161 *See* Konstantinos Sergakis, *The UK Stewardship Code: Bridging the Gap Between Companies and Institutional Investors*, 47 REVUE JURIDIQUE THÉMIS 109, 121 (2013).

162 *See generally* INSTITUTIONAL SHAREHOLDERS' COMMITTEE, THE RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS AND AGENTS – STATEMENT OF PRINCIPLES (2007), http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCStatementofPrinciplesJun07.pdf [https://web.archive.org/web/20081002162504/http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCStatementofPrinciplesJun07.pdf] (outlining the responsibilities of institutional shareholders).

163 *See, e.g.*, Jennifer Hughes, *FSA Chief Lambasts Uncritical Investors*, FIN. TIMES (Mar. 11, 2009), https://www.ft.com/content/9edc7548-0e8d-11de-b099-0000779fd2ac (quoting the chief executive of the Financial Services Authority accusing institutional shareholders of not adequately monitoring).

for short-term returns at the expense of heightened risk and exposure.[164] In the Walker Review, Sir David Walker concluded that institutional investor apathy and "acquiescence" in risky management decisions were not a key cause of the financial crisis but likely exacerbated it.[165]

In July 2010, the Financial Reporting Council ("FRC") issued the Stewardship Code to encourage genuine active engagement by institutional investors through greater transparency and disclosure.[166] According to the revised Stewardship Code in 2012, institutional investor stewardship of portfolio companies is intended to foster long-term company success "in such a way that the ultimate providers of capital also prosper" for the benefit of the economy as a whole.[167] It follows that "[f]or investors, stewardship is more than just voting. Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration."[168]

D. Several Impediments to Engagement

A number of arguments have been made regarding the reason investors do not engage more actively with their portfolio companies. Nevertheless, investors still face several engagement impediments, principally because of free-rider problems, legal concerns, liquidity concerns, conflicts of interest, and a business model fundamentally incompatible with activism.

1. Free-Rider Problem and Legal and Liquidity Concerns

Large investors face disincentives in becoming activists because of a "free rider" problem.[169] As previously argued by "voice theory," they would incur large costs from interventions that would be borne solely by

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164 *See, e.g.*, Natasha Burns, Simi Kedia & Marc Lipson, *Institutional Ownership and Monitoring: Evidence from Financial Misreporting*, 16 J. CORP. FIN. 443, 444 (2010) (arguing institutions can be influenced by investor reactions and focus on short-term performance).

165 DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: FINAL RECOMMENDATIONS 72 (2009), https://webarchive.nationalarchives.gov.uk/+/www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

166 *See* Stewardship Code, *supra* note 6, at 10 ("Transparency is an important feature of effective stewardship.").

167 *Id.* at 1.

168 *Id.*

169 *See* Sanford Grossman & Oliver Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. OF ECON. 42 (1980); Andrei Shleifer & Robert Vishny, *Large Shareholders and Corporate Control*, 94 J. POLITICAL ECON. 461 (1986).

the activist shareholder; however, any benefits from the activities would be spread and enjoyed among all shareholders. That is, many rational institutions will make investment decisions not to maximize absolute returns but rather to maximize returns relative to market indicators. If an investor improves corporate performance by monitoring the target company, it increases returns to all other investors. Thus, the free-rider benefits at no cost from the fund's monitoring activity.[170]

In addition, investors might not intervene if they fear that they will breach legal rules. For instance, in accordance with diversification requirements for mutual funds or pension funds, investors may not take a stake that is sufficiently large to incentivize engagement. That is, to qualify for substantial tax benefits under subchapter M of the Internal Revenue Code and "diversified" status under the Investment Company Act, mutual funds must maintain high levels of diversification.[171] Regarding pension funds, regulatory constraints require diversification as well.[172] Compliance with regulatory constraints reduces overall incentives and the ability to monitor corporate boards.[173] In addition, rules on "acting in concert" can discourage engagement because such rules imply a legal risk when investors coordinate engagement.[174] That is, shareholders are concerned with incurring potential liability by being held to have "acted in concert" by engaging in any wide-scale shareholder communication and, thereby, not filing the required Schedule 13D to the

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170 Fisch, *supra* note 34, at 1021-22.

171 15 U.S.C. § 80a-5(b)(1) (2012) (to be a "diversified company" under the Act, 75% of a mutual fund's assets must comply with the limitation that (a) the fund may own no more than 10% of the outstanding securities of a portfolio company and (b) the stock of one portfolio company may not constitute more than 5% of the value of the fund's assets).

172 For instance, by reason of the Employee Retirement Income Security Act of 1974 (ERISA), private pension funds are required to be diversified. *See* 29 U.S.C. § 1104 (2012); *see also* Mark Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 19-21, 24-25 (1991) (summarizing the various diversification limits imposed on U.S. mutual funds and private pension funds). Similar requirements are imposed for EU mutual funds by the Undertakings for Collective Investments in Transferable Securities Directive (UCITS Directive). *See, e.g.*, Directive 2009/65/EC, of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), 2009 O.J. (L 302) 32, 63 (prohibiting mutual funds from investing more than 5% of their assets in shares of the same issuer).

173 *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1049 (2007).

174 *See* 15 U.S.C. § 78m(d) (2012). Section 13(d) of the Act requires persons acquiring more than five percent of a company's equity securities to file certain disclosures and expose themselves to certain potential liabilities for failure to provide such disclosure filings. *See id.* Additionally, Section 13(d) of the Act also provides that two or more persons who "act as a partnership, limited partnership, syndicate or other group . . . shall be deemed a 'person' for the purposes of [Section 13(d) of the Act]"). *See id.* § 78m(d)(3).

extent that such a "group" owns in aggregate more than five percent of the company's equity.[175] Finally, disclosure regulations (e.g., the U.S. "Regulation Fair Disclosure") might discourage investors or managers from engagement.[176] Mutual fund management must also disclose semiannually the quantities and values of the fund's securities.[177]

Research shows that investors who are more concerned about liquidity use voice less intensively, as previously argued.[178] This statement is consistent with Coffee, who argued that market liquidity encourages investors to "cut and run" rather than intervene.[179] Similar arguments come from exit theories, which indicate that market liquidity increases the trustworthiness of the exit threat, reducing the necessity for governance through direct intervention.[180] Investors first attempt to engage firms behind the scenes through direct interventions and then take public measures (e.g., shareholder proposals) only after the private interventions have failed.[181] A number of arguments have been made regarding the reason investors do not engage more actively with their portfolio companies.

2. Institutional Investors Lack Incentive for Engagement

a. Mutual and Pension Funds

The fundamental reason that mutual funds and pension funds are reluctant to engage in activism is their business model, which highlights the pursuit of relative returns.[182] Mutual and pension fund managers are judged against their performance relative to their peers.[183] A manager engaging in activism must bear all of the costs of the effort of such engagement while sharing the returns with its competitors who hold shares in the target company.[184] Consequently, such a manager's

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175 *See* Blake A. Bell, *Do Shareholder Activists Violate Federal Proxy Solicitation Laws Through Internet Message Boards?*, WALL STREET LAW., Sept. 1998, at 8.

176 *See infra* Part VI.

177 *See* 15 U.S.C. § 80a-29(e) (2012).

178 McCahery et al., *supra* note 9.

179 Coffee, *supra* note 45.

180 *See, e.g.*, Edmans & Manso, *supra* note 50.

181 McCahery et al., *supra* note 9.

182 *See* JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING: FINAL REPORT 39-42 (2012), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf.

183 *See id.* at 42.

184 Gilson & Gordon, *supra* note 4, at 890-93.

performance relative to its competitors will decline. Thus, even though activism increases the value of the company and advantages beneficiaries, managers are hesitant to engage in activism.

Traditional institutional investors will realize little performance value from the proactive exercise of their governance rights because the exercise costs are purely too expensive.[185] Institutional investors are primarily concerned with comparatively better investment performance over relatively short periods while minimizing costs and risk.[186] As stewards, institutional investors have consistently struggled to effectively monitor portfolio companies.

The short-term comparative performance criteria on which the vast majority of portfolio managers and funds are evaluated constraints institutional activism. The performance of managers and funds is often monitored on a quarterly basis relative to similar funds or an index.[187] This metric of evaluating investment performance does not easily match the long-term engagement even if it may potentially profit individual shareholders in the long run.[188] For example, a mutual fund may engage in analyzing its portfolio companies to identify poor performance and business strategies resulting from poor governance.[189] In fact, when this analysis reveals poor performance and governance, the fund manager has two choices: (1) attempt to intervene in the board's governance; or (2) sell its position.[190] However, the fund manager has no incentive to proactively engage portfolio companies and, therefore, does not develop the expertise to do so.[191] Thus, institutional investors specialize in delivering comparatively superior investment performance over short periods while minimizing costs and risk.[192]

185 Coffee, *supra* note 45, at 1283 ("The primary explanation for institutional passivity is not overregulation, but the insufficiency of existing incentives to motivate institutional money managers to monitor.").

186 *See* Gilson & Gordon, *supra* note 4, at 889.

187 Simon C.Y. Wong, *Why Stewardship is Proving Elusive for Institutional Investors,* 7 J. INT'L BANKING & FIN. L. 406, 407 (2010).

188 *See* Gilson & Gordon, *supra* note 4, at 890.

189 *See id.*

190 *See id.*; Coffee, *supra* note 45, at 1281 (highlighting this "trade-off" faced by institutional investors).

191 *See* Gilson & Gordon, *supra* note 4, at 890.

192 David William Roberts, *Agreement in Principle: A Compromise for Activist Shareholders from the UK Stewardship Code*, 48 VAND. J. TRANSNAT'L L. 543 (2015).

b. Hedge funds

As previously discussed, traditional institutional investors, such as mutual and pension funds, lack the incentive to engage and monitor portfolio companies. Conversely, today, hedge fund activism takes many forms to influence corporate management and strategy. These forms include exerting public pressure on company executives, running proxy contests to gain seats on the board of directors, and engaging in litigation.[193]

Given that hedge funds are largely unregulated, as noted above, they possess substantial economies of scale relative to similarly sized institutional owners.[194] Unlike mutual and pension funds, hedge funds need only comply with regulatory laws that generally apply to investors. These laws include disclosure requirements of Section 13(d) of the Securities Exchange Act[195] and the short-swing profit rules under Section 16(b).[196] Under 13(f), hedge fund managers need only disclose on a quarterly basis holdings of "registered equity securities"—traded shares and options listed on an exchange.[197] In practice, most small and many medium-sized hedge funds can avoid making any disclosures as long as they keep a substantial portion of their holdings in nonregistered derivatives and debt instruments. As a result, hedge funds can use derivatives to accumulate large economic positions in the target companies without disclosure unless they exceed the five percent threshold under Section 13(d). Moreover, less than one hundred million dollars of holdings of "13(f) securities"[198] need not be disclosed.[199] Furthermore, unlike mutual and pension funds, hedge funds frequently use hard-to-quantify leverage and investment derivatives.[200] As a result, hedge funds can concentrate a significant portion of their assets in a single position, unlike a mutual fund with comparable net assets.[201]

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193 *See* Kahan & Rock, *supra* note 173, at 1029.

194 *Id.* at 1062-63.

195 *See* 15 U.S.C. § 78m(d) (2012) (requiring disclosure when an investor owns more than five percent of the equity securities of a public company).

196 *See id.* § 78p.

197 17 C.F.R. § 240.13f-1 (2018).

198 *Id.* § 240.13f-1(c).

199 *See id.* § 240.13f-1(a)(1).

200 *See* Kahan & Rock, *supra* note 173, at 1063.

201 *See* 15 U.S.C. § 80a-5(b)(1) (2012).

c. Difference Between Traditional Institutional Investors and Hedge Funds

The incentives for hedge funds to monitor portfolio companies are quite different from those of traditional institutional investors, making hedge funds a more capable corporate monitor.

On the one hand, activist investors actually use activism as their profit strategy by accumulating toehold positions in target companies that allow them to agitate for change and finally benefit from their activism.[202] Thus, activist hedge funds tend to target companies that are underperforming relative to their peers in the same industry and have low market value relative to book value.[203] On the other hand, institutional investors do not use activism as a profit-making strategy; they do not take positions in portfolio companies to profit from their activism.[204] That is, institutional investors find themselves as a low-cost channel and an ineffective monitor for excessive diversification.[205]

However, contrary to the argument that activism is destructive to long-term value, certain empirical studies on hedge funds found that activists are able to create sustainable, long-term improvements in the company's share value and operational performance.[206] The reasons are as follows. Activist hedge funds are not controlling shareholders that are able to thrust their desired changes into the company's strategy or governance but are influential shareholders that engage in monitoring the target company and proposing value-enhancing changes to other shareholders.[207] The shareholders to which hedge funds propose such changes are traditional institutional investors, that is, mutual funds and pension funds with long-term investment horizons.[208] Although mutual funds and pensions are reluctant to engage in activism, they are increasingly adopting transparent voting policies and scrutinizing

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202 *See, e.g.*, Gilson & Gordon, *supra* note 4, at 904; Kahan & Rock, *supra* note 173, at 1068.

203 *See* Bebchuk et al., *supra* note 73, at 1117.

204 *See* Jeffrey Ubben & David Haarmeyer, *With Activism Comes Accountability*, INSTITUTIONAL INVESTOR (July 20, 2006), https://www.institutionalinvestor.com/article/b18bl42xm7z4xm/with-activism-comes-accountability (contrasting activist investor returns with the performance of traditional money managers).

205 *See, e.g.*, Wong, *supra* note 187, at 407.

206 *See* Lucian A. Bebchuk, Alon Brav, Robert J. Jackson, Jr. & Wei Jiang, *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1, 16 (2013).

207 *Id.* at 12 (documenting that the average activist stake reaches 8.8% with a median of 6.3%).

208 *See* John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 IOWA J. CORP. L. 545, 572 (2016).

proposals submitted for a vote.[209] Therefore, hedge funds are actually influential investors that may create sustainable, long-term improvements in companies.

3. Engagement in the UK Stewardship Code

After the global financial crisis of 2008–2009, in 2010, the UK became the first jurisdiction to adopt a stewardship code,[210] following a recommendation from the 2009 Walker Review on corporate governance in financial institutions. The UK introduced a "soft law" approach through the Stewardship Code, which is a set of best practice principles on a "comply or explain" basis.[211] The Code is aimed at encouraging institutional investors to actively engage in stewardship of their portfolio companies and ultimately seeks to foster the long-term success of companies through such active engagement.[212] The UK Stewardship Code encourages institutional investors to exercise their stewardship responsibilities through voting, monitoring, and engaging in "purposeful dialogue" with companies on matters including strategy; performance; risk; capital structure and corporate governance, including culture and renumeration.[213]

Later in 2018, the FRC is due to present a revised stewardship code for public consultation. Respondents to a recent FRC consultation supported modifying the UK Stewardship Code to include a duty for investors similar to that currently imposed on company directors under Section 172 of the UK Companies Act 2006.[214] Under this section, directors have a duty to promote the success of a company for the benefit of shareholders; however, in doing so, they must have regard for a number of other factors and stakeholders, including employees.[215]

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209 *See* Jessica Toonkel & Soyoung Kim, *Activist Investors Find Allies in Mutual, Pension Funds*, REUTERS (April 9, 2013, 7:11 AM), http://www.reuters.com/article/2013/04/09/us-funds-activist-idUSBRE9380DU20130409.

210 *See* Stewardship Code, *supra* note 6.

211 *See id.* at 1 ("The UK Stewardship Code sets out the principles of effective stewardship by investors. In so doing, the Code assists institutional investors better to exercise their stewardship responsibilities, which in turn gives force to the 'comply or explain' system.").

212 *See id.* at 1 ("Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole.").

213 *See id.* at 1, 6.

214 *See* FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE (2018), https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.PDF.

215 *See* Companies Act 2006, c. 46, § 172 (Eng.).

Even though the SEC adopts any provision of the UK Stewardship Code, the provisions thereof as best practice are not binding because issuers and institutional investors are free to decide not to adopt them. Given that institutional investors in the U.S., unlike those in the UK, lack the incentive to engage corporate boards, the Code overall is ill-fit for the U.S..[216] As such, adoption of an entire best practices code, such as the Stewardship Code, which is aimed at institutional investors' monitoring and engaging portfolio companies, is unlikely to result in an effective system of corporate accountability.[217]

IV. INSTITUTIONAL INVESTORS' CONFLICTS OF INTEREST AND FIDUCIARY DUTIES

A. Institutional Investor Conflicts

Engagement might also be hindered by investors' conflicts of interest.[218] Banks and insurance companies are the least willing to oppose corporate managements because they fear that their firms will lose business—of either the specific firm whose management they have opposed or the corporate community generally if the investor is perceived as an "activist."[219] Conflicts of interest are particularly severe for pension funds such that public pension funds are subject to political pressure and private pension fund managers seek to obtain and maintain business from their corporate clients.[220] First, in a private pension plan, company management appoints a trustee who operates the plan, and then the trustee selects outside managers who actually invest its capital. Both are likely to desire to please those who have appointed them,[221] especially if the plan holds a significant stake of the company's stock. Such ties of the plan's managers to company managers could affect voting.[222] Moreover,

216 Roberts, *supra* note 192, at 574.

217 *Id.*

218 *See* Black, *supra* note 8, at 595-608 (arguing that conflicts of interest may prevent significant monitoring by institutional investors).

219 *See* Coffee, *supra* note 45, at 1321.

220 For an excellent investigation of the conflicts of interests plaguing institutional investors, see Black, *supra* note 8, at 595-608.

221 *See, e.g.*, Proxy Voting by Investment Advisers, 68 Fed Reg. 6585, (Feb. 7, 2003) (to be codified at 17 C.F.R. pt. 275) ("An adviser may have a number of conflicts that can affect how it votes proxies. For example, an adviser (or its affiliate) may manage a pension plan, administer employee benefit plans, or provide brokerage, underwriting, insurance, or banking services to a company whose management is soliciting proxies. Failure to vote in favor of management may harm the adviser's relationship with the company.").

222 Paul H. Edelman, Randall S. Thomas, & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1401 (2014).

private pension fund trustees are often corporate employees or agents who report to senior management and predictably share their attitudes toward institutional activism.[223] If corporate management controls the allocation of investment funds among money managers, money managers seem likely to often decide not to watch the interests of their beneficiaries.[224] Second, most of the greatest conflicts of interest problems are attached to public pension fund managers who are pressured by numerous interest groups seeking to advance agendas inessential to the monetary interests of fund beneficiaries.[225] In addition, they must deal with state and local governments that pressure them to provide investment capital for local economic development.[226] In government pension plans, fund trustees are often elected officials or political appointees. For example, the New York City Comptroller, an elected official, controls NYCERS, a large pension plan for city employees.[227] The political ambitions of the trustees may lead them to cast votes to further their political aims at the expense of pension fund beneficiaries.[228] As a result, these public sector funds may be more involved in broader public policy issues, such as supporting social investments.[229]

Furthermore, mutual funds' conflicts come from employers' choices about the options to provide employees in their tax-favored retirement plans.[230] Employers can choose from a variety of fund and fund managers and are unwilling to cast votes that might cause employers to cut off their access to employees' retirement money.[231]

223 *See generally* John H. Langbein & Daniel Fischel, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1126-28 (1988).

224 Robert G. Vanecko, *Regulations 14A and 13D and the Role of Institutional Investors in Corporate Governance*, 87 NW. U.L. REV. 376 (1992).

225 *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 471 n.84 (1991) (describing how CalPERS was recently challenged to hire more minority and female-owned money managers).

226 *Id.* at 471-72 (describing pressure on public pension funds in New York to aid in the bailout of New York City).

227 *See* Jill Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 883 (2010) (the plans for California employees and teachers also have or have had elected officials in management roles).

228 *Id.* at 882-83.

229 *Id.*

230 Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 2003-04 (2010) (describing alternatives chosen by plan providers).

231 *See* Kahan & Rock, *supra* note 173, at 1055-56, 1056 n.170.

B. Institutional Investors' Fiduciary Duties

For private pension plans, as previously described, the trustee appointed by company management, and the outside managers appointed by the trustee are both likely to desire to please not fund beneficiaries but those who appointed them.[232] Conflicts of interest and fiduciary duty issues arise. Under the Restatement (Third) of Trusts (the "Restatement"), fiduciary duties imposed on institutional investors under the law of trusts[233] demand that a trustee act "as a prudent investor would."[234] "This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust."[235] In addition, trustees' fiduciary duties require loyalty and impartiality to beneficiaries, diversification of investments, and prudence in delegating responsibilities and paying attention to reasonable costs.[236] The Restatement discusses social investing but does not offer clear guidance on whether it is consistent with trustees' fiduciary duties.[237] The Prudent Investor Rule, as described in the Restatement, incorporates modern portfolio theory by focusing on the portfolio as a whole.[238] When applied in practice, this theory requires broad investment diversification.[239] For private pensions, ERISA governs private defined benefit pension plans[240] and imposes fiduciary duties on the investment of their assets.[241] Under ERISA, fiduciaries that build on the common law of trusts, must: (1) act for the exclusive benefit of beneficiaries; (2) defray reasonable expenses; (3) act in accordance with the prudent fiduciary standard; (4) diversify investments; and (5) follow plan documents and the law.[242] In addition, fiduciaries must act in the best

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232 *Id.*

233 *See* RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. a (AM. LAW INST. 2007).

234 *Id.* § 90.

235 *Id.* § 90(a).

236 *Id.* § 90(b)-(c).

237 *See* David Hess, *Public Pensions and the Promise of Shareholder Activism for the Next Frontier of Corporate Governance: Sustainable Economic Development*, 2 VA. L. & BUS. REV. 221, 248 (2007); TRUSTS § 90 cmt. c.

238 TRUSTS § 90(a).

239 *Id.* § 90 cmt. g.

240 *See* Anne M. Tucker, *Retirement Revolution: Unmitigated Risks in the Defined Contribution Society*, 51 HOUSTON L. REV 153, 164-65 (2013).

241 *See generally id*. at 163-76 (discussing the distinctions between defined benefit and defined contribution plans).

242 *See* 29 U.S.C. § 1104 (2012).

interest of beneficiaries without undisclosed and unmitigated conflicts of interest or self-dealing.[243] ERISA regulations alter the common law prudent investor standard by imposing a higher standard for the duty of loyalty which disallows conflict of interest transactions,[244] even if otherwise profitable.[245] Moreover, the duty of care under ERISA requires specialized skills, drawing the scope of reasonableness from those "acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[246] The reporter's notes on Section 90 of the Restatement discussing and distinguishing ERISA acknowledge "an interpretation [of ERISA] that impose a standard of skill in investment management different from that imposed by general trust law."[247]

V. REGULATION FAIR DISCLOSURE

According to existing research, many corporate officers and directors view Regulation Fair Disclosure ("Reg FD") as a significant impediment to more vigorous shareholder communication.[248] To keep confidence in securities markets and prevent the use of inside information for trading purposes, the SEC promulgated Reg FD in October 2000, which essentially prohibits public companies from making selective

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243 *Id.*

244 *ERISA Fiduciary Advisor*, DEP'T OF LABOR, https://webapps.dol.gov/elaws/ebsa/fiduciary/q4d.htm (last visited Jan. 30, 2019) (parties that are prohibited from doing business with the plan are also called parties-in-interest, which includes the employer, the union, plan fiduciaries, service providers, and statutorily defined owners, officers, and relatives of parties-in-interest); *see also* Christopher Geczy, Jessica S. Jeffers, David K. Musto & Anne M. Tucker, *Institutional Investing When Shareholders Are Not Supreme*, 5 HARV. BUS. L. REV. 73, 81-82 (2015).

245 *See* RESTATEMENT (THIRD) OF TRUSTS § 90 note (AM. LAW INST. 2007) ("Heavy emphasis in the regulations on the duty of loyalty and prohibited transactions (even for otherwise prudent, profitable investments is understandable in this context.").

246 29 U.S.C. § 1104 (2012). *Compare id.* ("a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims") *with* TRUSTS § 90(a) ("This [prudent person] standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.").

247 TRUSTS § 90.

248 *See* STEPHEN DAVIS & STEPHEN ALOGNA, TALKING GOVERNANCE: BOARD-SHAREHOLDER COMMUNICATIONS ON EXECUTIVE COMPENSATION 5 (2008), https://millstein.law.columbia.edu/sites/default/files/content/docs/2008%2012%2008%20talking%20governance%20v2%20(4).pdf.

disclosures.[249] Reg FD was designed to promote the full and fair disclosure of vital issues and, thus, to prohibit corporations from selectively disclosing information in a manner that could result in insider trading.[250] Issuers must make that public disclosure simultaneously with the selective disclosure in the case of intentional disclosure and promptly in the case of inadvertent disclosure.[251] Under Reg FD, when a public company or someone acting on its behalf discloses material nonpublic information to market professionals or its shareholders, who may trade on the information, the company must publicly disclose such information.[252] Therefore, companies must be aware of Reg FD in all of their communications with selective shareholders or communications during meetings that are closed to the public. Certain studies showed that concern over potential violations of Reg FD reduces corporations' willingness to enhance their engagement with shareholders.[253] "Reg FD's restriction on the free flow of accurate information is both problematic and unnecessary in light of the current state of insider trading law."[254]

In 2010, the SEC issued interpretive guidance on Reg FD aimed at reducing such concerns.[255] The SEC emphasized that Reg FD does not prohibit corporate directors and officers from engaging in private meetings with shareholders.[256] The SEC further argued that corporations can discuss material nonpublic information with shareholders as long as such shareholders expressly agree to keep the information confidential.[257] Finally, even if corporations inadvertently disclose material nonpublic information, they can avoid violating Reg FD by promptly disclosing the information to the public.[258] In total, the SEC has attempted to make clear

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249 17 C.F.R. § 243.100 (2018); *see also* TRUSTS § 90 note ("The possibly higher standard of skill [in ERISA] results from reference to a prudent person 'acting in a like capacity' and 'familiar with such matters'—language that has been interpreted to create not a standard of a 'prudent expert' but one of prudence fitting the particular trust.").

250 Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (to be codified at 17 C.F.R. pt. 240, 243, and 249).

251 *See* 17 C.F.R. § 243.100 (2018).

252 *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,716.

253 *See id.*

254 Susan B. Heyman, *Rethinking Regulation Fair Disclosure and Corporate Free Speech*, 36 CARDOZO L. REV. 1099, 1101 (2015).

255 *See Compliance and Disclosure Interpretations: Regulation FD*, U.S. SEC. EXCH. COMM'N, https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm (last updated June 4, 2010).

256 *See id.*

257 *See id.*

258 *See id.*

that, with appropriate planning, Reg FD should not discourage corporate dialogue with shareholders.[259]

"Only the SEC can bring an action under Reg FD, and there is no private right of enforcement."[260] Studies revealed less than ten Reg FD enforcement actions and no enforcement action or investigation related to companies that have had or are planning to have private meetings with shareholders.[261] Thus, the SEC through guidance and its enforcement practice has attempted to make clear its intent not to use Reg FD to discourage shareholder communication with boards, potentially reducing concerns about the impact of the regulation.[262] "Moreover, companies seeking to engage with shareholders have adopted many of the procedures recommended by the SEC, which in turn has enabled them to avoid potential legal liability [when engaging in] constructive conversations with their shareholders."[263]

VI. PROXY ADVISORY

Proxy voting entails costs, as noted above, particularly because many investors have to cast votes on several thousand securities. Institutional investors exert substantial voting power, as also previously described, but lack the appropriate incentives to cast informed ballots with respect to their portfolio companies. Then, many institutional investors employ the services of proxy advisors to assist them in exercising their voting rights.[264] In some cases, institutional investors may even subcontract their voting decisions to proxy advisors.[265] As a result, the proxy advisory industry has grown substantially during the past

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259 Fairfax, *supra* note 154.

260 *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,726 (Aug. 24, 2000) (to be codified at 17 C.F.R. pt. 240, 243, and 249); *see also* Fairfax, *supra* note 154, at 836.

261 *See* DAVIS & ALOGNA, *supra* note 248, at 10.

262 Fairfax, *supra* note 154.

263 *See id.* at 836.

264 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 7 (2007), http://www.gao.gov/new.items/d07765.pdf (exploring competition and potential conflicts of interest in the proxy advisor market at 13 describing ISS's client base as consisting of an estimated 1,700 institutional investors).

265 *Proxy Research Services Policy Options*, RISKMETRICS GROUP, http://www.riskmetrics.com/proxy_advisory/options [https://web.archive.org/web/20110131150011/http://www.riskmetrics.com/proxy_advisory/options] (detailing the choice of ISS guidelines that subscribers can use and incorporate into "RiskMetrics' turnkey voting agency services").

decade.[266] In contrast, the expanded fiduciary duties that the SEC implemented in 2003 require institutional investors to vote in the "best interest" of their clients.[267] The SEC "could provide that the mere hiring of a proxy advisory firm is insufficient to satisfy fiduciary obligations, and further that institutional investors must exercise some level of due diligence when subscribing to a proxy advisory firm's voting recommendations."[268]

The SEC published in 2010 the Concept Release on the U.S. Proxy System,[269] which raised two issues on the current operation of proxy advisory firms that could impair shareholder voting: first, a lack of "adequate accountability for informational accuracy in the development and application of voting standards" and, second, conflicts of interests that are "insufficiently disclosed and managed."[270] These issues include the quality of their voting advice and their conflicts of interest. The proxy advisors' recommendation criteria entail a lack of transparency, which makes assessing the quality of voting recommendations difficult, whereas proxy advisors may have incentives to conduct only low-cost analyses.[271] Regarding the second issue, for example, Institutional Shareholder Services ("ISS") serves as a consultant, advising firms on how they can improve their corporate governance and simultaneously recommending how investors in these firms should vote.[272] Some commentators argue that this dual role may give rise to recommendations that are affected by conflicts of interest.[273]

VII. CONCLUSION

Any single shareholder, including any institutional investor, does not pursue the totally same value in a corporation, which might create a conflict of interests in a corporation pursued by many different shareholders. Many different shareholders set their "corporate value" in

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266 *See* Sagiv Edelman, *Proxy Advisory Firms: A Guide for Regulatory Reform*, 62 EMORY L.J. 1369, 1375 (2013).

267 *See* 17 C.F.R. § 275.206(4)-6 (2018); *see also* Stephen Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 653 (2009).

268 Edelman, *supra* note 266, at 1407.

269 Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982 (July 22, 2010).

270 *Id.* at 43,011.

271 *See* David Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J. L. & ECON. 173, 201–02 (2015).

272 *See, e.g.*, Robert J. Rhee, *Intrafirm Monitoring of Executive Compensation*, 69 VAND. L. REV. 695, 719 (2016).

273 *See* David Yermack, *Shareholder Voting and Corporate Governance*, 2 ANN. REV. of FIN. ECON. 103, 110 (2010).

the corporation, including the issue of whether the corporate value equals the long-term success of the corporation. In addition, given increasing importance of institutional shareholders' engagement, dialogue between boards and shareholders is increasingly common in both the U.S. and the UK.[274] Such dialogue is essential to encourage institutional investors to fulfill their stewardship functions. However, institutional investors, who are deemed as appropriate monitors, face several engagement impediments, principally because of free-rider problems, legal concerns, liquidity concerns, conflicts of interest, and business models. Moreover, traditional institutional investors lack incentive and expertise for monitoring and engagement. Are there no appropriate shareholders that are qualified to or actually engage the corporation? As for this question, activist hedge funds may be influential shareholders that engage in monitoring the target company and proposing value-enhancing changes to other shareholders, including traditional institutional investors with long termism. This type of collective engagement may be workable. Access to institutional investors' policies for collective engagement would empower activist hedge funds to gauge the likelihood of the success of their activism. Ultimately, activist hedge funds will be enabled to continue to serve their vital role as governance intermediaries in the market for corporate governance.

In January 2017, the Investor Stewardship Group ("ISG"), a coalition of some of the largest US-based and international asset owners and managers,[275] released its *Framework for U.S. Stewardship and Governance*.[276] ISG's Corporate Governance Principle No. 3.3 deals with director–shareholder dialogue, stating, "the appropriate independent directors should be available to engage in dialogue with shareholders on matters of significance, in order to understand shareholders' views."[277]

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274 Giovanni Strampelli, *Knocking at the Boardroom Door: A Transatlantic Overview of Director-Institutional Investor Engagement in Law and Practice*, 12 VA. L. & BUS. REV. 187, 239 (2018).

275 The ISG comprises sixteen founding international institutional investors, which together invest more than seventeen trillion dollars in U.S. equity markets. *See* Inv. Stewardship Grp., *Corporate Governance and Stewardship Principles*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (Feb. 7, 2017), https://corpgov.law.harvard.edu/2017/02/07/corporate-governance-and-stewardship-principles.

276 *See e.g.*, *The Principles: Stewardship Framework for Institutional Investors*, INV. STEWARDSHIP GRP. (Jan. 2017), https://isgframework.org/stewardship-principles [hereinafter ISG Stewardship Framework]; *Corporate Governance Principles for US Listed Companies*, INV. STEWARDSHIP GRP. (Jan. 31, 2017), https://isgframework.org/corporate-governance-principles [hereinafter ISG Corporate Governance Principles]; *see also* Abe M. Friedman, *Investor Coalition Publishes US Stewardship Code*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG. (Feb. 7, 2017), https://corpgov.law.harvard.edu/2017/02/09/investor-coalition-publishes-u-s-stewardship-code.

277 ISG Corporate Governance Principles, *supra* note 276.

Additionally, as part of their engagement process, Stewardship Principle E.3 requires institutional investors to "clearly communicate their views and any concerns with a company's practices on governance-related matters."[278]

The ISG's new stewardship principles are more tentative and ambiguous than the UK Stewardship Code. Although the new ISG stewardship principles refer to collaboration between institutional investors, this collaboration appears aimed directly at encouraging the adoption and implementation of corporate governance/stewardship principles rather than engaging in collective activism per se.[279]

The UK Stewardship Code's Principle 5 encourages institutional investors to maintain and disclose policies for collective action. The guidance under Principle 5 is described as follows: "institutional investors should disclose their policy on collective engagement, which should indicate their readiness to work with other investors through formal and informal groups when this is necessary to achieve their objectives and ensure companies are aware of concerns."[280] The disclosure should also indicate the kinds of circumstances in which the institutional investor would consider participating in collective engagement.[281]

One idea is that the ISG should insert the same language as Principle 5 into the Framework for U.S. Stewardship and Governance. This insertion may be useful to fill the gap between shareholders and management within a limited range, assuming that directors are still completely responsible for the overall control of the corporation subject to the ESV approach.

278 ISG Stewardship Framework, *supra* note 276.

279 *See id.*

280 *See* Stewardship Code, *supra* note 6, at 8-9.

281 ISG Stewardship Framework, *supra* note 276.