The Role of institutional Investors in the Corporate Governance

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Corporate governance has recently received much attention due to Adelphia, Enron, WorldCom, and other high profile scandals, serving as the impetus to such recent U.S. regulations as the Sarbanes-Oxley Act of 2002, considered to be the most sweeping corporate governance regulation in the past 70 years, and enhancing the long standing bandwagon for increasing shareholder power. More broadly, the Berle and Means model, in which professional managers control large public companies, is being questioned. The separation of ownership and control creates an agency problem, that managers may run the firm in their own, rather than the shareholders interest, choosing the maximization of their own utility over the maximization of shareholder value. Commentators with a Law and Economics bent have long claimed that shareholder passivity is inevitable. Modern companies have grown so large that they must rely on many shareholders to raise capital. The shareholders then face severe collective action problems in monitoring corporate managers. Each shareholder owns a small fraction of a company's stock, and thus receives only a fraction of the benefits of playing an active role, while bearing most of the costs. Passivity serves each shareholder's self-interest, even if monitoring promises collective gains. Thus, commentators have entrusted the hostile takeover mechanism to discipline the managers by threatening to oust poor performers by bidders who would consolidate ownership and control.

Anti takeover legislation and the spread of intra-corporate mechanisms such as poison pills have, in effect, sterilized the hostile takeover mechanism of its

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1 One of the vocal proponents of such a shift has been Prof. L. A. Bebchuk; see L. Bebchuk, The Case for Increasing Shareholder Power, 118, Harv. L. Rev. 833.
3 And as the conduct of, now former, CEOs like Bernie Ebbers of WorldCom and Dennis Kozlowski of Tyco has demonstrated, poorly monitored managers often do run corporations in pursuit of their own private interest.
4 One can conceive of linkages between corporate governance and corporate performance that might affect a wide range of social, political and economic issues. From a broad perspective corporate performance might be about more than enhancing shareholder wealth. For example, it could be evaluated for its impact on the cost of capital (efficiency in the financial markets), the role of labor in management (up to and including labor-owned firms), the role of corporations in education and training (efficiency in the labor market), and the contribution of corporations to research and development (efficiency in the knowledge market). Corporate performance could also be judged by its contribution to a country's ability to compete successfully in international markets. Nonetheless, in this paper I shall refer mainly to enhancing shareholder value, as the main goal of corporate governance, this view has been widely accepted by commentators at the SEC roundtable discussing the shareholder access proposal held on March 10th, 2004. See at http://www.sec.gov/spotlight/dir-nominations.htm.
5 Since the bidder will become the sole owner of the post takeover firm, his pre-takeover activities are not classified as a public good and since the rewards accrue only to him there is no collective action problem. See at Roberta Romano, A Guide to Takeovers: Theory, Evidence and Regulation, 9 Yale J. on Reg. 119, 122-33 (1992).
disciplining effect, and have turned commentators’ attention to Institutional investors as potential monitors of management. Institutional Investors, such as pension funds and mutual funds, which control over half of publicly traded equities in the United States, by virtue of their size are an exception to the small, rationally apathetic shareholder envisioned by Berle and Means, and thus become the natural candidates to watch the watchers.

Bernard S. Black has eloquently stated the case for institutional oversight noting that:

“The case for institutional oversight, broadly speaking, is that product, capital, labor, and corporate control market constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only watchers available.”

And indeed, Institutional investors have, in the past decade, increasingly engaged in corporate governance activities, introducing proposals under rule 14a-8, the Securities and Exchange Commission's (SEC) proxy proposal rule, and privately negotiating with management of targeted firms with the stated goal of improving corporate performance (jawboning). Shareholder activism, championed by institutional investors and embraced by individuals, has revolutionized U.S. corporate governance. Investors have assumed a looming presence in corporate boardrooms, and the stories of ousted CEOs,

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6 See, e.g., Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 575-91 (1990) (arguing that institutional investors' combination of large shareholdings and economies of scale allow them to overcome the traditional problems of shareholder passivity and thus effect changes in corporate policy and emphasizing the major role of public pension funds); Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. Rev. 811, 873-88 (1992) (proposing modest reform, which was partially implemented, to provide institutional investors with greater voice in corporate policy as means of inducing more active monitoring); John C. Coffee Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1336-38 (1991) (proposing reforms that would align pension fund managers' interests with those of their funds in order to increase the incentives for corporate monitoring).

7 In 2001, institutional investors held 55.8% of the publicly traded equities in the U.S. See The Conference Board: Institutional Investment Report, March 2003, at 32.

8 See Bernard S. Black 1992 supra note 6.


emboldened outside directors, shareholder “target” lists, and corporate capitulations fill the financial headlines.

The evident increase in Institutional Investor’s activity, stemmed, inter alia, from the change of position of U.S. government agencies regarding institutional involvement in corporate ownership, control, and monitoring. For instance, the Labor Department now encourages pension funds to be active in monitoring and communicating with corporate management if such activities are likely to increase the value of the funds’ holdings\(^\text{11}\). In 1992 and 1997 decisions by the SEC allowed shareholders more flexibility in communicating with each other and submitting shareholder proposals. And, in 1999, the U.S. Congress repealed the Glass-Stegall Act, ending restrictions on direct ownership of U.S. equity by banks\(^\text{12}\). More recently, in July 2003, the Securities and Exchange Commission proposed opening up the director nominations process to shareholders\(^\text{13}\) (“SEC Roundtable”). The General feature of the above regulatory milieu change is enabling Institutional Investors to take action not aimed at control and enable Institutional Voice\(^\text{14}\).

To be sure institutional activism hasn’t been monolithic and different institutions vary in their craving for the task and there are reasons to suspect that even further reducing legal encumbrances won’t stir the more lethargic institutions of their somnolence.

Taking them as a whole, I conclude that there is a strong case for enhanced legal measures that will further facilitate joint shareholder action not directed at control, and further reduce obstacles to particular institutions owning stakes not large enough to confer working control. Narrowly speaking, I purport that the core of legislative action should be on requiring companies, under certain

\(^{11}\) The Labor Department has oversight responsibility for corporate pension funds through ERISA (the Employee Retirement Income Security Act).

\(^{12}\) Albeit banks have remained relatively muted in the recent surge of institutional activity, a potential merit of allowing banks to directly own firms equity is ameliorating of shareholder-creditor tensions and increasing banks’ willingness to grant firms credit at times of credit crunch, thus reducing bankruptcy costs.

\(^{13}\) See at supra not 4.

\(^{14}\) This term was adapted by Black (1992) supra note 6 from A. O. Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States (1970).
circumstances, to include in their proxy materials shareholder-nominated candidates for the board.

The concerns about institutional oversight arise for two main reasons. First, controlling shareholders may divert funds to themselves at the expense of non-controlling shareholders or may pursue interests of special interest groups that will use their power as lever vis-à-vis corporate management\(^\text{15}\). Second, the institutions are themselves managed by money managers who need (and often don't get) watching and appropriate incentives.

Several factors limit the downside risk from increasing institutional power: First, the accumulated evidence concerning the consequences of the increased institutional investors activism proves that much of the alleged adverse effects of institutional voice did not materialize\(^\text{16}\). On the contrary, with a few exceptions the institutions are mainly passive. Second, institutional voice means asking one set of agents (money managers) to watch another set of agents (corporate managers). Money managers have limited incentives to monitor because they keep only a fraction of the portfolio gains. But, money managers also won't take the legal chances that an individual shareholder might, because they face personal risk if they breach their fiduciary duty or break other legal rules. The institution, however, realizes most of the gains from such misdeeds. That limits the downside risk from institutional voice. Third, institutional voice requires a number of institutions, including different types of institutions, to join forces to exercise influence. That further limits the downside risk from institutional power, because money managers can monitor

\(^{15}\) Critiques of the SEC’s proposal to enable shareholders’ access to the ballot, have pointed out to the potential use labor unions could make of such access (through institutions employee stock ownership plans) to exert pressure on management, enabling “special Interests” to creep into the board room, at SEC Roundtable Supra note 4.

\(^{16}\) Mr. Richard C. Breeden, Chairman of Richard C. Breeden & Co. and former Chairman of the US SEC, commented at the SEC Roundtable: “We tried to restructure the proxy rules in -- from 1990 to 1992, when I served as chairman…And I can remember Jack Welch in my office upstairs, telling me that the options had no value and therefore it would create chaos…The same arguments were raised at the proposal than…They're premature, they were unnecessary, they were an over-reaction, they were going to be costly… The world would end if we adopted them. And we did adopt ….them, and last time I checked, the world is still here.” See at Supra note 4.
each others’ actions to some extent, and won’t cooperate unless a proposed initiative benefits all the shareholders; Reputation is a central element in this second form of watching. Diversified institutions are repeat players that interact over and over, at many different companies, over a span of years. Game theory teaches us that a repeat game of this sort induces the actors to cooperate earn good reputation and elicit cooperation from other institutions; realizing that cheating will invite retaliation (“tit for tat” strategy). Fourth, corporate managers can watch their watchers, and if the institutions abuse their power, corporate managers can complain -- loudly and often -- to lawmakers. If the costs to other shareholders, including smaller institutions, of abuse of power by the largest institutions exceed the other shareholders' gains from better monitoring, those shareholders will support corporate managers' efforts to clip the large institutions' wings. Money managers know that, which limits their incentive to misbehave in the first place.

Much of the promise of shareholder monitoring lies in informal shareholder efforts to monitor corporate managers or to express a desire for change in a company's management or policies. But, in order to induce managers to cooperate with the active shareholders in the pursuit of improved corporate performance, shareholders must have a “big stick” in the form of a viable option to remove the board of directors and subsequently the underperforming management17. Moreover, because institutional incentives push against direct, company-specific monitoring, facilitating indirect monitoring through the board of directors would enhance the chance of awakening private institutional investors from their alleged somnolence. If the institutions can more easily select directors, at least for a minority of board seats, they can hire directors to watch companies on their behalf18 and be accountable to them. Currently, directors are often more loyal to corporate officers than to the shareholders whom the directors nominally serve.

17 The importance of having this “big stick” is reaffirmed by comments made by institutional investors' representatives at the SEC Roundtable. According to participants such as Richard H. Moore, The treasurer of the State of North Carolina and the trustee of the ninth largest public pension plan in the US, the mere fact the SEC was considering the proposal increased tremendously managers' responsiveness to shareholders proposals. See SEC Roundtable supra note 4.

18 Even under current situation, in which nominating a director on behalf of a shareholder is an expensive and cumbersome process, when much is at stake; institutional investors take on the challenge. A recent example is the successful endeavor of 4 pension funds to nominate two directors to the Disney board, this last November.
Reform should focus on the process of voting, rather than on substantive governance rules. To be sure, lawmakers should not mandate activism or impose large regulatory costs on companies or shareholders; rather they should empower the institutions to make their own decisions about optimal governance structures. They have incentives to make good choices -- or at least better choices than lawmakers would. Oversight will take place only where the institutions conclude that the benefits of monitoring outweigh the costs. The desired policy goal will let six or ten institutions collectively have a significant say in corporate affairs, while limiting the power of any one institution to act on its own. The focal point of lawmakers’ efforts should be on measures that would sway the incentives of shareholders towards more active monitoring of corporate management; the final decision should be left to the shareholders.

This paper proceeds as follows. Part 2 develops the qualitative case for believing that institutional voice can improve corporate performance in general and specifically through evaluating the issue of CEOs succession. I evaluate the potential benefits of greater oversight examining the domains in which institutional oversight is more likely to be value enhancing. Moreover, I explore the SEC’s proposal to enable shareholder access to the ballot and stress the importance of indirect monitoring through trade groups and through the board of directors. Finally, I explore the role of indirect monitoring through trade groups and the role of the Institutional Investor Service (“ISS”). Part 3 contends that the downside risk from institutional voice is negligible. It responds to the predominant concerns with institutional power, including the risks inherent in asking one set of agents to monitor another set of agents; whether money managers will use their power to obtain private benefits or promote special interest; and concerns about institutional or managerial focus on the short term. Part 4 deals with the evidenced disparity in scope and focus of institutional oversight between different types of institutional investors, and examines the incentive structure of different institutional investors. In addition, since monitoring has to be done by money managers within the
institutions, I investigate the incentives of money managers and the impact of promanager conflicts of interests. Furthermore, I assess the regulatory milieu in which various institutional investors operate in order to determine whether legal barriers the cause of relative somnolence of certain types of institutional investors. And finally, I consider the policy questions raised by increased shareholder activism and try to determine the optimal format policy-makers should pursue regarding shareholder activism. Part 5 concludes this paper.

2. **The Potential of Institutional Oversight**

This Part explores what institutional voice has achieved and it can potentially achieve if measures to enhance its effectiveness are taken. Subsection 2.1 identifies shareholder voting in context of one of a number of imperfect constraints on managerial discretion. Subsection 2.2 investigates the Monitoring Hypothesis in connection with institutional ownership and presents empirical evidence with regards to the value enhancing effect of institutional oversight. Subsection 2.3 investigates the contention that shareholders are better able at identifying suboptimal governance structure through the investigation of evidence in connection with the issue of CEO succession. Subsection 2.4 identifies areas where institutional oversight can increase corporate value. Subsection 2.5 explores the central role of indirect monitoring through the board of directors and gives specific attention to the SEC’s proposal to enable shareholder access to the ballot. Subsection 2.6 evaluates indirect monitoring through blockholders or trade groups and the role of the ISS, which has played a pivotal role in enhancing the effectiveness of proxy voting.

2.1 **Why and Where is Shareholder Voice Important?**

Shareholder monitoring is one strand in a web of imperfect constraints on corporate managers. Other constraints include the corporate control market, the product market, the capital market, the labor market for corporate managers, incentive compensation arrangements, creditor monitoring, the risk
of bankruptcy if a company can't service its debt, fiduciary duties, and cultural norms of behavior.

The debate over the strength of these constraints on managerial discretion has been with us for quiet some time. Commentators who find negligible merit in shareholder voting tend to see other constraints as strong\(^\text{19}\). Others find much greater scope for managerial discretion\(^\text{20}\). Yet others, purport that even institutional voice won’t restrain managers\(^\text{21}\) and suggest that allowing shareholders to *initiate* and vote to adopt changes in the company's basic corporate governance arrangements would improve corporate governance and enhance shareholder value by addressing important agency problems that have long afflicted publicly traded companies\(^\text{22}\). A succinct discussion of the limits of other constraints is desirable, because the stronger the other constraints, the less room for shareholder monitoring to improve corporate performance.

Opponents of institutional voice rely heavily on the market for corporate control. The lull of the hostile takeover market during the previous decade in conjunction with growing number of sub-par performing managers, demonstrate the ineffectiveness of that mechanism. Moreover, hostile takeovers are a cumbersome way to discipline corporate managers. Society bears the heavy costs of changing ownership, when all that was needed was new managers or closer oversight of the current managers. Manager’s conduct has to be more than sub-par to justify the typical 50% takeover premium, which limits the frequency of use and thus the effectiveness of that device. Additionally, many acquisitions reflect empire-building by the bidder's

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21 The fascinating SEC Roundtable, provides an epitome of the division of views regarding the effectiveness of constraints on managers discretion. Whilst CEO’s and corporate lawyers such as Martin Lipton contend that managers are responsive to shareholders, that rule 14a-8 provides an effective vehicle for shareholders to communicate with managers and with other shareholders, and that the newly adopted Sarbanes-Oxley Act poses major restraints on management discretion, Institutional Investors (especially those of the public sector), labor organizations, and corporate law scholars contend that the measures taken during the 1990’s are not enough and that shareholders need effective tools to realize their franchise in their corporation and dissolve of lethargic managers and hidebound boards at a lower cost. I believe that the recent scandals and the erosion of investors’ trust, so critical to the operation of capital markets, prove that the later view is more valid. See at supra note 4.

22 See L. A. Bebchuk (2005), at supra note 1
managers, rather than market discipline of poor target managers. Furthermore, hostile takeovers today face heavy legal obstacles, notably poison pills and strict antitakeover laws.

The other inhibitions can be powerful if a company or its management stray far off the profit maximizing path, but are often weak as long as a company functions reasonably, but yet shareholders are dissatisfied. Product market competition is strong in some industries, but weaker in others. Capital market constraints are weak for firms that can service their debt and rarely sell new equity or when markets are “irrationally exuberant”, as FED chairman Alan Greenspan once said, enabling even underperforming firms to accumulate capital for a rainy day. As for labor market constraints, most CEOs stay in their jobs until retirement. And if a company is mismanaged, it doesn't help to know that the CEO may have trouble finding another job if the board won’t fire him.

These constraints complement but do not replace shareholder monitoring. The essential domain for shareholder voice is where bankruptcy and capital market constraints are weak -- for the sub-par managed, fairly mature, public company that can service its debt and generate internally or borrow much of the cash it needs to fund new investments. Shareholder monitoring may prevent some companies from wandering too far and for too long off the profit path. It can be a quicker, lower-cost alternative to hostile takeovers or bankruptcy constraints.

If independent directors, in fact as well as in legal fiction, owe their primary loyalty to the shareholders, poorly performing CEOs may be replaced sooner. Fewer companies will falter for years because their managers can’t adapt to new circumstances and resent seeking outside help. Society would save the

23An interesting anecdote is that Bernie Ebbers, the former CEO of WorldCom whose conduct is a quintessential example of the need to restrain managers, was a wonderful user of the corporate control market. According to Mr. Damon Silvers, of AFL-CIO (federation of labor organizations) “He (Bernie Ebbers) bought up a lot of “undervalued assets”, “It's not clear that that was wonderful for those of us whose retirement funds lost billions of dollars when those assets were all sort of vaporized”. See at SEC Roundtable supra note 4.
cost of excessive conglomerate mergers, which benefit empire-building managers but not diversified shareholders. Corporations will “scale down” more often distributing more of their surplus funds to shareholders for reinvestment elsewhere, instead of squandering them on perquisites or overexpansion.

Shareholder monitoring might reduce the cost of capital. Better monitoring may reduce the risk, and hence the risk adjusted cost, of equity capital. Commentators believe that Japanese and German firms have a cost-of-capital advantage for precisely this reason\(^\text{24}\). A predominant feature of the Japanese Keiretsu is that the same institutions provide equity and debt capital, abating shareholder-creditor conflicts, and enhancing lenders’ willingness to lend in times of crisis\(^\text{25}\).

Institutional voice can diminish both shareholder and manager myopia. Improved communication between shareholders and managers will enable managers to focus on long-term performance\(^\text{26}\). Shareholders can be more admitted if they know what managers are doing and know that they have effective lever vis-à-vis managers who consistently fail to perform. Managers who engage with their predominant shareholders can worry less about shareholder impatience. And when managers promise long-term performance but don't deliver, managerial change will be more likely.

Shareholders voice can also strengthen other strands in the web. Shareholders can limit manager-sponsored antitakeover devices, thus preserving vitality in

\(^{24}\) See W. Carl Kester & Timothy Luehrman, Cross-Country Differences in the Cost of Capital: A Survey and Evaluation of Recent Empirical Studies, *Journal of Applied Corporate Finance* 5, no.2 at 29-41 (1992). It’s worth noting that the tremendous growth of US economy during the 1990’s combined with the slow down of Japan and German economies during that period, have generally decreased commentators’ efforts to seek corporate governance solutions in these countries corporate governance systems.


\(^{26}\) This is especially true with regards to heavily indexed pension funds who engage marginally in active trading and whose investment horizon is naturally long. For an in depth discussion, see part 4.
the corporate control market. If poor managers are more likely to be fired, the labor market for managers becomes a more viable constraint. Shareholders can have greater impact on management compensation plans that managers currently choose for themselves, assuring linkage to performance over prolonged periods of time.

It’s important to note that many of these advantages would accrue ex ante, granting shareholders a viable lever vis-à-vis management, would provide management with incentives to serve shareholder interests. Better performance by management, in turn, would make it less likely that shareholders would have to use their increased powers.

A study by Paul Gompers et al. found that companies whose managers enjoy more protection from takeovers (as measured by a governance index taking into account both corporate arrangements and state antitakeover provisions) are associated with poorer operating performance - including lower profit margins, return on equity, and sales growth. This study also found that companies whose managers enjoy more protection from takeovers are more likely to engage in empire-building. Albeit this evidence does not directly refer to the impact of increased shareholder voice, there is much reason to believe that the increased likelihood of managerial change and the reduction in employment of management sponsored antitakeover devices that would stem from increased shareholder voice, would yield similar ex ante mitigation of the

27 There is evidence of a correlation between anti-takeover protections and lower firm value. This evidence indicates that the aggregate effect of management insulation on shareholder value is negative. In a recent study, Alma Cohen and Lucian Bebchuk find that staggered boards, with the substantial antitakeover protection they provide, are correlated with an economically significant reduction in firm value. See Lucian Arye Bebchuk & Alma Cohen, The Costs of Entrenched Boards, John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law School., Discussion Paper Series No. 478, 2004. The study investigates the connection between firm value and staggered boards during the period from 1995 to 2002 and uses Tobin's Q, which is a ratio of market value of assets divided by the replacement value of assets, a standard measure used by financial economists, as a proxy for firm value.

28 Between the years 1996 and 1997 Coca Cola company continued to present to investors owe inspiring growth rates leading to increase in stock price and exceptional rewards to its managers. The amazing thing about this consistent growth was that it took place at the background of a global slow down. Recently the “secret” was discovered to the world, it turned out that Coca Cola improved credit terms to its Japanese distributors inducing them to accumulate immense stocks. Exploiting the big profit margins it had in the Japanese market Coca Cola’s management inflated its income artificially (the temporary increase in accounts receivables section was offset at subsequent years) albeit legally. This anecdote exemplifies the importance of linking compensation to long term growth and not to yearly results which are subject to managerial manipulation.

29 See Paul Gompers et al., Corporate Governance and Equity Prices, 118 Q.J. Econ. 107, 111, 129 (2003).

30 See id. at 136-37.
agency cost associated with greater management insulation. This reduction in agency cost would happen on a broader scope and at a lower cost to society than the reduction that stems from the hostile takeover mechanism. Changes such as these are, for me, the promise of enhanced institutional voice.

2.2 Institutional Ownership and the Monitoring Hypothesis

Several studies have recorded that institutional investors play a significant and effective role in contemporary corporate governance. An analysis of firms targeted by the pension fund CalPERS\textsuperscript{31}, finds a positive stock price reaction when a firm adopts changes\textsuperscript{32}. A positive reaction is also reported in another study, when corporations reach a settlement on governance proposals made by the United Shareholder Association\textsuperscript{33}. In both studies, the authors estimate that the gains to shareholders far surpass the costs. Another study examined the performance of 42 companies targeted by CalPERS between 1987 and 1992. It shows that the stock price of these companies trailed the Standard & Poor 500 Index by 66%, in the five year period before CalPERS acted, but outperformed that index by 52.5% in the following five years. The report concludes that "this Effect is again statistically significant"\textsuperscript{34}. In addition to the described visible successes there are some invisible successes in the format of promanager changes that aren’t made. For instance institutions seldom convince corporate managers to repeal staggered board provisions, but few companies propose new provisions of this sort knowing that their chances of success are low. This can be partially attributed to the efforts of activists to repeal staggered boards that gave much salience to the matter and led many institutions to adopt voting policies opposing staggered boards.

\textsuperscript{31} The California Public Employees Retirement System (CalPERS) is America’s largest public pension fund with assets in excess of 186 Billion USD. See at http://www.calpers.ca.gov/ (last visited July 28, 2005)
Commentators have long documented that shareholders with large stakes in a firm have a greater ability and incentive to monitor the firm’s management. Such shareholders are typically institutions such as pension funds that hold a significant fraction of the firm’s stock. The comparative advantage of institutional investors in monitoring managers is threefold. First, because institutional investors typically control a larger block of votes, managers are more amenable to their demands. The aforementioned researches document that institutional investors induce changes in governance structures and real activities of firms by actively pressuring companies through public targeting of firms with poor performance and through sponsorship of proxy proposals. In addition, institutional investors have greater incentives to monitor since they cannot always sell share of underperforming firms. This is not only because trading their larger holdings could create adverse price shifts and exacerbate losses, but also because many institutions index a large portion of their holdings. Second, since the cost of acquiring information about managerial effectiveness probably contains a fixed component, institutional investors can exploit economics of scale because they own a large number of shares in many corporations. Finally, institutional investors also generate additional indirect monitoring. There is evidence that more analysts follow the stock and monitor the operations of firms that attract larger institutional interest. All the above arguments suggest that, inter alia, institutional investors create value through mitigation of value dissipating activities within the firm; below I analyze specific areas where institutional oversight can enhance value.

36 See researches at supra notes 34 and 35.
37 See e.g., Coffee (1991) at supra note 6.
38 At the SEC Roundtable, Richard Moore, mentioned in supra note 19, reaffirmed this observation when commenting on the famous Wall Street rule: “I’m often told by my friends who are directors of large companies, “Well, Mr. Treasurer, why don’t you just vote with your feet?” And I think this point has been made. We no longer can vote with our feet. And I want to give you just some very quick statistics… Twenty-five years ago, the State of North Carolina had a $433 million equity portfolio. We had two managers. They were both actively-managed accounts. The managers could vote with their feet… Today, we have a $35 billion domestic equity portfolio. But here’s the interesting part of it. Only 22 percent of it is actively managed. And I think these are representative statistics of all public pension funds. So in 78 percent of the time, we cannot vote with our feet.” See SEC Roundtable at supra note 4.
2.3 Shareholders Are Better Able to Identify Suboptimal Governance Structures than Incumbent Boards.

The contention that shareholders are better able to identify suboptimal governance structures than incumbent boards, can accord wide support among commentators and in underlying empirical evidence. The epitome real-world exemplifications of this phenomenon come from the area of CEO succession. The data suggest that incumbent boards often wait too long to replace a CEO. Recent leadership battle at the NYSE along with the recent CEO outplacements at Motorola, and older experience at prominent companies such as, Goodyear, General Motors, and IBM, all support this notion.

The NYSE

Some commentators contend that a critical turning point in the debate over Dick Grasso’s tenure came when predominant institutional investors expressed the view that Mr. Grasso would have to step down. Those institutions are not owners of the Exchange, but rather customers who control significant order flow and who have a meaningful ability to sway public opinion. Outsiders with appropriate incentive structures, such as institutional investors, can be effective in forcefully identifying problems.

Other CEO Replacements

More recently, the stepping down of Motorola CEO was correlated with a 9% increase in the price of the company’s common stock. That market response corresponds to an approximate $2.6 billion increase in shareholder value. The change of leadership at Motorola was preceded by prolonged and

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40 It’s valuable noting that Joseph A. Grundfest, of Stanford Law School, contends that although shareholders are better at identifying a sub optimal governance structure, incumbent boards are better equipped to address the problem and find solutions, superior to those suggested by the shareholders. See, Joseph A. Grundfest, An Alternative Mechanism for Shareholder Participation in the Nomination and Election of Corporate Directors, this paper can be downloaded from the SEC Roundtable at supra note 4.

41 Applying a similar analogy would suggest that shareholder would have an advantage in deciding which board members should be replaced. For a broader discussion see 2.4 below.


43 Joseph A. Grundfest, mentioned in supra note 40, interprets this market reaction as a vote of confidence in Motorola’s board ability to nominate a better successor, asserting that “if the market expected that the new CEO would perform only as well as the recently ousted CEO, then there would have been no reason for Motorola’s share price to increase upon Galvin’s ouster”. I think this contention is slightly unwarranted, market response such as this could stem from the fact that investors corrected a discounted share price that reflected their dissatisfaction with the incumbent’s performance or that the market interprets this move as a proof of increased responsiveness to shareholder dissatisfaction on the part of Motorola’s board. I believe a more accurate assessment of professor’s Grundfest’s assertion could be obtained only after analyzing market’s response to the new nominee chosen by the board.
consistent shareholders’ call that management changes at Motorola were long time due, and the pattern of events to this point suggests another example of a board that has been too slow to respond.

Joseph A. Grundfest suggested that significant shareholder value could be created if boards, listening to the responsible concerns of large shareholders who have no agenda other than the preservation of the value of their investments, moved more rapidly to replace underperforming CEOs. His study indicated that:

“CEO replacement decisions at Goodyear, Allied Signal, Tenneco, and General Motors, increased shareholder value by 11.6%, 12.5%, 14.7% and 6.1%, respectively. At early 1990’s equity values, those CEO replacements added $2.7 billion in market capitalization.”

I believe that the sighted evidence provides a convincing argument in favor of the contention that shareholder value can be substantially increased through enhanced shareholder voice. Considering the fact that current equity values are much higher than those prevailing at the time the above research was conducted, further intensifies the potential gains to society from improvements in corporate governance through shareholders voice.

2.4 In Which Areas Can Institutional Oversight Add Value?

Institutional shareholders can't, don’t want to and shouldn't watch every step a manager takes. Several issues warrant board attention. Even fewer warrant shareholder involvement. The shareholders can, though, structure manager incentives to be more congruent with shareholder incentives, discourage actions such as diversification that benefit managers but not shareholders, and

45 Considering the fact the institutional investors, fiduciaries investing for millions of American households, holdings account for over half of the publicly traded equities in the U.S (see supra note 7), implies that indeed it is society’s gains.
Step in when a CEO, having been given a fair opportunity to run the business, repeatedly fails to deliver. The institutions’ incentives discourage them from engaging in company specific issues. Company-specific actions don't involve scale economies in monitoring. In contrast, shareholders have stronger incentives to take an active interest on issues for which scale economies will partly offset the incentives for passivity created by fractional ownership. Systematic shortfalls in corporate performance are amenable to correction by diversified institutions. My emphasis is on avenues for value adding by institutional investors without micromanaging.

As evident in a decade of active monitoring, by some institutions, they are not only interested in issues that involve economies of scale. Some company-specific issues warrant attention on their own merits, especially for larger companies. In that calculus, the opportunity for deterrence, which preserves some scale economies for actions formally taken only at a few companies, has led the institutions to target attention at poor performers. The CalPERS Focus List, targeting specific firms with poor financial and governance performance, exemplifies that deterrence effect. The press release that accompanies addition to the list and the discounting effect it has on the targeted firm share’s price enhance the deterring effect of such actions.

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46 The efforts of Roy Disney and CalPERS that has led to the removal of Michel Eisner from his position as Disney’s CEO, is a quintessential example of institutions assuming this role.
47 CalPERS Focus List is selected from the pension fund’s investments in more than 1,800 U.S. corporations, and is based on the companies’ long-term stock performance, corporate governance practices, and an economic value-added evaluation. See at e.g., http://www.calpers.ca.gov/index.jsp?bc=/about/press/archived/pr-2004/june/2004focuslist.xml. CalPERS claim to have pointed firms where poor market performance is due to underlying financial performance problems as opposed to industry or extraneous factors alone.
48 One might contend that the losses that would stem from the decrease in the targeted firm’s share price would discourage institutions from taking such actions. On the other hand, there is good reason to believe that this reduction is temporary and for institutions with long term investment horizons, such as pension funds, the future gains from improved governance provide an incentive to act notwithstanding the temporary “on the paper” loss, they are bound to suffer.
Antitakeover Devices

As aforementioned, antitakeover amendments and antitakeover laws have significant negative effects on long run firm value. Institutional shareholders could defeat value-decreasing charter amendments – as some have done in past decade and as many state as their open proxy voting rule. They could also weaken or even rescind current entrenchment devices through bylaw changes, charter amendments, or reincorporation in a less promanager state. Weaker defenses mean shareholders will have a greater role in deciding which deals succeed and which fail. They ought, on average and over time, to make better decisions than target company managers. A close analysis of the ISS 2004 postseason report, which analyses issues on shareholders agenda during this year proxy season, implies that shareholders remained active on the issue of antitakeover devices, and that the continuing pressure is becoming more fruitful. Another potential advantage of weaker takeover defenses, other than disciplining management, is assuring that more value increasing takeovers overcome target’s management’s desire to remain in office.

Corporate Diversification

Closely related to the issue of antitakeover devices, corporate diversification is still an area where shareholder oversight can still produce value. Managers typically want their one-and-only company to grow. There is ample evidence that corporate diversification is generally a bad idea, made worse by the common practice of overpaying for someone else’s business. Yet, conglomerate acquisitions persist and many companies resist divesting non

49 See page 11 above.
51 ISS the world's leading provider of proxy voting and corporate governance services proclaims a negative approach to antitakeover devices and on a regular basis recommends his clients to vote against the adoption of such devices. Many prominent institutional investors that do not use ISS services, such as Fidelity (the world’s largest mutual fund family) state that their policy is to vote against the adoption of antitakeover devices by portfolio firms. See the words of Mr. Eric Roter of Fidelity at the Sec Roundtable at supra note 4.
52 Although the number of shareholder proposals in connection with removal or weakening of antitakeover devices has fallen in 2004, the number of companies which voluntarily removed such mechanisms (mainly pursuant to ignored majority shareholder votes in previous years) has risen dramatically, suggesting, as ISS implied in its 2004 post season report, that an impressive degree, constructive dialogue between shareholders and corporations replaced confrontation. See at http://www.issproxy.com/governance/issreports/index.jsp (last visited July 27, 2005). I believe that this trend can be at least partially attributed to the “sword” of the shareholder access to the ballot proposal that the SEC is currently considering.
53 Black (1992), supra note 50, Part II(B).
synergetic businesses. Diversified institutions are ideally situated to encourage greater corporate focus and resist diversification, especially for a company that wants to enter a completely unrelated business. Using the vast research that reveals the factors that predict that a takeover won't be value increasing\textsuperscript{54}, institutions can assess the likely wisdom of a takeover bid, and follow up those judgments with pressure on the bidder to justify a suspect bid or abandon it. Shareholders can also encourage directors to be more skeptical about a CEO's acquisition ideas. More voice may mean fewer deals. Conversely, many value-increasing takeovers never happen because the target's managers want to remain independent. Here too, institutional pressure, based on a mix of judgments about bid type and assessments of particular transactions, could lead to greater target acceptance of value-increasing offers. Institutional oversight can also limit excessive defenses and thus reduce transaction and disruption costs.

\textit{Board Structure and Composition}

The recent corporate governance crisis highlighted the importance of good board performance. Much of the value of institutional voice would be realized through improving boards of directors, many of which could surely stand improvement. The institutions have neither incentive nor ability\textsuperscript{55} to monitor many corporate actions directly. They can, however, hire directors to undertake company-specific monitoring for them\textsuperscript{56}. Directors can stop a misdirected acquisition before it gets started; shareholders can at best act after the transaction is announced, when it may be too late. Directors can remove a CEO at less cost than shareholders. Directors are the ones setting the management compensation scheme and with it structure their incentives to maximize shareholder value. If the incumbent directors are part of a company's problem, institutional shareholders can prompt board turnover.

\textsuperscript{54} See \textit{ibid}. Part II(C) (collecting studies).

\textsuperscript{55} At the SEC roundtable Eric Roiter of Fidelity commented that “Last year (2003), to give you a rough sense of our size, we voted proxies at the annual meetings of over 3600 U.S. companies. If you count foreign companies, it gets to about 6,000. I'm not sure we can get into the headhunting business and come up with a roster for all of those companies, or even for a significant fraction of those.” See at SEC roundtable supra note 4.

\textsuperscript{56} See e.g., Gilson & Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, \textit{43 Stan. L. Rev.} 863 (1991), \textit{asserting that institutional efforts should be focused on choosing better outside directors.}
albeit at higher cost, before a loan default or bankruptcy, much as they do today after a default\textsuperscript{57}.

Vigorous, independent directors won't cure all corporate ailments, but they should help at the margin. Nonetheless, and as evidenced in recent years, institutional voice might reduce the number of truly awful boards and compensation committees\textsuperscript{58}. There is ample evidence that boards with a majority of independent directors are more likely to dismiss an underperforming CEO, and are reluctant to endorse an overpriced takeover bid. In addition, companies whose independent directors own little stock are more likely to become subject to a hostile takeover bid, implying a collapse of standard governance mechanisms\textsuperscript{59}. Therefore, there is value in institutional efforts to ensure that more boards have a majority of independent directors, to insist that directors own a significant equity stake, and to strengthen boards in other ways. I discuss the SEC’s shareholder access proposal below, but even at this stage an important caveat has to be considered. Many commentators believe that the institution of “Independent Director”, which regulators and commentators alike see as the panacea to all of the corporate governance ailments, is overstated claiming that:

“Director’s independence is not a magical cure-all. The independence of directors from the firm’s executives does not imply that the directors are dependent on shareholders or otherwise induced to focus solely on shareholder interests”\textsuperscript{60}.

Other issues related to board structure and composition, currently on the shareholders’ agenda include, board declassification ensuring annual election of all directors and separation of CEO and board chairman positions\textsuperscript{61}. Both of

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\textsuperscript{57} See e.g., Easterbrook (1984); Fama (1980); and Fama & Jensen (1983) at supra note 19.
\textsuperscript{58} Once again, I mention in this vicinity the struggle of CalPERS and other mutual funds to nominate 2 independent directors to Disney’s board and their coalition with Roy Disney to overturn Michel Eisner which has led the company to consistent sub par performance in recent years.
\textsuperscript{59} See, black (1992) part II A, at supra note 50.
\textsuperscript{61} For a general survey of current issues on shareholder’s agenda see ISS postseason report at supra note 52.
these issues have proved to be systematic shortfalls in corporate performance and thus are a natural realm for diversified shareholder activism. Institutional efforts have had a substantial impact on board structure. Issues once seemed to be the ceiling of proper governance, such as installing a majority of independent directors and an independent nominating committee, have now become the floor. As one commentator eloquently put it, "it's muscle-flexing by large institutional investors that has helped shift the balance of power in corporate boardrooms toward independent directors."

Regulatory Consequences of Portfolio Companies’ Conduct

B. Black raises another domain in which shareholders can add value. Reflecting on investor’s concern with Exxon-Mobile’s environmental problems subsequent to the Exxon Valdez disaster, he notes that Shareholders can also be more sensitive than managers to the effects of company actions on the political climate for business. For example, it may be sensible for any one oil company to risk an oil spill, but foolish for the industry as a whole, because the industry risks costly regulation. Diversified shareholders bear the costs of regulation for all portfolio companies. In contrast, most of these costs are an externality for any one company. Thus, there is some rough logic to investor concern about Exxon’s environmental problems.

Corporate Cash Retention

There is substantial evidence that many managers hoard excess cash and then spend the cash unwisely, often on misguided acquisitions. The problems are systemic. In a recent empirical study of investment decisions Christopher Hennessy and Amnon Levy find evidence of empire-building. Michael Jensen collected evidence that firms with free cash flow (cash flow that isn’t

\[\text{http://ssrn.com/abstract=334742}\]
needed to fund the firm's positive net present value projects) often waste that
cash flow on excessive growth. A recent study reports that firms that
substantially increase capital investments subsequently achieve negative
benchmark-adjusted returns, with the negative abnormal returns stronger for
firms that have greater investment discretion. Another adverse effect of
retention of undistributed liquid funds ("free cash flow") or assets that can be
turned into such funds is the increase in the autonomy of management vis-a-
vis the capital markets (eroding capital market constraints) and the
enhancement of its freedom to pursue expansion plans.

Informed shareholders or directors can assess a company's capital needs and
encourage payout of surplus funds, beyond a reasonable cushion for future
adversity or opportunity. Shareholder oversight can also reduce the
likelihood that managers will misappropriate the cash cushion they retain. Ongoing
oversight may increase institutional willingness to provide capital in times of
need, and thus reduce the cushion needed in ordinary times, with its inevitable
temptations. Lower retention of capital would decrease management’s
insulation to capital market and invigorate this constraint. Another issue that
can be addressed through increased shareholders’ oversight, is certain
companies’ tendency to pay dividends they can’t afford in an effort to fool
investors about their profitability. Many utilities companies pay taxable

66 See, Jensen, The Takeover Controversy: Analysis and Evidence, in Knight, Raiders & Targets: The Impact of the
Hostile Takeover 314, 321-22 (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988); Jensen, Free Cash Flow and
the Effects of Mergers and Acquisitions on the Economy, in The Merger Boom (1987), (L. Browne & E. Rosengren
eds. 1987) at 102.

67 See, Sheridan Titman et al., Capital Investments and Stock Returns 1-3 (Nat'l Bureau of Econ. Research, Working

68 Jensen offered a simplistic solution to the problem of excessive cash retention- very high leverage, see Jensen
(1987) at supra note 66. But, this solution ignores bankruptcy and workout cost. Further, companies need some
borrowing capacity and cash reserves for bad times or new opportunities. In addition, high leverage might lead to
reduced investment in R&D. Relying on an unfettered takeover market to cause firms to scale down is also
unwarranted. The threat of takeover can discipline some cash rich companies, but cause other firms to spend their
cash on unwise acquisitions.

69 L. Bebchuk is skeptical with regards to the effect of increased shareholder voice on cash retention and empire
building by management, noting that “At present, all decisions concerning distributions are in management's hands.
Management decides whether to distribute to shareholders a cash or an in-kind dividend. Such decisions transfer
assets from company control into shareholder hands, in effect reducing the size of the empire under management's
control… In such circumstances, however, management might refrain from taking actions that would reduce the size
of the empire under its control.” In Bebchuk’s view the fact that management is the only one who can initiate the
scale down, sterilizes the effect of “encouragement” to do so by shareholders when it is not in management best
interest, therefore he suggests that shareholders would be allowed to initiate a bylaw amendment that would enable
them to initiate the dividend distribution when they deem feet. See Bebchuk (2005) at supra note 1. Albeit this
proposal has many merits I’m doubtful as per the feasibility of its implementation at the prevailing political climate in
the U.S.
dividends at the same time they're selling new shares. Dividend cuts also often lag far behind business reversals. Institutional oversight can make companies less likely to pay dividends they shouldn't.

Primary Issuance of Equity

As elucidated above managers often have the propensity to undertake investments and activities that enhance their own utility but dissipate shareholder value. Since equity issues represent some of the largest infusions of capital for a firm, often combined with an increase in ownership dispersion, they constitute a setting in which institutional oversight could yield benefits. In a study of 1,621 public equity issuances of primary shares between the years 1982-1995, D'Mello et al.\textsuperscript{70} found that the announcement period abnormal returns are significantly less negative\textsuperscript{71} for firms with larger institutional holdings. This suggests that although investors maybe concerned about the free cash flow problem subsequent to the issue, the adverse impact on the issuer’s share price is ameliorated through institutional oversight.

Management Compensation

A system where the average CEO's pay rises year after year, even if profits decline, can certainly stand some improvement. An epitome of current system ailments is Calpine’s 21 years incumbent CEO, Peter Cartwright, who earned a 6-year average compensation of $13.0 million, notwithstanding an annualized 6-year return of -7%\textsuperscript{72}. Executive pay is not merely symbolic it has substantial practical importance for shareholders. Bebchuck and Grinstein found that the aggregate compensation paid by public companies to their top-five executives during the period 1993-2003 has added up to about $290 billion, and the ratio of aggregate top-five compensation to profits increased

\textsuperscript{70} See R. D'Mello, F. seasoned, and V. Subramaniam, Are there monitoring benefits to institutional ownership? Evidence from seasoned equity offerings, at www.tulane.edu/~vencat/mstn.pdf, (last visited on June 1 2005).


from 4.8% in 1993-1995 to 10.3% in 2001-2003\(^{73}\). Large shareholders can keep CEO pay from exceeding the bounds of reason and decency. Institutional investors have accepted executives’ outrageous compensation, succumbing to the claim it’s necessary to maintain executives’ incentive to perform. Bebchuck and Fried show that managerial power vis-à-vis board/shareholders is correlated with pay arrangements that are more favorable to insiders\(^{74}\). They survey empirical evidence that pay is greater/less sensitive to performance in firms with: More antitakeover provisions, weaker shareholder rights, CEO who is also chairman of board, directors appointed under current CEO, compensation committee has little company stock, more interlocking directors, and Without large outside block-holders. As the empirical evidence demonstrates, the mere presence of large blockholders reduces managements’ ability to extract excessive pay, showing that institutional presence mitigates this form of agency cost. Institutional investors should press for tightened link between pay and performance, making managements’ compensation dependent on its own performance, rather than rewarding for general market and industry-wide movements. Currently, most of the conventional options and restricted stock rewards managers for sheer “luck”, and companies camouflage excessive compensation through generous retirement plans\(^{75}\). Preliminary step in mitigating this conduct is for institutional shareholders to require portfolio companies to report at general meetings the annual increase in present value of retirement benefits. Further, institutional shareholders should limit management’s broad freedom to unload vested options/restricted stock, by requiring that these steps be approved at the general meeting, at least in principle\(^{76}\). This conduct that rewards for short-term price increases that may not last, whilst producing perverse incentives, is not congruent with many institutional shareholders’ focus on long term growth. They can change the corrupt process of setting CEO pay, where the CEO hires a supposedly


\(^{75}\) For example Jack Welch, former CEO of GE, notable in his record salary of $94 million a year, indulged a record retirement plan, that grants him $8 million a year and a right to use GE’s jet for his personal needs. See at http://en.wikipedia.org/wiki/Jack_Welch last visited on June 1\(^{st}\), 2005.

\(^{76}\) Even if shareholders wish to allow management much leeway, there are good reasons to require shareholders granting management a general power to take such actions.
independent consultant to recommend a compensation plan to a compensation committee. Bebchuck and Fried document how boards provide managers with more than they were contractually entitled to, granting “golden goodbyes” to executives when they retire, resign, or their firm is acquired, even when the performance of the manager is sub-par. Increased shareholders voice can empower shareholders so that they can require that any agreements of this sort shall be brought to shareholders approval at the general meeting, or again, at least that the board authority to do so shall be granted in the general meeting. Institutional investors can also be sensitive to the effects of executive pay levels on worker loyalty and public attitudes towards business. Conversely, each manager has an incentive to get the best deal he can.

Above all, the issue of executives’ compensation questions the wisdom of a corporate governance system that depends on boards to serve as guardians of shareholder interests, whilst largely insulating boards from intervention and removal by shareholders. Increased shareholder voice can reduce the insulation of the board, thus increasing the cost (to board members) of yielding to management and ameliorating the perverse incentive structure of the directors.

Deterrence and Targeting of Poor Performers

A further way for institutions to pursue corporate governance issues is to target poor performers. One sees this pattern in, for example, CalPERS' Focus on November 2004 CalPERS adopted a plan to tackle abusive executive compensation – according to the accompanying press release the plan is meant to target focused list of directors, corporations, and compensation consulting industry. One of the stated reasons to the plan was a research by Businessweek, stating that the average Chief Executive Officer salary has grown to 535 times the average worker's salary in 2000 from 42 times in 1980. See http://www.calpers.ca.gov/index.jsp?bc=/about/press/archived/pr-2004/nov/abusive-exec-comp.xml (last visited on June 1 2005).

I analyze directors’ incentives within the discussion of the SEC’s shareholder access proposal, nonetheless it should be noted, at this stage, that currently CEO’s has the power to reward directors and going along with him increases the chances of re nomination, both these factors tilt the directors’ incentives away from maximizing shareholders’ value.

The discussion in section 2.2 above sheds additional light on this subject and provides some empirical evidence. See p. 12 above.
List of Corporate Laggards. Last April the fund added behemoths such as AIG and AT&T to the list stating that “These… companies are now on our radar screen for their poor corporate governance and in many cases poor performance that has economically damaged shareowners.” Another example, this time not of activism by public institutional investors, is Robert Monks's 1991 campaign for election to the Sears Roebuck board, which has led to a turnaround that has saved the firm from collapsing and was estimated to have created $5 billion in additional value to investors.

Albeit such conduct may seem company-specific, defying the economics of scale logic, on a closer look, it involves economies of scale. Deterrence goals can explain why diversified institutions care about the severance pay of a particular CEO or the makeup of a particular board of directors. By focusing on a few egregious cases, the institutions send a message to other managers to mend their ways, lest they too become a test case for institutional pressure.

2.5 Shareholder Access to the Ballot

Notwithstanding the empirical evidence provided above as per the beneficial impact of shareholder activism on shareholder value and firm’s performance. Several financial empirical studies suggest that this activism, mainly in the form of proposals under rule 14a-8, has an insignificant effect on targeted firms' performance. Bernard Black, who in light of the empirical finance literature shifted from an optimistic assessment of institutional investor activism to that of a "pessimist," offers a set of possible explanations for the overall insignificance of activism: that most proposals are precatory and are

85 Sean Harrigan, former President of CalPERS Board implies that deterrence is one of the aims of this conduct by stating: "We will recognize the good guys who compensate for performance and we will call out some prime examples of those who are hurting long-term shareholder value by paying for lack of performance". See the link provided at supra note 79.
86 See section 2.2 above.
87 17 C.F.R. section 240.14a-8 (2000). I believe that the studies’ focus only on this form of activism, and not on the many avenues for activism described in section 2.2 above, is partially “responsible” to their findings.
88 For a survey of these studies see Black (1998) at supra note 9.
ignored by management; that institutional investors are unable to organize effectively to influence management or are uninformed about what issues to propose; and that the overall level of activism—a small number of institutions spending a trivial amount of money—is low.\textsuperscript{89} Even if there is much contradicting evidence as per the effectiveness of shareholder activism\textsuperscript{90}, and even if the focus on one avenue of activism has contributed to the results, there is good reason to believe that there is a need to increase shareholder power.\textsuperscript{91} Increasing shareholder power and granting them a lever vis-à-vis management and board of directors, which can be activated at low cost, would restrain management’s ability to ignore even the “precatory” proposals filed under rule 14a-8. Realizing that, the SEC is currently considering a proposal that all registrants subject to the proxy rules also be required to provide certain shareholders\textsuperscript{92} with direct access to the corporations’ proxy apparatus so that those shareholders could nominate at least one and up to three directors (short slate), depending on the size of the company’s board, to run in opposition to the incumbent’s proposed slate, if certain triggering conditions are satisfied (the “Proposal”).

2.5.1 Is Reforming Directors’ Election Process the Correct Course of Action?

Much of the blame for the recent governance crisis can be attributed to mediocre performance of the “guardians of shareholders’ interests”, the “supervising body”, the board of directors. Reforming corporate elections

\textsuperscript{89} Ibid at 463.
\textsuperscript{91} For a general discussion of the reasons for increasing shareholders’ power see Bebchuk (2005) at supra note 1.
\textsuperscript{92} Shareholders eligible to nominate directors must establish that they have beneficially held at least 5% of the company’s voting securities continuously for at least two years, and that they have filed beneficial ownership reports under schedule 13G. See Proposed Rule: Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (Oct. 23, 2003), section 14a-11(b).
\textsuperscript{93} The shareholder right to nominate directors is triggered if: (a) more than 35% of the votes cast at a meeting to elect directors are marked to withhold authority for the election of at least one of the registrant’s nominees for the board of directors; or (b) shareholders who have held at least one percent of the registrant’s voting securities for at least a year submit a shareholder proposal, pursuant to Rule 14a-8, that the shareholder nomination provision of Rule 14a-11 be triggered, and that proposal receives the affirmative support of more than fifty percent of the votes cast on that proposal. See ibid. at sections 14a-11(a)(2)(i) and 14a-11(a)(2)(ii). Any shareholder’s ability to participate in this process is conditioned on the requirement that “applicable state law does not prohibit the registrant’s security holders from nominating a candidate or candidates for election as a director.” See ibid. at 14a-11(a)(1).
would improve the selection of directors and the incentives they face. Directors have wide discretion to make or approve important decisions, and courts adhere to these decisions. Inter alia, directors have the power to block managers from engaging in value decreasing empire building, as well as to set the compensation (and thus shape the incentives) of the firm’s management.

In theory, shareholders’ power to replace directors should ensure that they will use their powers in shareholders’ best interests, making them accountable to shareholders. Albeit shareholder power to replace directors is the corner stone of most corporate laws worldwide, it is largely a myth. Empirical evidence demonstrates that attempts to replace directors are extremely rare, even if the firm is consistently under performing for prolonged periods of time. In most cases directors nominated by the company run unopposed and thus their election is secured. Remaining on the firm’s slate is a key element to directors who seek re-election. Whether the nomination committee is controlled by the CEO or by independent directors, incentives to serve the interests of those making nominations are not necessarily identical to incentives to maximize shareholder value. Other than ensuring re-election directors subordinate shareholders’ interests to those of the executives for an array of other reasons: CEO has power to reward directors with pecuniary and non-pecuniary benefits, collegiality and team spirit causes directors to prefer the interests of their group, social studies of group dynamics demonstrate the tendency of board members to defer to company’s leader and that loyalty and friendship causes the directors to succumb to the management. Further, cognitive dissonance causes directors who are current/former executives, to prefer their peer group. Cognitive dissonance also causes incumbent directors to resent shareholder nominees, as they grasp admitting them as acknowledging previous underperformance on their part.

For the avoidance of any doubt, shareholders who are displeased with their board can nominate director candidates and then solicit proxies for them. The

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94 In the SEC Roundtable, Nell Minow from The Corporate Library, commented, cynically, “As for attracting people to be on boards, you know what? We've been attracting the wrong people. *Boards always ask for consensus builders,* and they're lovely people to have. I don't happen to be one, but they are wonderful people to have.” See SEC Roundtable supra note 4.
costs and difficulties involved in running such a proxy contest, however, make such contests quite rare. Traditional proxy contests create a classic public good problem; the bearers of the costs cannot exclude other free riding shareholders from the benefits of their corporate governance activities. The initiators of a proxy contest capture only a fraction of the corporate governance benefits that a successful contest would produce. An offsetting factor of this collective action problem stems from the substantial holdings of institutional investors. A shareholder that holds 1 million shares captures 1000 times the benefits that a shareholder that holds 1000 shares captures. Therefore, the former has 1000 times stronger incentive to become active or at least to cast an informed vote than the later. Thus, “the incentive to cast an informed vote increases exponentially as shareholdings grow.”

L. Bebchuk has summarized the case for increasing shareholder access to the ballot very eloquently noting that:

“The safety valve of potential ouster via the ballot is currently not working. In the absence of an attempt to acquire the company, the prospect of being removed in a proxy contest is far too remote to provide directors with incentives to serve shareholders. Confronting poorly performing directors with a non-negligible risk of ouster by shareholders would produce such incentives.”

2.5.2 The Cost of Insulation

There is abundant empirical evidence that insulation from removal via a takeover has adverse impact on management performance and on shareholder value. There is also evidence that greater insulation results in higher consumption of private benefits. Borokhovich et al, found that firms with stronger antitakeover defenses provide higher levels of executive

95 For a general discussion of the collective action problems that plague proxy contests, see e.g., R. C. Clark, Corporate Law 390-396 (1986), and L. A. Bebchuk and M. Kahan, A Framework for Analyzing Legal Policy Towards Proxy Contests, 78 CAL. L. Rev. 1073, 1088-1096 (1990).
96 See, Black (1992) supra note 6 at 822.
98 See supra notes 27, 29, 30, and accompanying text.
compensation⁹⁹. In addition, a study by Bebchuk et al, found that targets with strong takeover defenses, and in particular effective staggered boards, engage in value-decreasing resistance to hostile bids¹⁰⁰. Targets of hostile bids that have an effective staggered board are much more likely to remain independent both in the short-run (twelve months) and in the long-run (thirty months) even though remaining independent makes their shareholders much worse off both in the short-run and in the long-run. On average, the shareholders of such targets that have staggered boards earn returns that are lower by more than 20%.

For the avoidance of any doubt, the empirical evidence presented does not provide a stylized picture of the consequences of granting or denying shareholders access to the corporate ballot. Nonetheless, the evidence indicates palpably that existing levels of seclusion are harmful to shareholders and the economy. It thus provides broad justification for reforms that would reduce management’s insulation. Allowing shareholder access to the ballot would be a moderate step in this general direction.

Because the proposal constitutes a significant deviation from the current state of insider control over the proxy apparatus it has provoked much criticism from prominent figures. Below I investigate weather this criticism provides any ground for repudiating the Proposal and preserving the present state of affairs.

2.5.3 Shareholder Access Would Have No Efficacy
Opponents of the proposal claim that it doesn’t justify its costs because “it will not likely result in significant numbers of shareholder-nominated directors being elected¹⁰¹”. The accumulated evidence buttresses the contention that money managers will not sponsor or initiate a dissident slate. Mutual funds

¹⁰¹ Letter from Robert Todd Lang, Co-Chair, the Task Force on Shareholders Proposals and Charles Nathan, Co-Chair, Task Force on Shareholders Proposals, ABA Section of Business Law, to the SEC 11 (June 13, 2003) available at http://www.sec.gov/rules/other/s71003/aba061303.htm
are at most “reluctant activists”\textsuperscript{102}. Inter alia, money managers would not wish to dedicate managerial resources to a contest over one firm’s governance because they focus on trading\textsuperscript{103} and portfolio management\textsuperscript{104} and they would wish to avoid any risk of litigation or company retaliation.

One can reasonably assume, however, that when other shareholders nominate a dissident short slate whose success would likely raise share value, such money managers would vote for this slate. And given the past activism of public pension funds (long run investors who can’t follow the wall Street rule due to size and indexing) and their statements at the SEC Roundtable, it’s reasonable to maintain that there will be powerful shareholders who will initiate a substantiated dissident slate. Further, it should be noted that the benefit of the proposal does not lie in the number of actual shareholder nominees who actually make it to the board room. Rather, the substantial gain would accrue ex ante in the form of improved incentive structure of more accountable directors.

2.5.4 Independent Nominating Committees Obviate the Need for Shareholder Access

Another argument against the Proposal is that it’s superfluous because shareholders can promote their nominees by presenting their candidacy to the nominating committee, which under a reform already underway shall be comprised exclusively\textsuperscript{105} of independent directors. As elucidated above, independent directors are not a panacea and there is no guarantee that their being independent from management tilts their incentives in favor of shareholder value maximization. On the contrary, the fact remains the same.


\textsuperscript{103} The incentive to trade rather than monitor is weakened by the general trend to use indexing as an investment tool, because it renders exit impossible. Albeit to a lesser extent than Public pension funds it seems reasonable to assume that private funds are also substantially indexed. Further their size makes it difficult to dispose of large holding without bearing substantial losses due to adverse price effects.

\textsuperscript{104} Eric Roiter of Fidelity, somewhat reaffirms this view stating that “In my view, if you think that stock is over-valued (because the board is hidebound you shouldn’t wait to the next GM and nominate a minority director that might turn the firm’s fortune to the benefit of all share holders), and you can find a stock that has a more reasonable value in the market, you should be selling the over-valued stock and buying the under-valued one”. Albeit stressing the important role of the Wall Street rule, Mr. Roiter agrees that the Proposal “can add to an overall improvement in corporate governance”. See SEC Roundtable at supra note 4. Further, for contradicting evidence on the activism and effectiveness of money managers, see Palmiter (2002) at 1435, at supra note 90.

\textsuperscript{105} See an E-mail from Henry A. McKinnell, Chairman and CEO, The Business Roundtable, to Jonathan G. Katz, Secretary, SEC (June 13, 2003), at \url{http://www.sec.gov/rules/other/s71003/brt061303.htm} at 3.
that to ensure re-election even an independent director should remain on the firm’s slate, which is controlled by its CEO, who also controls an entire set of pecuniary and non-pecuniary benefits which directors covet. Furthermore, even if independent nominating committees would by and large do the right thing, that doesn’t obviate the need for a safety valve\textsuperscript{106}, that would empower shareholders with adequate means to apply pressure on the committee. Moreover, shareholders should be able to replace directors in the event of ubiquitous discontent with the independent nominating committee and board, in which case independent nominating committees cannot be relied upon to cure the problem. Shareholder access to the ballot would not be made unnecessary but rather would suitably complement the future operation of independent nominating committees.

2.5.5 The Proposal Would Yield Costs Due to the Occurrence of Contests

Opponents of the Proposal distinguish between two manners in which the occurrence of contests would generate costs: contested elections would cause disruption and waste of resources or discourage potentially good directors from serving.

Shareholder Access Would Cause Disruption and Diversion of Resources

Critics paint a grim picture in which shareholder access yields large-scale disruption of corporate management. Contested elections would require the company to incur substantial out-of-pocket costs, wasting company resources. More importantly, they would divert management’s effort and attention. The resulting reality of wide-spread full scale elections, critics argue, “would be very unhealthy for our nation’s companies”\textsuperscript{107}. There is no reason, however, to assume that this bleak picture would become a reality. Full scale contests that attract vast managerial resources would occur only seldom, exactly in those cases in which widespread shareholder dissatisfaction would be coupled with

\textsuperscript{106} At the SEC Roundtable Richard Moore, mentioned in supra note 17 above, commented on shareholders need of that safety valve noting that “And the reason we need this particular avenue (the option to use firm’s apparatus for distributing short slate vote) is because….. the total loss of an inside check, a situation where it's totally a group of people spending other people's money. In many instances, it's a lot like government in large, publicly-traded companies. We need this outside check. This is an appropriate outside check. See SEC Roundtable supra note 4.

\textsuperscript{107} Letter from Wachtell, Lipton, Rosen & Katz, to Jonathan G. Katz, Secretary, SEC (June 11, 2003), at http://www.sec.gov/rules/other/s71003/wachtell061103.htm at 2 (Last visited on June 1\textsuperscript{st}, 2005).
consistent underperformance\textsuperscript{108}. After all, it is those critics who contended that money managers are “reluctant activists” who seldom vote en masse against management\textsuperscript{109}. Even if critics’ suspicion that management launching a full scale campaign would become the norm, merited validity, it can be very well remedied through adjustment of the threshold set in the Proposal for launching a contest. Nonetheless, it doesn’t provide a valid reason for denying shareholder access. Moreover, the shareholder access regime would improve selection and incentives of directors in many corporations, leading to a wide range benefit that more than justifies the costs that few, poorly managed firms, would suffer as a result of a contest.

\textit{Shareholder Access Would Deter Good Directors from Serving on Boards}

Yet another argument the Proposal’s opponents make, is that the occurrence of elections might deter good directors from serving on boards of public companies\textsuperscript{110}. Surely, every position would be more tempting if it were coupled with immunity from removal. And yet, companies don’t grant the lion’s share of their employees immunity from removal, even though doing so would mitigate the employer’s compensation expenditures. I suspect it is because employers wish to preserve the employees’ incentives and to prevent complacency\textsuperscript{111}. Given the fact that board is the supervising body, whose actions have substantial impact of shareholder value, improving directors’ incentives via shareholders’ access should prevail over the erosion of, this well paid and prestigious position, attractiveness. Even if shareholder access did yield this adverse effect\textsuperscript{112}, shareholders would be better off countering this effect with increased pay rather than with reduced accountability.

\textsuperscript{108} As always the devil is in the details, the Proposal requirements of qualified shareholders and triggering events that require a majority of the vote cast, deny the possibility of small interest groups pursuing contests that serve their own narrow interest. Further, the SEC can always adjust the thresholds after experience has been accumulated to ensure that full scale contests don’t become the norm.
\textsuperscript{109} For that reason critics asserted that the Proposal would have no practical meaning.
\textsuperscript{111} Israel’s public sector is filled with employees who were granted permanency status that immunes them from removal. And, indeed, many economists and commentators put the blame for the mediocre performance of Israel’s public sector exactly on this immunity, which erodes the employees’ incentives, to excel or give the citizens good service.
\textsuperscript{112} There is some evidence that even in companies in which shareholders successfully employed strict standards and stringent governance structure; the director’s position still lured many people. As Mr. Richard C. Breeden, mentioned in supra note 16, commented in the SEC Roundtable “And lastly, I just wanted to respond to the idea that we can’t find good board members in this country. I think some companies have problems finding board members, and it may be because those companies, these days are perceived as having unresponsive boards, and boards that aren’t doing a
All of the above criticisms share a common premise that, regardless of the outcome, the mere occurrence of contests would harm corporations and their shareholders. Opponents also claim that, in those instances in which shareholder-nominated candidates would in fact be elected, additional costs would be imposed. In particular, critics claim that the election of shareholder-nominated candidates would (i) bring into the board “special interest directors”, and produce balkanized and dysfunctional boards, and (ii) produce directors that would be less qualified and well-chosen than the company-nominated candidates.

Critics claim that unlike company nominated directors that act in the best interest of all shareholders, shareholder nominated directors would be committed to advance the views, social, environmental or otherwise, of a fraction of the shareholders, those who nominated them. Considering this argument we should bear in mind that shareholder nominated directors could be elected only by a majority vote, and such a majority cannot be formed if the candidate is seen by shareholders as representing a special interest. Moreover, given the tendency of money managers to vote with management and to pursue the single goal of shareholder value maximization, a special interest candidate would be unable to attract their support.
Another possible objection is that even if elected by a majority of the shareholders a director would bend in favor of the nominating group interests in order to secure re-nomination\textsuperscript{115}. Interestingly though, the critics ignore the fiduciary duties a director owes to all of the shareholders, a fact which they rely heavily on when considering the merits of company candidates to the board. Nonetheless, to the extent that this issue poses a serious concern the Proposal could be modified so that a shareholder nominated candidate that has been elected would appear automatically on the ballot in the next election. This modification would not ensure re-election but rather ensure that the specific director is considered only on the merits of her contribution assessed by a majority of shareholders.

Even if shareholders nominee would be a good choice on a stand alone basis, opponents of the Proposal argue, it would have adverse effects on the board functioning as a team, infringing the collegiality and harmony of work in between board members and between directors and the firm’s top executives. Critics argue that the election of a shareholder nominated candidate would produce balkanization, politicization, and dysfunction of the board\textsuperscript{116}. It is unwarranted that the election of a shareholder nominee would produce such division and discord. Elected directors would be unlikely to represent special, parochial interests not shared by the other directors. Rather, they would be candidates with appeal to a majority of the shareholders, including most money managers, and with commitment to enhancing shareholder value. Other directors should not have legitimate reasons either to be on guard against such shareholder-nominated directors or to treat them with suspicion.

Either way, institutional investors, repeatedly engaged in the election of a shareholder-nominated candidates, would be aware of whatever costs in terms of board discord might result from such a choice. Shareholder-nominated candidates thus would be elected only when shareholders would conclude that,

\textsuperscript{115} See Letter from Michael J. Holliday, Chairman, Committee on Securities Regulation, Business Law Section of the New York State Bar Association, to SEC 6 (June 13, 2003), at http://www.sec.gov/rules/other/71003/secblsnyb061303.htm

\textsuperscript{116} See Lipton & Rosenbaum at supra note 107. In this vicinity it should be noted that some commentators at the SEC Roundtable have put the blame for boards’ failure to perform their gate keeping function in all the corporate scandals on companies’ tendency to seek consensus builders to the board rather than people that would ask the difficult questions. See supra note 94.
on the basis of a cost benefit analysis the election of some shareholder-nominated candidates is desirable overall. When board performance is poor enough and shareholder dissatisfaction is strong enough that shareholders would likely elect a shareholder-nominated candidate, it would be unwise to preclude such nominations in the name of board harmony.

**Shareholder Access Would Yield Sub-Par Directors**

Critics also argue that shareholder-nominated directors would be less qualified than those nominated by the company’s nominating committee, who may fail because a less qualified director was nominated by the shareholders\(^{117}\).

This concern reflects the critics’ belief that in the election of a shareholders’ nominated candidate the shareholders would be making a bad and unwise choice. The little confidence opponents have in shareholders choices stands in stark contrast to their robust confidence they place in the choices of the nominating committees. The predominant justification for this confidence is that independent directors have a fiduciary duty running to all shareholders. They can therefore be trusted to make the right choices, it is argued, unlike nominating shareholders who do not have the same duty to act in the best interests of the other shareholders of the corporation\(^{118}\).

The question, however, is not whether nominating committees or qualified shareholders are better at selecting candidates. It should be reiterated that a shareholder-nominated candidate would be elected only with the support of a majority of the shareholders. Thus, the question is whether shareholders should ever be given a chance to prefer a shareholder-nominated candidate over a board-nominated candidate, realizing their franchise in the corporation\(^{119}\). It’s unreasonable to expect that, in those occasions in which a

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\(^{117}\) The following concern expressed by the Business Roundtable is typical: “For instance, a nominating committee may determine to seek out a board candidate who has desired industry or financial expertise . . . . However, as a result of shareholder access to the company proxy statement, such a candidate might fail to be elected because of the election of a shareholder-nominated director who does not possess such expertise.” See, SEC Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors 32, 33 (July 15, 2003), at http://www.sec.gov/news/studies/proxyreport.pdf at 3.

\(^{118}\) E-mail from Sullivan & Cromwell, LLP to Jonathan G. Katz, Secretary, SEC 3 (June 13, 2003) at http://www.sec.gov/rules/other/s71003/sullivan061303.htm

\(^{119}\) At the SEC Roundtable Mr. Damon Silvers (Employee representatives) commented on the issue of shareholders qualification to interfere in such decisions noting that “And, in fact, what’s left is…. There's no one -- no one -- who is
majority of shareholders would choose a shareholder nominee over a board nominee, they would generally be making a mistake.

First and foremost, if anyone has an interest to make choices that would be in the best interests of shareholders, the shareholders do. Even if nominating committees can be relied on to be solely concerned with shareholder interests most of the time, it is also possible that they would occasionally be influenced by other considerations. Accountability is important because the interests of an agent and principal do not always fully overlap, and independence from management doesn’t ensure dependence on shareholders. Shareholders, by definition, will always have an incentive to make choices that would serve shareholders.

Incentives apart, are shareholders capable of making the optimal choices? Some critics claim that nominating committees have an informational advantage over shareholders and better skills for the task. Albeit institutional investors might not have the same skills or information, its unwarranted to assume that they are unaware of any informational or other advantage possessed by the board and its nominating committee. Institutional investors usually display a substantial tendency to defer to the board, and that state of affairs is unlikely to be altered if the Proposal were to be implemented.

In some instances, however, the circumstances, including, the past conduct of incumbent directors, or a given candidate’s attributes might lead shareholders to conclude that they would be better off voting for a particular shareholder-nominated candidate. Even if shareholders might be occasionally wrong, given that their money is on the line, shareholders naturally would have incentives to make the decision that would best serve their interests. And there is no reason to expect that choices they would make in favor of a shareholder-nominated candidate would likely be wrong. The fact that choosing candidates under the really worthy to hold the CEO accountable. Their answer, three years after Enron, is no one. No accountability. Nothing. And that answer just doesn't pass the laugh test. The Commission has crafted a proposal that, in the opinion of many of us in the worker shareholder community, is not strong enough, but it does have the -- it is conceptually correct. It has the right approach to the question of who? Who holds them accountable? Because the answer "no one" just doesn't work. And that, I think, is the -- that is the issue on the table. And it is connected to this question of collegiality.” See at supra note 4.
Proposal relies heavily on institutional investors, who are long term investors aware of any decision making disadvantages they might have, makes such a paternalistic approach especially unwarranted. Indeed, institutions can hardly be regarded as excessively reluctant to defer to management. When circumstances convince shareholders to overcome their tendency to defer to management, there is little basis for paternalistically viewing their choices as misguided.

2.5.7 Miscellaneous Costs

Shareholder Access Would Create Costs to stakeholders

Opponents of the Proposal also claim that even if it were to make directors more amenable to shareholders, it may very well make directors too amenable. The board, it’s argued, has to weigh not only the interests of the shareholders, but also those of many other constituencies, such as employees, creditors, suppliers etc. Allowing shareholders to nominate directors would pressure the directors to concentrate on the interests of the shareholders neglecting the, often competing, interests of stakeholders\(^\text{120}\).

It is overreaching to conclude that insulating boards from shareholder nominations would benefit stakeholders. The interests of directors are less aligned with those of stakeholders than they are with those of shareholders. Directors do not hold any instruments that tie their wealth to the wealth of stakeholders, whereas they usually hold options or shares, which makes their interests more congruent with those of shareholders. Therefore, there is little reason to believe that reduced accountability to shareholders would translate into greater attentiveness to stakeholders. By making directors accountable to no one, and immunizing them from removal even in instances of dismal performance, the current system creates costs to both shareholders and stakeholders\(^\text{121}\).

\(^{120}\) See, Lipton & Rosenbaum supra note 107.

\(^{121}\) For a general discussion of how stakeholder-based arguments do not provide a reasonable basis for limiting shareholder power, see Bebchuk (2005) supra note 1 part VI.
The Shareholder Access is Over Conclusive

Opponents of the proposal claim that it prescripts a uniform solution to a diverse corporate universe, containing companies that vary greatly in their characteristics and circumstances. One size, it is argued, doesn’t fit all. Even if implementation of the Proposal would benefit some companies, it would have no benefit or even adverse effects for many other companies. Assuming this argument merits validity, all it implies is that the proposal has to be modified, enabling corporations to opt out of the rule subject to shareholder approval. Therefore, the considered argument cannot provide a basis for a general opposition to the Proposal, at most this claim implies that the Proposal has to be modified enabling either opting out from a default arrangement or opting in into an otherwise nonbinding arrangement.

2.5.8 Now is not the Time to Implement the Proposal

Not only do critics of the shareholder access question whether it was ever desirable but also they argue that, given recent sweeping reforms, now is not the time to consider the Proposal. Building on the premise that gradual changes are always preferable, critics argue that, until the scope and effects of initiatives already implemented is fully understood, the Proposal has to be shelved. Given the prolonged time it would take companies to adjust to the reforms and for the empirical evidence about their effects to accumulate, these arguments imply freezing the Proposal for years, a common procedure to dissipate reforms in the public domain. Albeit augmenting the recent reforms with the proposal would indeed produce a monumental change in corporate governance, the sheer magnitude of the change shouldn’t dissuade us from realizing it. These groundbreaking changes is a proportionate reform to the epic crisis in corporate governance and loss of investors’ confidence.

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122 See, supra note 105, at 5 (noting “the diversity that exists among the roughly 14,000 publicly-owned companies, which vary greatly in size, industry, complexity, resources, ownership and other circumstances”).

123 These reforms include the 2002 Sarbanes-Oxley Act and the new listing standards of the stock exchange.

124 See also Letter from Broc Romanek, Chair, Corporate & Securities Law Committee, American Corporate Counsel Association, to John G. Katz, Secretary, SEC (June 13, 2003), at http://www.sec.gov/rules/other/c71003/acca061303.htm ("Until the impact [of Sarbanes-Oxley Act] can more accurately be assessed, we believe it is appropriate to wait before making the proposed changes.")
Yet another justification for postponing the implementation of the Proposal is that the problems it is meant to solve might be fully addressed by the reforms. Because the recent changes in stock exchange listing requirements would place the nomination of directors in the hands of independent directors, critics argue, they would “obviate the need for direct shareholder access to the issuer proxy statement.” The discussion in section 2.5.3 above addresses, inter alia, the reasons why independent nominating committees do not obviate the need for the safety valve provided for by the Proposal.

2.5.9 Beyond the Proposal; Who Will Bear the Cost of Campaigning?

To have a meaningful chance of success at nominating a short slate, challengers would have to expand vast resources to present their case effectively to shareholders. In the case of a large cap company, the costs of printing and postage for just the first mailing are a “million dollar proposition” and a serious contest might require more than one mailing. Further, the costs of getting a mailing “to the point where you can legally send it, meaning writing the documents and getting it through the SEC process is between 250,000 and 500,000 dollars, if it is not seriously contested”.

Theses costs will usually be higher since whenever incumbents feel there is a viable chance of their removal they are likely to extend vast resources to defeat the rival nominees. Institutional investors may be reluctant to expend their client’s capital to such costly campaigns, even if they are certain that a successful campaign would enhance shareholder value. Scholars that investigated the costs of a proxy contest concluded that it would be desirable to reform the rules governing the financing of proxy contests. These reforms are especially essential in cases of contests over shareholder nominated short slate, in which a victory would not grant the winners control over the board.

125 See Sullivan and Cromwell, supra note 118 at 3.
127 See ibid at 84.
128 The concern that the costs of running a short slate would remain too high even if companies were required to include shareholder nominations in the company’s proxy materials is shared by Robert C. Pozen, ex chairman of Fidelity. See Robert C. Pozen, Institutional Perspective on Shareholder Nomination of Corporate Directors, 59 Bus. Law (2003). Further, at ibid on p. 62-64 Mrs. Sarah Teslik, executive director of the Council for Institutional Investors, describes how the costs of launching a proxy contest discourage challenges.
129 See Bebchuk & Kahan, (1990) at supra note 95, p 1135.
and thus, as most state laws stipulate, no reimbursement for the proxy expenses. Accordingly, the SEC would act wisely if it were to supplement the Proposal, ensuring that, at least when the challenger in such a contest attracts substantial shareholder support\textsuperscript{130}, the company would bear part or all of the challenger’s expenses (distribution of proxy materials and legal fees in connection with their preparation).

Opponents of the Proposal have raised a wide range of objections to such reform. An examination of these objections, however, indicates that they do not provide a good basis for opposing a well-designed shareholder access regime. Such reform would contribute to making directors more accountable and would improve corporate governance. The proposed shareholder access arrangement would be a moderate step in a beneficial direction.

2.6 \textit{Indirect Monitoring and the Role of the ISS}

Institutional investors’ incentives push against direct involvement in portfolio companies’ management. Therefore, indirect monitoring through the board of directors\textsuperscript{131} or trade groups and informal communication between corporate managers and institutional investors are the cornerstone of institutional voice. In the UK, where institutions enjoy much leeway for activism, American style proxy contests are quiet rare and most activism wears the form of informal jawboning.

Indirect monitoring can be achieved, inter alia, by encouraging or funding block-holding funds who will bear the legal risks involved in holding large percentage stakes, and thus mitigate the affects of legal barriers to joint action and enhance the shareholders overall lever vis-à-vis management. An epitome

\textsuperscript{130} For example when a group of predominant shareholders unite and present a joint short slate exercising Institutional Voice.

\textsuperscript{131} An alternative to institutional directors is a shareholder advisory committee, through which representatives of a company’s largest shareholders would meet periodically with top management to listen to the managers’ plans for the future and express shareholder concerns. I conceive shareholder advisory committees as a poor substitute for institutional directors. If shareholder advisory committees become popular, no doubt CEOs and CFOs will learn to tolerate a semiannual meeting with an advisory committee. But it's unclear whether the institutional representatives will know enough about particular companies to ask hard questions at these meetings, or whether managers will pay more attention to shareholder complaints voiced at such a meeting than they now do to complaints through letters or telephone calls. Commentators such as Gilson & Kraakman are also skeptical about shareholder advisory committees. See, Gilson & Kraakman (1991) at supra note 56, p 871-72.
of this form of indirect monitoring is the emergence of "white squire" funds, funded mainly by institutions, with the stated goal of acquiring large equity stakes that will give them both the incentive and the ability to monitor company managers. Yet another avenue of indirect monitoring is blockholding by a single institution that has developed a reputation for not abusing power and for promoting the interests of shareholders as a group. Warren Buffett's Berkshire Hathaway is the prototype. Berkshire has bought large stakes in a number of companies, and Buffett took over as CEO of Salomon Brothers after a scandal forced the old CEO to resign. This style of friendly investing isn't possible, though, when managers react to a large shareholder with instant hostility.

The need to aggregate power across institutions has led some institutions to rely on trade groups and independent advisors to coordinate governance initiatives. These organizations give voting advice, develop opinion papers on governance issues, sponsor research, and raise the salience of particular issues. Trade groups can also develop lists of director candidates and criteria for assessing director performance; the ISS director database is a quintessential example. Today, the ISS is the world's leading provider of proxy voting and corporate governance services. ISS serves more than 1,300 institutional and corporate clients worldwide, analyzes proxies and issues informed research and objective vote recommendations for more than 33,000 companies across 115 markets worldwide. Between the shares that the ISS votes on behalf of clients and the shares held by institutions that follow ISS recommendations, an ISS recommendation can make a 15-20% difference in the support that a shareholder proposal receives. Consequently, shareholder proponents often tailor their proposals to meet ISS guidelines on which proposals it will support and devote significant efforts to win that support. Company managers, in turn, lobby ISS to oppose shareholder proposals and

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133 The principal trade groups are the Council of Institutional Investors, the Investor Responsibility Research Center, and Institutional Shareholder Services (ISS).
135 See, Black (1998) supra note 9 at 466.
approve management proposals on issues such as mergers\textsuperscript{136}. From a theoretical standpoint, the ISS is a specialized informational intermediary, which flourishes because its existence lowers institutions costs of casting an informed vote and enables higher quality voting. The ISS prominence reaffirms the importance of voting for institutions.

To prevent doubts, trade groups won’t make a difference without some direct institutional support. In the UK, for example, pension funds, mutual funds, insurers, and investment trusts each have their own trade group\textsuperscript{137}. The trade groups facilitate communication between shareholders and sometimes form committees to analyze particular troubled companies. These committees have successfully dealt with some specific situations, but at other times the trade groups have seemed to be paper tigers\textsuperscript{138}.

After having discussed the potential merits of institutional voice and the areas in which it could yield maximum social gain and after having presented the case for allowing shareholder access to the corporate ballot via the corporate proxy apparatus, I turn to addressing the potential dangers of increased institutional powers and demonstrate that the risks are remote.

3. \textit{The Dangers of Increased Institutional Power}

This section addresses the central concerns with institutional power and argues that the risks from institutional \textit{voice} are limited. Subsection 3.1 discusses generally the issues raised when we ask money managers -- themselves imperfectly monitored agents -- to watch corporate managers. Subsections 3.2 and 3.3 evaluate the principal consternations: will money managers divert

\textsuperscript{136} The relentless efforts that HP’s former CEO, Carli Fiorina has made to gain the ISS support in the HP Compaq merger demonstrate the decisive importance of the ISS. See, Pui-Wing Tam & Gary McWilliams, H-P Garners Major Endorsement Deal— ISS Advisory Firm Backs Acquisition of Compaq, \textit{Wall St. J.}, Mar. 6, 2002, at A3 (reporting that “many money-management firms take ISS’s reports into account before voting in a proxy battle”). Further, ISS’s recommendation to shareholders to vote in favor of Procter & Gamble Co.’s $57 billion acquisition of Gillette Co. helped brushing aside Massachusetts Secretary of State William F. Galvin's concerns about the deal. See, Andrew Caffrey, Key Investor Group Endorses P&G’s Acquisition of Gillette, \textit{The Boston Globe}, June 28, 2005.

\textsuperscript{137} E.g., the National Association of Pension Funds

\textsuperscript{138} See, generally, Artus, Tension to Continue, in \textit{Creative Tension? 12, 12-13 National Association of Pension Funds, Ltd. (1990).} A series of essays on issues arising from the relationships between British public companies and institutional investors.
corporate income to themselves at the expense of other shareholders; will money managers focus myopically on short-term gains or cause managers to do so, and subsection 3.4 deals with ancillary concerns with institutional voice: facilitating antitrust violations and insider trading.

Common themes in the literature’s response to these concerns include the limited incentives of money managers to breach fiduciary duties or other legal rules because they are agents and lose much more if they're caught than they gain if they succeed; the ability of money managers to watch each other; the role of diversification in giving money managers incentives to preserve reputation and in reducing incentives to cheat; money manager fear of political reaction to abuse of institutional power; and the need to balance the risk of institutional abuse of power against the certainty of corporate manager abuses under the existing system. Moreover, the accumulated evidence from a decade of institutional activism proves that none of the alleged dangers have materialized and they all remain theoretical at this stage.

It should be noted that effective oversight of corporate managers and bulletproof protection against money manager abuses, is unattainable. The downside risks from institutional voice are modest, and outweighed by the potential gains. In contrast, institutional control has both large potential benefits and large potential costs. We are on safer ground if one institution can't do too much by itself.

3.1 Money Managers Watching Corporate Managers

Institutional Voice involves principals (investors or beneficiaries) hiring a first-tier set of agents (money managers) to watch a second-tier set of agents (corporate managers). The first-tier agents are often themselves organizations with principal-agent problems. Some money management firms are publicly

139 See, part IV in Black (1992) at supra note 6.
held, with fiduciary obligations both to investors and to their own shareholders.

The desirability of this monitoring structure rests on the institutional specific factors\textsuperscript{140}. On the corporate manager side, what incentives do corporate managers have to act as faithful agents of investors; what opportunities do corporate managers have to divert corporate wealth to themselves or simply fritter it away; what legal or other factors limit stealing or mismanagement; how will corporate managers react if watched more closely by money managers\textsuperscript{141}; and can corporate managers subvert the watching process by buying off the money managers\textsuperscript{142}. On the money manager side, how well can money managers watch corporate managers; what incentives do money managers have to watch well; can money managers enrich themselves at the expense of investors or other shareholders; what legal or other factors limit stealing or shirking by money managers; how well can investors or shareholders of money management firms watch money managers; how well can money managers watch each other; and can corporate managers watch their watchers and complain to investors or legislators if money managers misuse their power.

Because there are half-a-dozen different types of institutions, each with its own governance, culture, incentives to watch, and opportunities to shirk or steal; different institutions may need different rules. Moreover, since monitoring will occur repeatedly across companies and across time, reputation imposes an important constraint on money manager actions. Monitoring will also take place in a complex political environment, where real or perceived abuses may provoke a political response. Fear of political intervention will constrain money managers in a way that it cannot constrain corporate

\textsuperscript{140} For a theoretical discussion of the value of having agents watch other agents, see Varian, Monitoring Agents with Other Agents, (1990) \textit{J. Institutional & Theoretical Econ.} 153.

\textsuperscript{141} See Shleifer & Vishny, Management Entrenchment: The Case of Manager-Specific Investments, 25 \textit{J. Fin. Econ.} 123 (1989), explore ways that corporate managers can, through investment decisions, make monitoring more difficult.

\textsuperscript{142} Gordon, Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law. 60 \textit{U. Cin. L. Rev.}(1991), develops a multiple principal/single agent model of the corporation, in which greater shareholder voice can be counterproductive because corporate managers can use corporate funds to bribe some shareholders at the expense of others, or because divergent shareholder preferences lead to cycling among various outcomes.
managers, because the money managers are playing a repeated game. In addition, money managers will be more closely watched as monitors than corporate managers are today. Money managers can watch each other in a way that corporate managers cannot. Also, stronger oversight of public companies will include stronger oversight of publicly-held financial institutions.

From the investors’ standpoint watching money managers is much easier than watching firms’ management. Money manager performance is more readily quantifiable (which may also limit its incentive to expand resources to monitoring so as not to present sub-par return due to expenses). For most institutions, if performance lags, investors or pension sponsors can change money managers. Conversely, shareholders can’t withdraw equity capital from companies. Thus, they must act jointly to affect corporate managers, with attendant collective action problems.

3.2 Will Institutional Investors Divert Corporate Income to Themselves?

An inherent worry to empowering only part of the shareholders is that this part will use its strengthened position to divert corporate funds to itself. For instance, banks, insurers, and mutual funds can use their influence to obtain business and public pension funds can trade votes for local jobs. This concern is ameliorated thanks to several factors that constrain the institutions’ ability and thus tilt their incentive structure away from diverting corporate income. These factors include: the ability of institutions to watch each other (3.2.1); legal constraints, especially fiduciary duties and public disclosure requirements (3.2.2); the ability of corporate managers to watch their watchers, enhanced by institutional fear of managements’ political clout (3.2.3); and the reality of institutional voice that operates most effectively indirectly through institutional directors, trade groups, and the ISS (3.2.4). Moreover, income diversion is principally a wealth transfer and only secondarily an efficiency loss (3.2.5).
The limits on institutional ability to abuse power aren't bulletproof. But if we keep the institutions weak, we enable abuse of power by corporate managers. The likely magnitude of institutional income diversion is a fraction of the evidenced diversion by corporate managers. Institutional voice may prevent future mega collapses like Enron and WorldCom that have sent shock waves through the economy and create social savings that may compensate for a lot of sins. And that's income diversion alone, wholly apart from any operating shortfalls that institutional voice has already corrected in the past and would certainly ameliorate with intense vigor under the suggested reforms.

3.2.1 Reciprocal Watching by Other Institutions

A fundamental feature of institutional voice is the need for shareholders to collaborate to influence corporate managers. Enforced collaboration, such as the one required under the shareholder access proposal\(^\text{143}\), enables money managers to watch each other. The predominant institutions interact over and over on a variety of issues, enhancing reputation impact as a constraint on income diversion. Institutions who have a reputation for playing straight will elicit cooperation from their counterparts and, conversely, institutions who cheat will invite non-cooperation or retaliation. Diversification means that an institution gains little and risks much by cutting a side deal with a single company. Nor is it obtainable for a half-dozen institutions to accord to share private gains. Confidentiality is practically unattainable given multiple parties, disclosure rules with stringent penalties, and corporate managers' desire to constrain the institutions. Multiple attempts will surely become public, and occasional action won't affect overall portfolio performance. Even if secrecy was assured, a multiparty deal among different types of institutions would be hard to put together. The institutions can readily agree to do what's good for the company, but they may have trouble agreeing on much else.

\(^{143}\) As discussed above under the shareholder access regime a shareholder interested in nominating a short slate would have to collaborate with 5 more institutional investors in order to promote his nominees. Six institutions cannot agree to engage in income diversion easily and the higher the number of institutions the greater the likelihood that the diversion will be discovered.
Comparative analysis reinforces the cardinal function of cross-watching. Japanese corporate governance can be analogized to American political governance, with its mutual checks and balances\textsuperscript{144}. Reciprocal watching can occur both within a keiretsu group and across the banks who typically own a quarter of most Japanese public companies. Similarly, in Britain the institutions must cooperate to get anything done. Even in Germany, which has the most concentrated institutional holdings, the three major banks must collaborate to control voting results.

### 3.2.2 Legal Constraints

A multitude of legal constraints limit the institutions incentives and ability to divert income. The lion’s share of institutional investors is fiduciaries required to operate for the sole benefit of their beneficiaries\textsuperscript{145}. Fiduciary liability is a more viable constraint on institutions’ self-dealing (duty of loyalty) than the comparable fiduciary rules for corporate managers (duty of care). Moreover, the incentives of an individual money manager to divert income to its institution are limited because the profit accrues to the institution whilst the money manager bears the brunt of potential criminal, uninsurable, liability that may cost him his career. The separation between what's beneficial for money managers and what's profitable for their institutions is a double-edged sword.

It limits incentives to monitor, but it also limits incentives to abuse power. Public reporting requirements augment the constraints on diversion incentives and opportunities. For instance, a 5% shareholder who undertakes a proxy campaign or other monitoring initiative must, among other things, comply with vigorous filing requirements under schedule 13(d) of the Securities Exchange Act and related SEC rules\textsuperscript{146}.

\textsuperscript{144} See, e.g., Mark Roe, Some Differences in Corporate Structure in Germany, Japan and United States, 102 Yale L.J. 1927 (1993).

\textsuperscript{145} Corporate pension plans are governed by ERISA (Employee Retirement Income Security Act of 1974); public pension plans, bank trusts, and insurance company variable accounts are governed by the common law of trusts; and mutual funds are governed by state corporate law and the Investment Company Act of 1940.

3.2.3 Political Backlash at Institutional Misconduct

Institutional incentive to divert income is further reduced by the certain response of corporate managers who will lobby lawmakers with the end of clipping institutional power. Other shareholders, including small to mid-cap institutions will join corporate managers’ political endeavor, if the cost from the largest shareholders diverting income exceed the other shareholders' gains from increased monitoring. Public funds are especially vulnerable to political backlash if they abuse their power. Corporate America has proven its political clout, at the state level, in procuring protection from takeovers. Job preservation considerations and interstate competition for industries further tilt lawmakers’ considerations in favor of corporate management. Institutions know they risk political retaliation if they misuse their power. They know that corporate managers are lurking to find reasons to oppose institutional oversight, and that lawmakers await a good scandal. That makes institutions less prone to try to divert corporate income. The wall to wall opposition of corporate America to moderate reforms such as the shareholder access proposal provides basis for the conviction that institutional investors, facing certain retaliation, would be restrained.

3.2.4 Institutional Voice Operates Most Effectively Indirectly

Diversified institutions cannot dedicate much attention to a single portfolio company. Therefore, much institutional monitoring is likely to involve process and structure issues, which don't lend themselves to abuse of power, or to occur indirectly, through institutional directors or trade groups. That intermediation mitigates the risk of abuse of their power. Many institutional directors will have no direct connection with a particular institution because of fiduciary and insider trading liability. These directors are unlikely to assist in diverting corporate income to particular institutions, for which they would receive little pecuniary benefit, face fiduciary liability as directors, and earn the scorn of their fellow directors. Trade groups also gain little and lose much

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147 When Fidelity revised its fund bylaws to allow it to exercise control over portfolio companies, other fund managers worried that "such activities would unleash the hounds of Congress on the industry." Fidelity Eases the Rules on Control, N.Y. Times, Oct. 27, 1991, § 3, at 15, col. 3.

148 See the comments of Eric Roiter of Fidelity brought at supra note 55.
by facilitating diversion of corporate income to one or a few of their members. Reputation is critical to a trade group's efficacy and won't be jeopardized in preferring a favored client. Thus, monitoring via trade groups or private organizations such as the ISS also constrains diversion potential, as compared to direct action by individual institutions.

3.2.5 Income Diversion is Not a Social Waste

In the typical scenario income diversion will constitute a wealth transfer rather than a deadweight loss. Most banks and corporate pension sponsors, many insurers, and some mutual fund companies are themselves publicly owned. When a Bank exploits its influence over a Company, causing it to borrow from the Bank at above-market rate, the interest payment may simply shift funds from one to another of a diversified investor's many pockets. Since market prices will reflect the Bank and the Company respective profits after the wealth transfer, undiversified shareholders will pay a fair price for shares of both the Bank and the Company. For the avoidance of any doubt, diversion may also produce an efficiency loss. Nonetheless, the efficiency loss is likely to be a fraction of any diverted income. And it's also possible that, similar to the Japanese pattern, close ties between a given bank and company will reduce creditor-debtor agency costs and thus enable the former to lend more than it otherwise might or continue to lend during credit crunches.

3.3 Managerial and Institutional Myopia

If institutions myopically focus on the short term gains or cause managers to do so, then institutional voice might prove harmful in the long run. Firstly, the available evidence strongly suggests that institutional investors are not systematically myopic. R&D is a quintessential long-term investment. Were institutional investors more myopic than other investors, they should've

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149 If the bank would spend its increased income on empire building or the company would waive a positive NPV project because of the increased interest rate paid to the bank.
150 The opinions expressed by institutional investors at the SEC Roundtable clearly demonstrate that this is not the case, and that institutions by virtue of their size and due to diversification are long term investors. See SEC Roundtable at supra note 4.
owned lower percentages of R&D-intensive firms, but institutions hold higher stakes in such firms\textsuperscript{152}. Institutions are also predominant owners of firms with high Tobin's $q$'s, which tend to be high-growth, low-dividend firms where the investment payoff is far in the future\textsuperscript{153}. Secondly, myopic institutions won't do much monitoring, because the payoff from oversight is long-term. Pension funds, the most active institutions thus far, are especially long-term oriented. That's where their liabilities are. Many are heavily indexed, which is consistent with a long-term horizon\textsuperscript{154}. Thirdly, institutional investors have little ability to reap short-term gains at the expense of long-term value. In a reasonably efficient capital market, even an investor who plans to sell next month must care about long-term value, because buyers will have a longer horizon. Finally, part of the promise of institutional voice is that it may reduce shareholder and creditor myopia. Enhanced voice may improve information flow, and thus enable shareholders to rely less on short-term earnings as a signal of long-term value, increasing institutions' willingness to be long-term investors. One does not hear complaints that Japanese and German banks, who can exercise effective voice, do so myopically, implying that voice is an alternative to a quick exit.

A related concern to institutional myopia is institutional risk aversion. Institutions, it is argued, are more risk averse than corporate managers and hence would restrain beneficial risk taking\textsuperscript{155}. It seems more likely to work the other way around. Corporate CEOs, with their human capital and much of their financial capital tied up in a single firm, will avoid risks that jeopardize a firm's viability. Conversely, diversified institutions won't oppose to firms taking substantial risks if the expected return is attractive\textsuperscript{156}. Diversification

\begin{itemize}
\item See comments of Richard Moore at supra note 38.
\item See, R. Comment, Wimpy Directors Likely Result of Proxy Reform, Wall St. J., Dec. 4, 1990, at A18, col. 3.
\item This may explain why institutions hold high percentages of the stock of many high technology companies and react favorably to increases in R&D spending and decreases in diversification.
\end{itemize}
across asset classes, and across firms within an asset class, is the means of choice by which institutions limit risk.

Greater institutional voice could lead managers to behave myopically, in the misguided belief that doing so will placate institutional hunger for a quick buck. For example, often, the CEO is only a few years from retirement and cares less about long-term projects for which others will take the credit. That may explain why R&D spending drops in the year before a CEO retires\textsuperscript{157}. Institutional voice, however, is more likely to mitigate than to exacerbate the scope of the problem. Shareholder voice should improve communication between shareholders and managers, enabling institutions to convince managers that they value long-term investments, and reduce the likelihood that managers will try to mislead shareholders about corporate values. The institutions can also endorse compensation systems that reward far-sighted investments and give less weight to immediate profits, mitigating the scope for profits management.

3.4 Ancillary Concerns: Insider Trading and Antitrust Violations

A potential concern with institutional power is that the institutions will trade on inside information about the company's prospects. The possibility exists, but the risk seems insignificant. An institution will face severe adverse publicity from an insider trading lawsuit. An individual who is caught will lose her job and her career. These sanctions are strong deterrents to fiduciaries that see a fraction of the gain and all of the downside from insider trading. In the wake of recent corporate scandals, institutions are likely to erect Chinese walls between the buy/sell decision making function and those engaged in corporate monitoring ensuring that no inside information is used by the formers. Moreover, many institutions will use outsiders to fill board seats because of insider trading risks and possible conflicts of interest. Those

outsiders have no incentive to pass on inside tips, nor natural ways to do so\textsuperscript{158}. Institutional size and diversification also constrain incentives to trade on inside information. Large trades may trigger insider trading detection screens at the stock exchanges. Small trades can slip through the computerized screens, but won't affect overall portfolio performance.

Another concern with institutional voice is that the institutions will enable anticompetitive activities. An institution who owns stock in competing companies could facilitate price fixing, market division, or other collusive behavior. Diversified shareholders may also try to affect firm decisions about which businesses to enter and exit. There is little reason to worry about institutional support for direct antitrust violations, for reasons similar to those developed above for insider trading\textsuperscript{159}. Additionally, an inside trader at least keeps all of the gains. Conversely, the gains from collusion accrue to the company, and each shareholder receives only a fraction. And whereas individual money managers or directors can trade for their own accounts, there is no equivalent avenue for money managers to profit directly from corporate collusion.

Institutional endeavors to reduce specific competitive actions, taken by institutions that own stakes in several firms in an industry, are a more plausible antitrust concern than overt collusion. An institution that owns stock in two drug companies may want them to focus each on his predominant domains (generic vs. innovative drugs) rather than compete with each other. Albeit possible, countervailing factors minimize the risk of such activities. First, decisions such as the above described are highly company-specific and hence not natural domain for institutional involvement. Second, these concerns are thus far entirely theoretical, in a decade of activism not a single

\textsuperscript{158} To be sure, some institutional directors may trade for their own accounts. But that's a risk for other directors as well. Absent incentives to trade for the institution's account, institutional voice shouldn't increase the background level of insider trading.

\textsuperscript{159} Violators face civil and criminal sanctions; the antitrust commission and private litigants devote substantial resources to enforcement; fiduciaries have incentives not to take legal risks; and institutional monitoring will often be indirect, through directors or trade groups which have no reason to facilitate collusion.
suit on such grounds against an institution, was filed\textsuperscript{160}. Finally, close bank oversight in Germany and Japan has not led to weak competition in those countries.

The above analysis established that the dangers of increased institutional power are not substantial and outweighed by its potential benefits. Now, I turn to analyze the incentive structure of different types of institutional investors so as to assess the likely results of a reform that would grant active institutions more leeway.

4. Which Institutions Monitor and Why?

As aforementioned, Shareholder activism is not monolithic. Institutional investors—banks, public and private pension funds, mutual funds and insurance companies—vary in their proclivity for activism. Although each performs financial intermediation for different classes of investors and each has fiduciary obligations to exercise an ownership role, the institutions have shown varying craving for the task. Institutions having business relationships with portfolio companies (such as commercial banks, insurance companies, and corporate pension plans) have been relatively inarticulate in exercising their governance rights\textsuperscript{161}. Institutions with political constituencies that face fewer of these conflicting interests (public pension funds and endowments/foundations) have been more assertive and more effective in exercising their governance role\textsuperscript{162}. To be sure, even if private sector Institutional investors are becoming increasingly active, though still are rather lethargic to realize the monitoring potential derived of their size, their mode of operation is much less publicized that that of their public counterparts.

\textsuperscript{160} In the global economy the best strategy from an institutional perspective may very well be to promote vigorous domestic competition, which will help local companies compete globally.

\textsuperscript{161} See James A. Brickley et al., Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267 (1988).

\textsuperscript{162} See Rahul Kochhar & Partibhan David, Institutional Investors and Firm Innovation: A Test of Competing Hypotheses, Strategic Mgmt. J., Jan. 1996, at 73 (finding that “pressure-resistant” institutions had a positive influence on firm innovation, while “pressure-sensitive” institutions had no effect). It should be noted that political aspirations of their trustees and social perspectives are also “suspected” in contributing to the increased activism of public institutional investors.
This section proceeds as follows: subsection 4.1 assumes the task of identifying the reasons for the alleged disparity in activism levels between private and public sector institutional investors. Albeit monitoring might yield portfolio gains, money managers may lack sufficient incentives to capture those gains\(^\text{163}\). Therefore, subsection 4.2 analyzes the incentives of private money managers\(^\text{164}\) and public pension funds managers. Subsection 4.3 addresses promanager conflicts of interests that may dampen incentives to monitor. For all types of institutions, we only need some money managers to become active monitors, as long as others vote carefully when called upon to do so. Subsection 4.4 contains an analysis of the regulatory milieu in which different institutions operate in order to determine weather these alleged legal barriers are real. Careful look at the UK, where legal encumbrances to institutional activism are much softer than in the US, teaches us that we cannot expect institutions to solely revolutionize corporate governance and reinforces the importance of indirect monitoring via the board of directors. And finally, subsection 4.5 tries to sketch potential regulatory measures that would reduce impediments to institutional activism.

4.1 Private Institutions Passivity vs. Public Institutions Activism

Commentators have offered a catalogue of largely untested explanations for mutual funds’ governance passivity. First, mutual fund managers are short-term investors, with recent portfolio turnover above 100%. In their focus on short-term returns, fund managers “don’t care about corporate governance”\(^\text{165}\). Second, mutual funds fear offending management of portfolio companies and losing access to valuable inside information. Because of their short-term orientation, mutual fund managers have greater interest in soft information that drives short-term returns than corporate change that contributes to long-term performance\(^\text{166}\). Third, mutual funds receive investments through

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\(^{163}\) See, e.g., Coffee (1991), supra note 6, at 1283 ("The primary explanation for institutional passivity is not overregulation, but the insufficiency of existing incentives to motivate institutional money managers to monitor.").

\(^{164}\) Private money managers make up 80% of the institutional investor universe.


\(^{166}\) See, Bill Barnhart, Mutual Funds Haven’t Joined the Rush to Shareholder Activism, Chi. Trib., Mar. 16, 1997, at C3 (stating view by Edward Regan, former activist comptroller for the State of New York, that a reason for mutual fund passivity is mutual funds’ short-term orientation).
retirement plans, offered by companies in which the funds also invest. This creates a conflict, as fund managers may be reluctant to vote or take other actions that risk offending company managers who steer business to them, even though these actions may be contrary to the best interests of plan participants. Fourth, mutual funds gain no relative advantage and may actually be disadvantaged by becoming activist. Most activism is not reimbursed and any activism-created performance gains are shared with all shareholders, including competing mutual funds. Motivated to outperform industry benchmarks and competing funds, mutual fund managers view their role as running portfolios, not companies. Fifth, mutual fund managers can free-ride on the activism of pension and union funds, whose managers face political and constituent pressures to be activist and may be more personally comfortable with confrontational politics. Sixth, the dominant mutual fund form, the open-end fund, must be able to redeem investors’ shares overnight on demand. To ensure liquidity, mutual funds do not hold big stock blocks, thus diluting their incentive to engage in governance activities. Others have observed that money managers generally lack the incentives to monitor portfolio companies since the mutual fund market tends to reward high-turnover strategies that generate short-term performance compared to industry benchmarks. In addition to governance passivity, mutual funds have been politically quiet, as compared to other institutional investors, in pursuing and commenting on regulatory reforms to expand voting prerogatives.

Public funds (the pension funds of state and local government employees) have, in fact, been more active than other institutional investors in corporate governance. For example, in 1990, Fidelity dropped its opposition to a Pennsylvania antitakeover bill when executives of a large Pennsylvania company threatened to switch the firm’s pension plan to Vanguard. This reinforces the importance of augmenting the shareholder access proposal with reimbursement clauses. Albeit the fact that the shareholder access proposal lowers the activism costs by enabling institutions to use the corporate apparatus, it may no suffice. These factors should be juxtaposed with the existence of trade groups and proxy voting services, which reduce monitoring costs and enhance the potential gains from activism. This assertion was reaffirmed by Eric Roiter of Fidelity at the SEC Roundtable. Once again the private funds’ incentive structure reinforces the importance of indirect monitoring through the board of directors and trade organizations and institutions like the ISS that reduce the direct costs of activism and spread them among several funds.

Active traders are also fighting an uphill battle against the logic of institutional size. Institutions dominate the stock market and trade mostly with each other. By trying to outperform the market, they only incur transaction costs, and hence underperform the market as a group.

For example, mutual funds were noticeably absent from the 1992 SEC rulemaking to facilitate shareholder communications and the 1998 revisions to the shareholder proposal rule. Although both initiatives anticipated an expanded role for institutional investors, mutual fund managers chose not to comment on the proposals, suggesting either a natural indifference or a tactical silence.
governance over the past few years, offering shareholder proposals and engaging in other highly publicized activities to influence management actions. In addition, they vigorously advocated the 1992 reform in SEC proxy regulations to enhance their ability to play an active role in corporate governance as they did with the shareholder access proposal that the SEC is still considering. There is a multitude of reasons for this activism by public funds. First, the low level of business ties with corporate managers mitigates public funds susceptibility to management pressures. Second, the sheer size of public funds and the fact that most public funds are 80% indexed, turns exit into a non viable option and forces public funds to express voice in order to improve corporate performance and with it beneficiaries’ returns. Third, pension plans have especially long term investment horizon and an ability to meet most beneficiaries’ ongoing retirement needs using the flow of incoming funds. This allows public funds to “sacrifice” liquidity and accumulate voting blocks that increase their clout vis-à-vis corporate managers. Fourth, recent corporate scandals have hurt pension funds beneficiaries at an unprecedented extent, this has created vast political pressure on public funds (whose boards contain many appointed and ex officio members) to become more active in protection of their beneficiaries assets. Fifth, Public funds are frequently managed by individuals with aspirations to higher political office whose reputations can be enhanced by populist crusading against corporate management. In addition, on-the-job perquisites figure more importantly for financial managers in the public sector, where financial compensation is lower than in the private sector. The prototypical free rider problem of corporate governance activities could therefore be mitigated for public funds more readily than for private funds because public funds are more likely to be managed by political entrepreneurs, who benefit personally from such visible activity.


173 See supra note 38 and accompanying text.

174 For example, Elizabeth Holtzman, New York City comptroller and a trustee for the city's pension funds publicized her active approach to corporate governance while campaigning for the Democratic party's nomination for U.S. Senator. See, Elizabeth Holtzman, When Management Falls Down on the Job: Pension Funds Can Put Independent Directors on the Board, Wash. Post, May 26, 1992, at A17.

The public funds susceptibility to political pressure is a double edged sword that may not only induce greater activism but also sway the funds in the opposite direction, to become less vocal players in the corporate governance movement or yield to management to preserve local employment and local economy or pursue social investments rather than value maximizing strategies. Public fund independence depends on an uneasy balance among politicians' desires to control a large sum of money, their fear of scandal if they use pension money for dubious purposes\textsuperscript{176}, beneficiaries' desires to keep politicians' hands out of the cookie jar\textsuperscript{177}, and corporate pressure on politicians to quiet the public funds. As public funds increase their activism and that activism affects the interests of politically organized groups, such as unions and corporate managers, political pressure on these funds will increase significantly\textsuperscript{178}. If activist public funds are required to embrace such an investment agenda, then their investment objective will diverge from that of other equity holders, who desire to maximize share value and will therefore not benefit from public funds' increased role in corporate governance. The fact that most of the public funds' assets are invested passively (indexing) alleviates the political pressure on their managers. Ensuring that public fund boards include individuals elected by fund beneficiaries, and applying the ERISA fiduciary standard for private funds to public funds could further reduce political pressure impact on public funds.

Skeptic commentators claim since pension and mutual funds will be administered by money managers who are likely to remain generally apathetic about most corporate governance issues. In effect, the important agency problem shifts from the corporate-manager level to the financial-intermediary


\textsuperscript{177} See, e.g., Hemmerick, Groups Take on California: Pension Funds, Organizations Fight Back Against New Law, Pensions & Investments, Dec. 9, 1991, at 59.

\textsuperscript{178} For instance, after it was disclosed that a New York state pension fund had invested in a leveraged buyout fund that financed contested tender offers, including the RJR/Nabisco buyout, the governor created a task force to investigate pension fund investment policy. The task force recommended restricting public pension funds' involvement in hostile takeovers and instructing them to take local concerns, such as the state economy and in-state employment, into account when acquiring or voting shares.
level. So long as economic incentives at the institutional level provide only weak incentives for agents at this level to participate in corporate governance, passivity will persist\textsuperscript{179}. Therefore a careful review of money managers is essential for evaluating the institutions prospects of fulfilling their monitoring role.

4.2 \textit{Private and Public Money Managers Incentive Structure}

If monitoring is profitable, financial institutions, like other businesses, will yield to competitive forces and find ways to pursue that profit. Commentators, skeptical as per mutual funds and other private sectors institutional investors incentives to monitor, point out that the agent (individual money manager) is less interested in the \textit{absolute} performance of the fund it manages than in its \textit{relative} performance versus its investment rivals; if its rivals can free ride on its efforts, then it is senselessly expending costs that do not improve its relative performance versus other fund managers\textsuperscript{180}.

If the institutions decide on assuming a more active role than they will find ways to motivate their employees to implement the tasks derived of this role. Moreover, the proposed regime requires several institutions to cooperate, which mitigates the free riding problem. Further, the sheer size of fund families such as Fidelity and Vanguard and the greater tendency to use indexing strategy make monitoring a prominent (or even the sole) avenue to improve long term performance. The bandwagon for increased shareholder power has brought much salience to active institutions, making those who engage in these activities more attractive to potential investors and providing an impetus to other institutions to engage in monitoring. Monitoring results take long time to ripen therefore, mutual fund managers’ incentives may need redirection toward longer-term goals, but lack of incentives doesn't seem to be a problem.

\textsuperscript{180} See ibid at 18.
Private money managers have incentives to improve performance by any available means, including monitoring. First and foremost, performance affects where clients place their investable funds. Private money management firms, mutual funds, bank trust departments, and insurers all compete in different ways for investable funds. Firms and individuals with good long-run track records will tend to attract new clients. Second, money managers typically keep a fraction of portfolio gains and losses through asset-based management fees. The fraction may be small, but the base is large, and the product of the two can be significant relative to the profits of a money management firm or the wealth of an individual money manager. Third, incentive compensation, structured carefully to induce activism would definitely tilt money managers’ incentives towards more active monitoring. Fourth, the labor market for individual money managers provides performance incentives. Non-pecuniary rewards, such as more prestigious assignments or peer recognition, also count. Finally, money managers have a fiduciary duty towards their beneficiaries to maximize the value of the funds’ holdings, and are encouraged to communicate with other institutions in pursuit of monitoring gains. Even if these duties don’t utterly offset the fear of free riding by other institutions, they definitely enhance the incentive to cast an informed vote on initiatives by other, more active institutions or seek the advice of trade groups or institutions such as the ISS on how to vote.

Concerns about weak incentives have greater force for the managers of public pension funds. Public fund employees usually don't directly share in their fund's gains or losses. But even for them, some performance incentives exist as the catalyst role, which public funds have played in a decade of activism, demonstrates. First, the labor market provides incentives. Good performance may increase job longevity or open up future employment opportunities. Some public fund managers later move to the private sector and sell their services to their former employer and its counterparts. Others must run for

181 For many insurers and corporate pension plans, portfolio gains are nearly a dollar-for-dollar source of profit.
182 See supra note 11 and accompanying text.
183 Some public pension money is managed by outside managers, who have performance incentives similar to those of other private money managers. But much public money is managed in-house, especially at the largest funds.
election. In that endeavor, a good performance record is a major asset. Monitoring efforts may also have political benefits even if the monitoring gains are hard to quantify. Non-pecuniary incentives may also be important. Cultural factors, a sense of professionalism, and desire for peer recognition all help to instill some interest in good performance. Public fund managers have a fiduciary duty to achieve better performance if they can. Fiduciary duties can't ensure optimal actions, but neither can they be dismissed as irrelevant. To be sure, some public fund managers may be interested in governance issues for their publicity value. That isn't necessarily bad, however.

4.3 Promanager Conflicts of Interest

Promanager Conflicts of interest erode weak institutions incentive to monitor. Nonetheless, conflicts might increase incentives for strong institutions to hold an influential stake so as to overcome the conflicts and use their clout to appropriate corporate business. Moreover, conflicts can be partly ameliorated by legal rules.

The extent to which conflicts will tilt money manager decisions away from monitoring will depend on the gains from monitoring, the intensity of the conflict, regulatory efforts to control conflicts, the number of strongly conflicted institutions, and whether the institutions can take steps to mitigate the conflicts. Legal reform that reduced obstacles to shareholder voice would increase the number of times when the expected gains from monitoring will exceed the cost of displeasing corporate managers. Some activity patterns are more conflict-prone than others. For instance, indirect oversight may be less threatening than direct efforts. Implementing the shareholder access proposal would enable institutions to use less conflict-prone forms of oversight (indirect oversight). Conflicts also vary in strength across institutions and with type of action. Some conflicts, such as the risk of losing access to soft information, are important mostly for active traders, who won't do much monitoring in the first

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place. Confidential voting could further ameliorate the conflicts by denying management the identity of the activist institutions, thus reducing the retaliation prospects\(^\text{185}\).

Public funds encounter fewer conflicts than private funds, because they don't rely on corporate business. Political pressure by corporate managers on state legislators may limit the public funds' activism\(^\text{186}\). Albeit public funds have been the catalyst of institutional activism in recent decade, no doubt that if the public funds were fully independent, we would have gotten more activism.

As a decade of activism proves, numbers, provide the institutions a safe bay. The more institutions are active the more the danger of losing corporate business recedes\(^\text{187}\). Cultural shifts have changed standards of accepted money manager behavior and ameliorated the conflicts. A decade of enhanced activism enables the institutions to press the laggards to conform to the new norm, without resorting to a proxy contest. Moreover, conflicts are interwoven with legal rules, which control some conflicts but ignore others. American legal regime invests heavily in controlling institutional power, but doesn’t invest in preventing corporate managers from co-opting intermediaries\(^\text{188}\).

Institutional conflicts can be addressed through regulation. The regulation’s intensity depends on the size of the wealth transfers from conflicts, whether those transfers result in efficiency losses, and on the offsetting gains from oversight. The activism of German and Japanese institutions exemplifies that conflicts don’t dampen activism.

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\(^{185}\) As the ISS 2004 postseason report demonstrates the issue of confidential voting has been on the agenda of institutional investors for quiet some time and much progress has been made. See ISS 2004 postseason report supra note 52.

\(^{186}\) See section 4.1 above.

\(^{187}\) For example, it's now common for money managers to oppose staggered boards or poison pills. Those who do haven’t lost much business. As one money manager commented: "[Loss of business] is something we worried about more than we had to. . . . I can think of only one case where I'm pretty sure we got fired because we opposed management on a poison pill." See, Norton, Who Owns This Company, Anyhow?, Fortune, July 29, 1991, at 131, 138-140 (quoting Robert Kirby, former chairman of Capital Guardian Trust).

\(^{188}\) For example, corporate managers are allowed to act as trustees for the corporate pension plans that collectively own 20% of U.S. equities, a situation which, in effect, prevents the formers from assuming an active corporate governance role.
4.4 Could Legal Rules Account for Differences in Institutional Levels of Activism?

Throughout last decade only seldom have institutions coordinated their activism efforts. Instead the institutions stay of each others’ way; two institutions try not to target the same corporation during the same year. Conversely, in the UK institutions often jointly approach a firm so as to increase their lever vis-à-vis management.\(^{189}\) As exemplified by the debate at the SEC Roundtable, American institutions put the blame for their lack of coordination on regulatory barriers;\(^{190}\) a group of shareholders acting together on a given issue and owning more than 5% of the firm’s shares triggers filing requirements under section 13(d) of the Securities Exchange Act and related SEC rules\(^{191}\) and risks a lawsuit by other shareholders or by the company claiming incomplete disclosure of their plans, reducing the scope of section 13(d) has the potential to enhance activism levels.\(^{192}\) Nonetheless the SEC has shown little inclination to amend the 13(d) rules thus far. Further, owning a 10% stake can trigger short-swing profit forfeiture under the Securities Exchange Act section 16(b) and related SEC rules\(^{193}\). A dominant shareholder or group also risks being considered a control person, with adverse consequences under securities, bankruptcy, and other laws. Banks, insurers, and mutual funds face additional legal limits on their ability to hold large stakes. The obstacles to owning a large stake are greater for an active shareholder than for a passive shareholder. For example, an active shareholder must report its holdings and plans on Schedule 13D; a passive shareholder can file a shorter Schedule 13G.

Legal encumbrances are especially great if shareholders seek to nominate some directors instead of rubberstamping the incumbents' choices. The


\(^{190}\) See e.g., the comments made by Eric Roiter of fidelity at the SEC Roundtable, supra note 4.

\(^{191}\) See supra note 146.

\(^{192}\) See e.g., Coffee (1994) at supra note 179.

sponsoring institution(s) risk being deemed to be a control person, or to have "deputized" the director (which would create short-swing profit forfeiture liability under section 16(b)\textsuperscript{194}). Nominating directors also creates a risk of insider trading liability under Securities Exchange Act section 10(b), because the director will have access to inside information\textsuperscript{195}. Legal rules also raise the costs of a proxy campaign or other shareholder action. The SEC's shareholder proposal rule, Rule 14a-8, albeit greatly reducing the cost of submitting a shareholder proposal, excludes several key issues, including director nominations and solicitations in opposition to manager proposals\textsuperscript{196}. A shareholder who contacts more than ten other shareholders on a voting proposal, for example, must have a "proxy statement" pre-cleared by the SEC's vigorous censors. Encumbrances to forming shareholder groups discourage cost-sharing that might otherwise reduce these cost barriers.

The actual regulatory barriers may be less formidable than the institutions depict them to be. For instance, the filing requirement under schedule 13D is rather simple, and the chances that a company will sue a major institutional shareholder are rather remote. The failure of the institutions to surmount these hurdles implies that other, non-legal, factors constrain the institutions craving for activism\textsuperscript{197}. An investigation of institutional shareholders activism in the UK, where active shareholders are much less constrained than their US counterparts, reveals\textsuperscript{198}:

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  The reluctance of even large shareholders to intervene, based on imperfect information, limited institutional capabilities, substantial coordination costs, the misaligned incentives of money managers, a preference for liquidity, and the uncertain benefits of intervention. Agency costs at the fund-manager level may be no less important than at the
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\textsuperscript{194} This limitation is especially powerful with regards to open end mutual funds that may have to redeem beneficiaries' participation units on a short notice, and thus are more likely to be subject to short swing profit limitation if they were to nominate a director to the board.


\textsuperscript{196} See supra note 10.

\textsuperscript{197} See e.g., Coffee (1991) supra note 6.

\textsuperscript{198} See Coffee & Black (1994) supra note 189 at 38.
corporate-manager level, with the fund manager focused more on performance relative to its rivals than on absolute performance. Coordination costs persist even when financial intermediaries aggregate large blocks of stock so as to possess the "clout" that the Berle-Means shareholder lacks.”

Nonetheless, the British experience, according to Coffee and Black, teaches us that reducing regulatory controls will indeed cause institutions to become more active\textsuperscript{199}, even if not substantially more.

4.5 \textit{An Agenda for the Legislators}

Because reducing legal barriers cannot be expected to produce a dramatic surge in institutional activism levels, a question comes in mind: what is the policy goal that the legislators should pursue in order to induce institutions to overcome the non-legal factors that tilt their incentives towards passivity? As a policy prescription, the basic answer must be to encourage institutional investors to rely on "voice," and thus to become long term blockholders. To this end, public policy could follow two general approaches: (1) it could make "voice" less costly, or (2) it could make "exit" more expensive. Increasing transaction taxes could obviously chill exit, albeit at a cost to the general investing public who isn’t expected to assume a monitoring role and, thus, at a cost to the economy (chilling the secondary markets). In light of substantial immediate adverse effects of the second policy avenue, I contend that the legislator would be wise in pursuing the first policy approach, which could be implemented using one or both of two basic methods: (i) the SEC could seek to reduce the expected costs and liabilities associated with institutions holding large equity stakes; and, (ii) similarly, it could seek to increase the shareholders’ access to the corporate proxy apparatus in order to increase the potential payoff from the exercise of "voice." Implementing the shareholder access proposal would be a straightforward implementation of this technique. The shareholder access proposal would reduce the information

\textsuperscript{199} Ibid, at 38.
costs and solve the institutional monitoring capability problem as the monitoring shall be executed by director(s), accountable to the shareholders, with cheap access to corporate information, and with a monitoring expertise. Reducing the expected costs and liabilities associated with institutions holding large equity stakes can be done, for example, by downsizing Section 13(d), and reducing the burden on shareholders not seeking control. Under the proposed change, a voting group organized to obtain a non-control related vote should be excluded from section 13(d)'s coverage. For instance, shareholder proposals relating to bylaw amendments, reduction of antitakeover protection, executive compensation, preemptive rights, and the other mundane matters of everyday corporate governance would be excluded. Similarly, any group organized to oppose a managerial initiative should also be excluded, because opposition to a management proposal (such as a leveraged buyout proposal) will not, by itself, result in a change in control. To be sure, the specific solutions presented above constitute a non-exhaustive menu of legal measures and one can imagine other measure along the lines suggested above.

Before concluding this paper I wish to emphasize a critical point, regulators and legislators should not coerce any institution to assume a more active role in the corporate governance. Rather, legislators should focus on tilting the institutions’ incentives towards enhanced activism. The decision whether to engage in a specific activity if at all should be left to the institutions themselves. They have an incentive to make, on average, better decisions than the regulators. Regulatory policy should aim at reducing regulatory barriers to joint shareholder action not aimed at gaining control, thus lowering the cost of “voice”. Implementing the shareholder access to the ballot proposal increases the expected benefits from expressing voice and circumvents the information deficit and the incentive problem at the money manager level. By not mandating activism the regulator enables institutions to locate themselves at a point along the activism continuum (ranging from passivity to being an activism catalyst) that conforms to their own cost benefit analysis.
This paper has elaborated the case for measured legal reform to facilitate institutional shareholder voice. The potential social gains from institutional voice become clearer in light of the colossal damages caused by recent corporate scandals motivated by unrestrained managers and hidebound boards. Financial intermediaries are the only available candidates for the job. Corporate governance is, and will remain, imperfect. Shareholder voting is only part of a complex web of constraints on corporate managers, which includes the product, capital, labor and corporate control markets, incentive compensation, fiduciary duty, and cultural norms. Nonetheless, institutional voice can be a valuable strand in that web, and can serve as a partial alternative to relying on takeovers to discipline corporate managers. Large institutions will surely become more active under a more facilitating legal regime. We shouldn't mandate oversight. Procedural reform can facilitate shareholder action, but oversight will occur only if the costs of monitoring are less than the benefits from reducing the agency costs that stem from the separation of ownership and control in large corporations.

Specifically, this paper calls for implementing the shareholder access to the ballot proposal, which enables the institutions to circumvent much of the non-legal impediments that turn them into “reluctant activists”. The business community sees the institutions as dangerous, short-term oriented, and inclined toward fads and "herd" behavior. This view is wrong. Because institutional investors are not inclined (for the most part) to be activist shareholders, they are not the dangerous conspirators that the business community perceives them to be. Indeed, they are highly vulnerable to co-option. In time, as managements learn this, the current paranoia over the rise of the institutional investor may subside. Further, the risks from institutional voice are modest since under the proposed regime several institutions act jointly to exercise effective voice, the institutions can watch each other at the same time that they're watching corporate managers. The conclusion of this paper is that, juxtaposing all relevant considerations for and against institutional voice, the upside is exceeds the downside.
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