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Agreement in Principle: A Compromise for Activist Shareholders from the UK Stewardship Code

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NOTES

Agreement in Principle: A Compromise for Activist Shareholders from the UK Stewardship Code

ABSTRACT

Equity ownership in the United States and Europe is now highly concentrated in the hands of institutional investors, which gives rise to new problems of agency and corporate governance. These large investment intermediaries, such as mutual funds, specialize in maximizing beneficial owner value based on short-term performance benchmarks but lack the expertise and incentive to actively engage corporate boards on business strategy and governance matters. Instead, institutional investors are "rationally reticent," meaning that they are willing to respond to governance proposals but not to propose them. Activist shareholders may offer an endogenous solution to address "latent activism" in institutional intermediaries and, ultimately, spur the effective monitoring of corporate boards. Activist shareholders, such as hedge funds, often achieve their business strategy and governance objectives by obtaining toehold positions in a corporation and soliciting support from institutional investors for their governance proposals. However, this solution is in jeopardy. Recently proposed regulatory changes in the United States track adopted legislation in the United Kingdom and Europe, and pose a threat to domestic activist shareholder success. This Note argues that incorporation of the UK Stewardship Code's Principle 5 into the U.S. regulatory scheme may help alleviate the potentially chilling effects of the proposed rule-making on shareholder activists.

TABLE OF CONTENTS

I. INTRODUCTION 544
II. THE EVOLVING ROLE OF INSTITUTIONAL OWNERS IN UK AND U.S. CAPITAL MARKETS 549
A. *The UK Stewardship Code* 550
1. Historical Background 550
2. Policies 553
3. Principles 554
B. *Rational Reticence: The Nature of Institutional Investors* 556
C. *The Emergence of Activist Shareholders* 558
D. *Rational Reticence and Activism* 561
III. THE CURRENT DEBATE 562
A. *Activist Shareholders As Governance Intermediaries* 562
B. *The Nature of Hedge Fund Activism* 565
C. *The Williams Act* 567
IV. THE PRINCIPLE 5 COMPROMISE 570
A. *The UK Stewardship Code's Principle 5 as a Compromise for Activist Hedge Funds* 571
B. *Changed Circumstances: Activist Hedge Funds Are the Superior Corporate Monitor* 572
V. CONCLUSION 573

I. INTRODUCTION

Institutional investors in the United States and the United Kingdom now hold more than 70 percent of the outstanding equity issued by each respective nation's largest public firms.[1] The agency problems posed by the classical Berle-Means theory of dispersed share ownership are today a moot point.[2] With the vast majority of

[1] *See* MATTEO TONELLO & STEPHEN RABIMOV, THE CONFERENCE BOARD, THE 2010 INSTITUTIONAL INVESTOR REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 27 (2010) (showing institutional ownership concentration statistics); INVESTOR RESPONSIBILITY RESEARCH CTR. INST. & INSTITUTIONAL S'HOLDER SERVS., CONTROLLED COMPANIES IN THE STANDARD & POOR'S 1500: A TEN YEAR PERFORMANCE AND RISK REVIEW 9–10 (2012), *available at* http://irrcinstitute.org/pdf/FINAL-Controlled-Company-ISS-Report.pdf [http://perma.cc/YW76-X989] (archived Oct. 14, 2014) [hereinafter IRRC Report] (showing the growth and frequency of public firms in the United States); *see, e.g.*, Simon C.Y. Wong, *Why Stewardship is Proving Elusive for Institutional Investors*, BUTTERWORTHS J. INT'L BANKING & FIN. L. 406, 406 (July/August 2010) [hereinafter Wong, *Stewardship*] (reflecting data for the United Kingdom).

[2] *See, e.g.*, Brian Cheffins & Steven Bank, *Is Berle and Means Really a Myth?*, 83 BUS. HIST. REV. 443, 467 (2009); Clifford G. Holderness, *The Myth of Diffuse*

equity interests held by intermediary institutions, like mutual funds and pension funds, individual investors now find themselves grappling with two sets of unwieldy agency relationships: (1) between themselves and corporate directors and (2) between themselves and intermediary institutions.[3] The result has been further displacement of ownership from control and further devaluation of governance rights.[4]

Beginning in the early 1990s, many commentators argued that institutional investors ought to bridge this widening gap by "monitoring" and "engaging" portfolio companies on behalf of their beneficial owners and the public generally.[5] In response to the global financial crisis in 2008–2009, some jurisdictions, including both the United Kingdom[6] and the European Union,[7] agitated for best practice codes [8] urging governance obligations of "stewardship" and "sustainable shareholder engagement" upon institutional investors.[9] The push for these governance obligations stemmed from a belief that

Ownership in the United States, 22 REV. FIN. STUD. 1377, 1384 (2009) (providing evidence suggesting that ownership patterns no longer reflect the Berle and Means theory).

[3] *Cf.* BEN W. HEINEMAN, JR. & STEPHEN DAVIS, ARE INSTITUTIONAL INVESTORS PART OF THE PROBLEM OR PART OF THE SOLUTION?: KEY DESCRIPTIVE AND PRESCRIPTIVE QUESTIONS ABOUT SHAREHOLDERS' ROLE IN U.S. PUBLIC EQUITY MARKETS 21–24 (2011), *available at* http://www.ced.org/pdf/Are-Institutional-Investors-Part-of-the-Problem-or-Part-of-the-Solution.pdf [http://perma.cc/5A9X-KKGT] (highlighting a mismatch between the goals of individual investors and the acts of institutions); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (May 2013) (illustrating a dual set of agency relationships).

[4] *See* Gilson & Gordon, *supra* note 3 (explaining how governance rights are devalued).

[5] *See, e.g.*, Stephen Davis, Jon Lukomnik, & David Pitt-Watson, *Active Shareowner Stewardship: A New Paradigm for Capitalism*, 2 ROTMAN INT'L J. OF PENSION MGMT. 10 (Fall 2009) (calling for a monitoring structure for portfolio companies).

[6] *See* JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING 44 (2012), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf (last visited Feb. 22, 2015) [https://perma.cc/Y89P-9Y4X] (archived Feb. 22, 2015) (urging the UK to adopt a best practice code and stressing its importance).

[7] *See* Resolution on a Corporate Governance Framework for European Companies, EUR. PARL. RES. (A7-0051/2012) ¶¶ 25, 34, 2012 O.J. (C 161) (adopting text P7_TA(2012)0118).

[8] *See Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, and the Committed of the Regions, Action Plan: European Company Law and Corporate Governance—A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies*, at 8, COM (2012) 740 final (Dec. 12, 2012) (emphasizing the importance of best practice codes).

[9] *See* FIN. REPORTING COUNCIL, THE UK STEWARDSHIP CODE, ¶ 4, at 1 (2012) [hereinafter STEWARDSHIP CODE], *available at* https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6 [https://perma.cc/VB6A-G5TG] (archived Jan. 31, 2015) (describing stewardship and shareholder engagement).

institutional investor stewardship will foster the long term success of companies "in such a way that the ultimate providers of capital also prosper."[10]

Institutional intermediaries, however, have proven to be ineffective as proactive corporate monitors because they lack the incentive and expertise for corporate stewardship.[11] As a result, the immense governance rights possessed by institutional owners have become significantly undervalued.[12]

Just because institutional investors are unwilling to actively engage corporate boards and propose changes in governance does not mean that they are unwilling to respond to such proposals.[13] Empirical evidence indicates that mutual funds often act on proposals presented to them, and oppose management, on core governance issues.[14] The theory underlying this behavior is known as rational reticence. While mutual funds are reluctant to proactively engage portfolio companies, mutual funds are not passive when faced with the opportunity to respond to proposals.[15]

In the United States, it has been argued that activist shareholders, such as activist hedge funds, are the capital market's evolutionary response to the agency gap that results from ownership concentration in institutional intermediaries.[16] Activist shareholders typically acquire noncontrolling toehold positions in corporations and then subsequently attempt to influence those corporations' business strategies.[17] Within this framework, activist shareholders play a

[10] *Id.* ¶ 1, at 1.

[11] *See* Wong, *Stewardship*, *supra* note 1 (stating efforts to get institutional investors to act as stewards have failed); *see also* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 595–608 (1990) (providing examples of the ways in which money manager incentives and conflicts of interest effect voting and activism); Marc Goergen, Luc Renneboog & Chendi Zhang, *Do UK Institutional Shareholders Monitor Their Investee Firms?*, 8 J. CORP. L. STUD. 39 (2008) (stating there is empirical evidence to suggest institutional investors do not perform any monitoring).

[12] *See* Gilson & Gordon, *supra* note 3 (detailing how the lack of incentives and capacity leads to the devaluation of governance rights).

[13] *See id.* at 867 (asserting that institutional shareholders are likely to respond to proposals).

[14] *See* Sean S. Collins, Inv. Co. Inst., *Trends in Proxy Voting by Registered Investment Companies 2007-2009*, 16 PERSPECTIVE, Nov. 2010, at 1, 4, fig. 1, *available at* http://www.ici.org/pdf/per16-01.pdf [http://perma.cc/3PNR-Q9JK] (archived Jan. 31, 2015).

[15] *See* Gilson & Gordon, *supra* note 3, at 867 (defining rational reticence).

[16] *See, e.g.*, *id.* (arguing that activist hedge funds offer a response to the shortfall in monitoring of institutional intermediaries); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1730 (2008) (noting that hedge funds target institutional intermediaries because it is easier to acquire a significant stake more quickly).

[17] *See Toehold Purchase Definition*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/t/toeholdpurchase.asp (last visited Jan. 10, 2015) [http://perma.cc/775X-8W63] (archived Jan. 30, 2015) (defining and explaining the rules behind a "Toehold

specialized corporate monitoring role, breathing life into the substantial governance rights that lay dormant in the hands of institutional investors.[18] Activists derive the support they need for successful proposals by convincing institutional owners that their plan will enhance shareholder value. [19] In this way, activist shareholders bring about a form of "market-based stewardship."[20]

Assuming that activists are integral to market-based stewardship in the United States, the current debate over the terms of the stock accumulation disclosure requirement under the Williams Act[21] threatens to negatively impact the incentives of would-be governance activists. The Securities and Exchange Commission (SEC) has recently indicated possible regulatory changes that are in line with changes that have been enacted in the UK Stewardship Code and the European Union. These changes would lower the threshold for activist reporting, shorten the disclosure window, and broaden the scope of derivatives that must be disclosed.[22]

Although institutional owner rational reticence makes the UK Stewardship Code overall a poor fit for the United States, the Code's Principle 5 offers a compromise to activist shareholders. Principle 5 suggests that UK institutional investors should be willing to act collectively with other investors as well as disclose policies on collective engagement.[23] If U.S. institutional owners develop and

Purchase"); *see also* Gilson & Gordon, *supra* note 3, at 904 (describing the effects of toeholds on activists).

[18] *See* Gilson & Gordon, *supra* note 3, at 867 (framing the role of activist shareholders). This approach stands in contrast to the raider-like takeover attempts of the 1980s.

[19] *See id.* (detailing ways in which activists gain power). Indeed, institutions are becoming increasingly willing to jump on board with activist proposals. *See, e.g.*, Martin Lipton, *Current Thoughts About Activism*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FIN. REGULATION (Aug. 9, 2013, 9:15 AM), http://blogs.law.harvard.edu/corpgov/2013/08/09/current-thoughts-about-activism/ [http://perma.cc/Y5SG-B4F6] (archived Jan. 30, 2015) (acknowledging that institutional portfolio managers are increasingly supporting activist investor proposals, while attempting to characterize this dynamic as a product of short-termism).

[20] *See* Gilson & Gordon, *supra* note 3, at 867 (describing how activists can perform a stewardship function).

[21] *See* 15 U.S.C. § 78m(d) (2012) (outlining the stock accumulation disclosure requirement).

[22] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929R(a)(1)(A), 124 Stat. 1376, 1866 (2010) (inserting "or within a shorter time as the Commission may establish by rule"); Mary L. Shapiro, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the Transatlantic Corporate Governance Dialogue (Dec. 15, 2011), *available at* http://www.sec.gov/news/speech/2011/spch121511mls.htm [http://perma.cc/K4XG-T7YR] (archived Jan. 31, 2015) (emphasizing the importance of increased disclosures and quality communication); Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (Mar. 7, 2011), *available at* http://www.sec.gov/rules/petitions/2011/petn4-624.pdf [http://perma.cc/8FS7-WDKM] (archived Jan. 31, 2015) (arguing for a shortened reporting window).

[23] *See* STEWARDSHIP CODE, *supra* note 9, at 8–9 (laying out guidance on Principle 5).

disclose their policies for collective action, activist shareholders will have a significantly clearer idea of how successful they will be in gaining institutional owner support for their proposals at the outset, which may help alleviate the new challenges posed by a shorter disclosure window or broader derivative disclosure requirement. In turn, activist investors will continue to serve their role as governance intermediaries and corporate monitors.

Part II of this Note provides an overview of the historical development, policies, and Principles of the UK Stewardship Code. It then frames the effectiveness of the Code and its underlying policies within the context of institutional investor rational reticence. Further discussion describes the evolution of U.S. capital markets and the role activist investors have come to play as governance intermediaries. Following this discussion, this Note briefly addresses the current domestic debate involving regulatory changes that would emulate those enacted in the United Kingdom and Europe.

Part III analyzes the incompatibility of the UK Stewardship Code as a whole with U.S. equity markets. Part III then discusses how activist shareholders serve as governance intermediaries and give voice to institutional investor governance rights. After this discussion, Part III analyzes current regulatory proposals under consideration by the Securities and Exchange Commission, their similarities to European regimes, and the chilling effects they may have on the role of activist shareholders.

Part IV begins by discussing the way Principle 5 of the UK Stewardship Code already aligns with current U.S. equity ownership patterns. This Note concludes that Principle 5 offers a potential compromise to both activist shareholders and those arguing for regulatory reform in the United States similar to that in the United Kingdom. This Note recommends that the United States adopt Principle 5 of the Stewardship Code in conjunction with shortening the ten-day disclosure window. By requiring institutional investors to maintain and disclose a collective action policy, activist investors will have the opportunity to gain a clear sense of the support they are likely to receive from institutional intermediaries when pursuing certain governance actions. As a result, the broadened derivative disclosure requirements will be less likely to stymie the role activist shareholders play in monitoring corporate boards and leveraging governance rights. By adopting Principle 5, the United States would incorporate a helpful aspect of the UK Stewardship Code, and continue to foster efficiency in evolving U.S. capital markets.

II. THE EVOLVING ROLE OF INSTITUTIONAL OWNERS IN UK AND U.S. CAPITAL MARKETS

The increasing concentration of equity ownership in the hands of institutional investors has been accompanied by a corresponding debate regarding the role that institutional investors should assume in monitoring portfolio companies.[24] As the agency gap between individual investors and company leadership widens, many argue that the institutions responsible for the widening should bridge the gap.[25] At first blush, this seems a reasonable solution given the size and sophistication of institutional investors and their proximity and access to the companies in which they invest.[26] On the other hand, many commentators express concern that institutional investors may be ill-suited to assume such a role in view of their predominantly short-term business models.[27]

In truth, much of the debate today is dependent on one's conception of the role of corporations in society more generally.[28] If one tends to think of a corporation as a living, breathing social organism, it follows that institutional stewardship is necessary to protect society as a whole.[29] If, on the other hand, one views corporations as more of a contractual nexus instituted for the transacting of business, the logical conclusion is that institutional stewardship of corporations is not a necessity because an efficient

[24] *See* Konstantinos Sergakis, *The UK Stewardship Code: Bridging the Gap Between Companies and Institutional Investors*, 47 R.J.T. n.s. 109, 118 (2013) (discussing debate and controversial conclusions).

[25] *See id.* at 119 (noting that the UK Stewardship Code attempts to bridge the gap by increasing the activism of institutional investors).

[26] *See, e.g.*, SIR ADRIAN CADBURY, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE ¶ 6.13, at 50 (1992) [hereinafter CADBURY REPORT], *available at* http://ecgi.org/codes/documents/cadbury.pdf [http://perma.cc/4255-GB86] (archived Jan. 31, 2015) (arguing that institutions are able to interface with the boards of companies in which they have invested).

[27] *See* John C. Coffee, *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277, 1281 (1991) (asserting that monitoring by financial institutions could be limited to only improving their own positions rather than that of the shareholders); *see also* HEINEMAN & DAVIS, *supra* note 3, at 21–22 (pointing out the mismatch between the goals of individual investors and the acts of institutions); discussion *infra* Part II.B (discussing rational reticence).

[28] *Compare* Gilson & Gordon, *supra* note 3 (arguing for reducing costs), *with* Adam O. Emmerich, Theodore N. Mirvis, Eric S. Robinson & William Savitt, *Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power*, 3 HARV. BUS. L. REV. 136 (2013) (arguing for fair markets).

[29] *See, e.g.*, Iris H-Y Chiu, *Institutional Shareholders as Stewards: Toward a New Conception of Corporate Governance*, 6 BROOK. J. CORP. FIN. & COM. L. 387, 388 (2012) (positing that stewardship serves all of society and not just stakeholders).

market will' evolve and produce a solution.[30] This Note does not purport to advance the correctness of either of these views but proceeds under the supposition that the latter is more representative of current U.S. equity market realities.[31]

Because this Note rejects domestic adoption of a code such as the UK Stewardship Code generally but recommends incorporation of a discrete part of the Code into the U.S. regulatory regime, it is important to first understand the origins of the Code and the economic theory on which its Principles are based.

A. *The UK Stewardship Code*

1. Historical Background

The Code is a recent creation of the UK's Financial Reporting Council (FRC), but is the product of two decades of momentum.[32] In 1992, the Cadbury Report concluded that institutional shareholders were better situated than individual investors to monitor portfolio companies and that it was therefore important for a regulatory system to encourage institutional shareholders to engage with corporate boards.[33] The Cadbury Report further encouraged institutional investors to make full use of their voting rights and to disclose their policies for doing so.[34] In 1998, the Hampel Report reiterated, and built upon, the suggestions urged by the Cadbury Report.[35] The Hampel Report clearly affirmed the UK's view of corporations as societal organisms.[36] The conclusions and recommendations of these two reports provided the foundation and starting point for most subsequent reports on institutional investor engagement and even for the current Stewardship Code.[37]

[30] *See generally* Gilson & Gordon, *supra* note 3, 866–69 (arguing that activist shareholders perform institutional stewardship).

[31] *See generally id.* (finding that activist shareholders are evolving to produce a solution).

[32] *See* Sergakis, *supra* note 24, at 121 (providing historical background).

[33] *See* CADBURY REPORT, *supra* note 26, ¶ 6.11(1), at 49 ("Institutional investors should encourage regular, systematic contact at senior executive level [sic] to exchange views and information on strategy, performance, board membership and quality of management.").

[34] *See id.* ¶ 6.12, at 50 (urging members to use their voting rights and disclose their policies).

[35] HAMPEL COMMITTEE, HAMPEL COMMITTEE ON CORPORATE GOVERNANCE, FINAL REPORT, ¶ 2.13(I), at 19–20 (1998) [hereinafter HAMPEL REPORT], *available at* http://ecgi.org/codes/documents/hampel.pdf [http://perma.cc/L2TX-UU5Q] (archived Jan. 31, 2015) (suggesting that institutional shareholders make considered use of their votes).

[36] *See id.* ¶ 1.1, at 7 (arguing for accountable organizations).

[37] *See generally* Sergakis, *supra* note 24, at 10 (describing the current Stewardship Code).

The ideals of institutional investor engagement continued to gain momentum in the United Kingdom in the early 2000s with the releases of the Myners Report,[38] the Higgs Report,[39] and guidance from the Institutional Shareholders' Committee (ISC).[40] Meanwhile, the ISC urged institutional investors to engage in active and consistent dialogue with their portfolio companies' directors, intervening when necessary, all the while disclosing institutional engagement policies and results.[41] The overall response to the early guidelines contained in Myners, Higgs, and the ISC documents was positive.[42] Therefore, there was little reason to doubt the effectiveness or practicality of the guidelines, at least while the global economy seemed to be flourishing.[43]

In the wake of the global financial crisis of 2008–2009, debate came roaring back.[44] UK regulatory authorities accused institutional investors of apathetic monitoring, commonly referring to institutional investors as being "asleep."[45] The House of Commons Treasury Committee encapsulated this sentiment, pronouncing, "[I]nvestors have failed in one of their core tasks, namely the effective scrutiny and monitoring the [sic] decisions of boards and executive

[38] *See generally* PAUL MYNERS, INSTITUTIONAL INVESTMENT IN THE UNITED KINGDOM: A REVIEW (2001), *available at* http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf [http://perma.cc/89VV-N6NP] (archived Jan. 31, 2015) (proposing more active engagement by institutional shareholders).

[39] *See generally* DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS 69–70 (2003), *available at* http://www.ecgi.org/codes/documents/higgsreport.pdf [http://perma.cc/EF8D-56ZK] (archived Jan. 31, 2015) (theorizing that investors could help ensure non-executive directors have an effective role on boards by questioning them on corporate governance matters).

[40] *See generally* INSTITUTIONAL S'HOLDERS' COMM., THE RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS AND AGENTS – STATEMENT OF PRINCIPLES (2009) (outlining the responsibilities of institutional shareholders).

[41] *See id.* (noting the ISC push to get institutional investors to increase active engagement).

[42] *See, e.g.*, Bonnie Hampel, *Forward* to HAMPEL REPORT, *supra* note 35, para. 4, at 6 (stating that the recommendations had been broadly welcomed by both companies and investors).

[43] *See* INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK: THE GLOBAL DEMOGRAPHIC TRANSITION ch. I, at 1 (2004) (establishing the growth of the global economy); UNITED NATIONS, WORLD ECONOMIC SITUATION & PROSPECTS 1 (2004) (stating there was an expectation of continued growth in the global economy).

[44] *See* Sergakis, *supra* note 24, at 122.

[45] *E.g.*, Jennifer Hughes, *FSA Chief Lambasts Uncritical Investors*, FIN. TIMES (Mar. 11, 2009, 11:31 PM), http://www.ft.com/intl/cms/s/0/9edc7548-0e8d-11de-b099-0000779fd2ac.html#axzz3SXZUf4SH [http://perma.cc/T8DD-R3PG] (archived Feb. 22, 2015) (quoting the chief executive of the Financial Services Authority accusing institutional shareholders of not adequately monitoring).

management in the banking sector . . . ."[46] Many commentators went as far as to say that institutional investors were part of the problem, not only by failing to intervene but also by actively pushing company management for short-term returns at the expense of heightened risk and exposure.[47]

In the Walker Review, Sir David Walker took the former stance.[48] Walker concluded that, while not a key cause of the financial crisis, institutional investor apathy and "acquiescence" in risky management decisions likely exacerbated the extent of the financial crisis.[49] While acknowledging that such behavior on the part of institutional investors was not "irrational," Walker went on to conclude that many of the root causes of the UK Banking Crisis could have been at least mitigated by heightened scrutiny and engagement by institutions.[50] The Walker Review, along with a revised ISC Code, both issued in 2009, formed the springboard for the Stewardship Code.[51]

In July 2010, the FRC issued the Stewardship Code in an effort to spur genuine active engagement by institutions through greater transparency and disclosure.[52] The Stewardship Code initially received mixed reviews—while some believed the Stewardship Code should have recommended even higher standards, others saw it as the potential first step in a corporate governance paradigm shift.[53] The initial version of the Code also lacked clarity as to its scope: it was ambiguous as to exactly which institutional investors were covered and precisely what was necessitated by its "comply or

[46] HOUSE OF COMMONS TREASURY COMMITTEE, BANKING CRISIS: REFORMING CORPORATE GOVERNANCE AND PAY IN THE CITY (NINTH REPORT OF SESSION), 2008-9, H.C. 519, at 64 (U.K.).

[47] *E.g.*, Natasha Burns, Simi Kedia & Marc Lipson, *Institutional Ownership and Monitoring: Evidence from Financial Misreporting*, 16 J. CORP. FIN. 443, 444 (2010) (arguing institutions can be influenced by investor reactions and focus on short-term performance); *see* Wong, *Stewardship*, *supra* note 1 (explaining why it is difficult for institutional investors to act as stewards).

[48] SIR DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: FINAL RECOMMENDATIONS ¶¶ 5.10–11 (Nov. 2009) [hereinafter WALKER REVIEW], *available at* http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf [http://perma.cc/N69D-H8DL] (archived Feb. 24, 2015).

[49] *Id.* ¶ 5.10.

[50] *Id.* ¶ 5.11.

[51] Sergakis, *supra* note 24, at 122 (noting that the ICS Code was the basis of the UK Stewardship Code).

[52] *See* Michael McKersie, *The Stewardship Code and the Pattern of Engagement By Institutional Shareholders with Listed Companies*, 5 CAPITAL MARKETS L.J. 439, 439–40 (2010) (describing the Stewardship Code issued by the FRC).

[53] *Compare* Simon C. Y. Wong, *The UK Stewardship Code: A Missed Opportunity for Higher Standards*, RESPONSIBLE INVESTOR (July 13, 2010) [hereinafter Wong, *Missed Opportunity*] (arguing for a stronger Code), *with* Chiu, *supra* note 29 (suggesting stewardship as the first step in a corporate paradigm shift).

explain" requirement.[54] After a consultation period, the FRC revised the Stewardship Code in 2012 to address many of these clarity concerns.[55]

2. Policies

According to the revised Stewardship Code, institutional investor stewardship of portfolio companies is intended to foster the long-term company success "in such a way that the ultimate providers of capital also prosper," for the benefit of the economy as a whole.[56] The Code's presumption of the corporation's overall societal function is clear, as it seeks to encompass a wide range of market participants as stewards subject to the Code's provisions.[57] In allowing institutional investors to outsource various functions associated with stewardship, the Stewardship Code expressly "applies, by extension, to service providers, such as proxy advisors and investment consultants."[58] By extending stewardship responsibilities to all service providers, the Code envisions an expansive array of market participants undertaking joint responsibility for stewardship and engagement.[59] The theory is that the benefits of total market stewardship will devolve upon individual investors and the general public.[60]

The Stewardship Code is a "soft law" code of best practices that derives compliance from its "comply or explain" provision.[61] Signatories must either comply with the Stewardship Code's Principles or disclose their noncompliance and explain why they are unable to comply.[62] This concept can be found in the Walker Report

[54] Sergakis, *supra* note 24, at 123 (describing the shortfalls of the initial code). The Code lacked clarity overall. Comply or explain will be unpacked more fully below.

[55] *See* FIN. REPORTING COUNCIL, CONSULTATION DOCUMENT: REVISIONS TO THE UK STEWARDSHIP CODE 1, 4 (2012), *available at* http://www.frc.org.uk/getattachment/fa05e79c-22c6-4f8f-b5b3-2ab55ec41113/ (last visited Feb. 23, 2015) [http://perma.cc/82R4-26SU] (archived Jan. 31, 2015).

[56] STEWARDSHIP CODE, *supra* note 9, ¶ 1, at 1. The Stewardship Code continues:

> For investors, stewardship is more than just voting. Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.

Id. ¶ 4, at 1.

[57] *See* Sergakis, *supra* note 24, at 123 (pointing out the Code's premise that "stewards are not merely a company's investors").

[58] STEWARDSHIP CODE, *supra* note 9, ¶ 2, at 2.

[59] *See* Sergakis, *supra* note 24, at 125.

[60] *See* STEWARDSHIP CODE, *supra* note 9, ¶ 1, at 1.

[61] *See* Chiu, *supra* note 29, at 388, 392.

[62] *See* STEWARDSHIP CODE, *supra* note 9, ¶ 3, at 4.

and seeks to promote compliance through public opinion.[63] The revised Stewardship Code offers guidance to both institutional investors and beneficial owners on how to disclose and how to interpret disclosures, respectively.[64] For signatory institutions, the Stewardship Code states:

> Those signatories that choose not to comply with one of the principles, or not to follow the guidance, should deliver meaningful explanations that enable the reader to understand their approach to stewardship. In providing an explanation, the signatory should aim to illustrate how its actual practices contribute to good stewardship and promote the delivery of the institution's or its clients' investment objectives. They should provide a clear rationale for their approach.[65]

On the other hand, the Stewardship Code suggests that beneficiaries not make judgments categorically and pay "due regard" to a signatory's specific circumstances, size, and complexity.[66] Although the revised Stewardship Code expanded greatly on just what is meant by "comply or explain," some commentators have questioned whether its guidance directed to beneficiaries relaxes institutional compliance.[67] The guidance continues:

> Whilst clients and beneficiaries have every right to challenge a signatory's explanations if they are unconvincing, they should not evaluate explanations in a mechanistic way. Departures from the Code should not be automatically treated as breaches. A signatory's clients and beneficiaries should be careful to respond to the statements from the signatory in a manner that supports the "comply or explain" process and bears in mind the purpose of good stewardship. They should put their views to the signatory and both parties should be prepared to discuss the position.[68]

While the guidance is meant to alleviate concerns over a rigid "comply or explain" set of rules,[69] it is unclear how it will affect the behavior of signatory institutions with already wide ranging conceptions of stewardship.[70]

3. Principles

The Principles of the Code invite signatory institutions to develop policies for engagement and stewardship and to disclose

[63] *See* WALKER REVIEW, *supra* note 48, at 17 ("Its status should be akin to that of the Combined Code as a statement of best practice, with observance on a similar 'comply or explain' basis.").

[64] *See* STEWARDSHIP CODE, *supra* note 9, ¶ 3–7, at 4.

[65] *Id.* ¶ 3, at 4.

[66] *See id.* ¶ 6, at 4.

[67] *See, e.g.*, Wong, *Missed Opportunity*, *supra* note 53 (noting that recent changes in the Stewardship Code have resulted in relaxed compliance requirements in some areas such as managing conflicts of interest).

[68] STEWARDSHIP CODE, *supra* note 9, ¶ 7, at 4.

[69] *See* WALKER REVIEW, *supra* note 48, at 11.

[70] *See generally* Wong, *Missed Opportunity*, *supra* note 53.

those policies to beneficial owners. Because Principle 5 is a focus of this Note, it will be discussed last. Principles 1 and 2 call for institutional investors to develop and disclose policies for discharging their stewardship responsibilities and managing conflicts of interest. [71] Principle 3 simply directs institutional investors to monitor their portfolio companies, and Principle 4 deals with setting guidelines for when institutions will escalate their monitoring activities.[72]

According to Principle 6, institutional investors should have a clear policy for voting and disclosure of voting activity. Specifically, Principle 6 guides institutions to "seek to vote all shares held" and "not automatically support the board."[73] Principle 7 simply urges periodic reporting of stewardship and voting activities, including a suggestion that institutions "report at least annually to those to whom they are accountable on their stewardship policy and its execution."[74]

Principle 5 involves collective action with other investors and thus is perhaps the most well-suited to translate to jurisdictions other than the United Kingdom and Europe.[75] "At times," according to Principle 5, "collaboration with other investors may be the most effective manner in which to engage."[76] This is by no means a surprising assertion given the high concentration of governance rights in the hands of institutional investors.[77] The guidance under Principle 5 continues:

> Institutional investors should disclose their policy on collective engagement, which should indicate their readiness to work with other investors through formal and informal groups when this is necessary to achieve their objectives and ensure companies are aware of concerns. The disclosure should also indicate the kinds of circumstances in which the institutional investor would consider participating in collective engagement.[78]

While the Code overall may not square with current U.S. equity market realities, Principle 5 may be a provision of substantial domestic usefulness.

[71] *See* STEWARDSHIP CODE, *supra* note 9, at 6.

[72] *See id.* at 7–8.

[73] *Id.* at 9.

[74] *Id.* at 9–10.

[75] *See id.* at 8–9.

[76] *Id.* at 8.

[77] *See* TONELLO & RABIMOV, *supra* note 1; IRRC Report, *supra* note 1.

[78] STEWARDSHIP CODE, *supra* note 9, at 9.

B. *Rational Reticence: The Nature of Institutional Investors*

Institutional investors will realize little, if any, performance value from proactive exercise of their governance rights; the mobilization costs are simply too high.[79] Institutional investors are primarily concerned with, and specialize in, delivering comparatively superior investment performance over short periods of time, while minimizing costs and risk.[80] Institutional investors have consistently struggled to effectively monitor portfolio companies as stewards.[81] In fact, to do so would run contrary to their nature.[82] This nature therefore yields a maze of interest conflicts between institutional investors and true stewardship of portfolio companies.[83]

The short-term, comparative performance metrics upon which the vast majority of portfolio managers and funds are evaluated constrains institutional activism.[84] The performance of managers and funds is often monitored on a quarterly basis compared to similar funds or an index.[85] This pervasive method of measuring performance does not easily accommodate long-term dialogue, even though it may potentially benefit individual shareholders in the long run.[86] For example, a mutual fund may engage in fundamental analysis of its portfolio companies, aimed at identifying poor performance and business strategy resulting from poor governance.[87] When this analysis reveals substandard performance and governance, the fund manager has two choices: (1) attempt to intervene and improve the

[79] *Cf.* Coffee, *supra* note 27, at 1283–85 ("[T]he primary explanation for institutional passivity is not overregulation, but the insufficiency of existing incentives to motivate institutional money managers to monitor."); Gilson & Gordon, *supra* note 3, at 895 ("Institutional owners . . . will assign a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor's profitability and ability to attract assets depends.").

[80] *See* Gilson & Gordon, *supra* note 3, at 889; Wong, *Stewardship*, *supra* note 1, at 406–07. Indeed, they are required to minimize risk through diversification to maintain "diversified" status. *See* 15 U.S.C. § 80a-5(b)(1) (2012).

[81] *See Commission Green Paper on the EU Corporate Governance Framework*, ¶ 2, at 11, COM (2011) 164 final (Apr. 5, 2011), *available at* http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf [http://perma.cc/8JYV-B2YW] (archived Jan. 31, 2015); Wong, *Stewardship*, *supra* note 1.

[82] Wong, *Stewardship*, *supra* note 1 ("Why is it so difficult for institutional investors to act as stewards? In essence, it is because stewardship is not in their genetic makeup.").

[83] For a general discussion of the conflicts of interest between institutional investors and stewardship, see generally Simon C. Y. Wong, *How Conflicts of Interest Thwart Institutional Investor Stewardship*, BUTTERWORTHS J. OF INT'L BANKING & FIN. L. 481 (Sept. 2011), *available at* http://ssrn.com/abstract=1925485 [http://perma.cc/P4GA-G3M5] (archived Jan. 31, 2015).

[84] *See* Wong, *Stewardship*, *supra* note 1.

[85] *See id.* at 407.

[86] See Gilson & Gordon, *supra* note 3, at 890.

[87] *See id.*

company board's governance or (2) sell the position.[88] Competitive forces dictate that fund managers are not always incentivized to attempt to intervene. This is because if the manager successfully intervenes and engages the corporate board toward improvement of the company's performance, all shareholders—including the fund's competitors—will enjoy the benefits.[89]

Thus, institutional investor X is only incentivized toward activism in portfolio company Y to the extent that X fund has a higher stake in portfolio company Y (relative to the fund size) than any other investor.[90] This is because, in the case of institutional investor X, the costs of activism to fund Y would be less than their profits otherwise.[91] In a market where fund managers are being evaluated based on their fund's performance relative to other similar funds, such a shared gain would provide no competitive advantage.[92] The result is that, even though it may ultimately benefit individual owners, fund managers have no incentive to proactively engage portfolio companies and therefore do not develop expertise in doing so.[93]

The fee structure of many institutional investors also attenuates active engagement. Consider the case of a passive index fund, designed to track the movements of a market index, such as the S&P 500 or the FTSE 100, over a long period of time. Considering the long-term objective and holding period of the fund, one might view an index fund as a prime candidate for stewardship of its portfolio companies.[94] Another chief objective of index funds, however, is low management fees—fees that would rise substantially should the fund actively engage in stewardship activities.[95] As a result, index fund managers allocate very little, if any, resources to portfolio company engagement.[96]

[88] *See id.*; Coffee, *supra* note 27, at 1281 (highlighting this "trade-off" faced by institutional investors).

[89] *See* Gilson & Gordon, *supra* note 3, at 890.

[90] *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1052–53 (2007) ("[Institutional activism] will increase a fund's relative returns only to the extent that the fund has a higher stake in the portfolio company (relative to the fund size) than competing funds do and the costs of activism to the fund are less than the profits from that differential.").

[91] *See id.*

[92] *See id.*; *see also* Gilson & Gordon, *supra* note 3, at 890 ("But a shared gain, unlike the private gain of a successful trade, provides little competitive advantage to the proactive investment manager whose portfolio products and services are chosen in comparison to competitors offering similar products or services."); Wong, *Stewardship*, *supra* note 1, at 407.

[93] *See* Gilson & Gordon, *supra* note 3, at 890.

[94] *See* Wong, *Stewardship*, *supra* note 1, at 409.

[95] *See id.*

[96] *See id.*

The regulatory landscape in the United States further deters activism. For example, mutual fund management must make semiannual disclosures of the quantities and values of the fund's securities.[97] As a result, it is unlikely that mutual funds will be able to accumulate positions in portfolio companies without drawing market attention.[98] Additionally, in order to qualify for substantial tax benefits under subchapter M of the Internal Revenue Code, and "diversified" status under the Investment Company Act, mutual funds must maintain high levels of diversification.[99] The mandate to diversify restrains a fund's ability to take a position in any individual company substantial enough to draw the ear of company management.[100] As a final example, by definition, open-end mutual funds must be prepared to redeem their shares upon the request of any shareholder at any time and on short notice.[101] This creates resource uncertainty for the fund manager and makes activism more difficult.[102] Compliance with regulatory constraints overall diminishes institutional incentives and ability to monitor corporate boards.[103]

Thus, there exists an agency gap between the relatively large concentration of governance rights possessed by institutional investors and the low value they themselves assign to those governance rights.[104]

C. *The Emergence of Activist Shareholders*

"Activist shareholder" is no longer a strictly pejorative term.[105] Once designated as crowds of "locusts" and "corporate raiders,"[106]

[97] *See* Investment Company Act of 1940 § 29(e), 15 U.S.C. § 80a-29(e) (2012).

[98] *See* Kahan & Rock, *supra* note 90, at 1049.

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

[100] *See* Kahan & Rock, *supra* note 90, at 1049.

[101] *See id.* at 1049–50 (citing 15 U.S.C. § 80a-5(a)(1) (2012)).

[102] *See id.* at 1050–53.

[103] *See id.* at 1049.

[104] *See generally* Gilson & Gordon, *supra* note 3 (terming this gap "the agency costs of agency capitalism").

[105] *E.g.*, Alexandra Stevenson, *No Barbarians at the Gate; Instead, a Force for Change*, N.Y. TIMES, Jan. 7, 2014, at B1, *available at* http://dealbook.nytimes.com/2014/01/06/no-barbarians-at-the-gate-instead-a-force-for-change/?_php=true&_type=blogs&_r=0 [http://perma.cc/B8UF-JAYF] (archived Jan. 23, 2015).

[106] Andrew Willis, *Corporate Raiders Now Wearing the White Hat*, GLOBE & MAIL, Aug. 18, 2006, at B16, *available at* https://secure.globeadvisor.com/servlet/ArticleNews/story/gam/20050818/RWILLIS18 [https://perma.cc/56GX-MTPR] (archived Jan. 23, 2015); *Activist Investors: Flight of the Locusts*, ECONOMIST, Apr. 8, 2009, at 63, *available at* http://www.economist.com/node/13446602 [http://perma.cc/QA82-JYE6] (archived Jan. 23, 2015).

activist shareholders—activist hedge funds in particular[107]—have come to serve an important role in improving shareholder value by serving as a check on incumbent management power.[108]

In general, activist investors are those investors that aggressively attempt to influence the decision making of corporate boards. [109] Activist hedge funds seek to influence corporate decision making by obtaining toehold positions in target companies, often soliciting the support of institutional investors for their proposals.[110] Activist hedge funds share the following characteristics with the overall hedge fund sector: they are (i) pooled, privately organized investment vehicles; (ii) administered by professional investment managers who serve as general partners (who have made a substantial investment and they are compensated on the basis of performance); (iii) with lock up periods of at least six months; and (iv) that are not widely available to the public, with a small number of sophisticated investors (usually high net worth individuals and, more recently, institutions and retail investors).[111]

The term activist investor earned a negative connotation beginning in the 1960s when "corporate raiders" launched attempts to take over companies in which they owned stock, often through the use of coercive cash tender offers.[112] Through the 1980s, activist investors

[107] The terms "hedge fund" and "activist" are frequently thrown around by the media but are more difficult to define than their daily usage might suggest. The D.C. Circuit recently reasoned that hedge funds are more readily defined by what they are not. Indeed, they are (and are designed to be) exempt from the Investment Company Act, the Investment Advisers Act of 1940 ("Advisers Act") and key portions of the Securities Act of 1933 and the Securities Exchange Act of 1934. They are not completely unregulated, however, as they are still subject to the antifraud provisions of the securities laws, commodities laws, and the Advisers Act. For further discussion, see Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006); Kuang-Wei Chueh, Note, *Is Hedge Fund Activism New Hope for the Market?*, 2008 COLUM. BUS. L. REV. 724, 725 (2008).

[108] *See* Lucian A. Bebchuk & Robert J. Jackson, *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39, 47, 49 (2012) ("These investments can be expected to make incumbents more accountable and to reduce agency costs and managerial slack."); Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 459, 462 (2013) ("[A]ctivist hedge funds are seen as capable of disciplining corporate management, thus filling the monitoring gap created by 'rationally apathetic' institutional shareholders.").

[109] Chueh, *supra* note 107, at 729.

[110] *See* Gilson & Gordon, *supra* note 3, at 897.

[111] *See* Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, *in* NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES 101, 115 (Yasuyuki Fuchita & Robert E. Litan eds., 2007).

[112] Andrew N. Vollmer & Paul R.Q. Wolfson, *The Williams Act: A Truly "Modern" Assessment*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FIN. REGULATION 1 (Oct. 22, 2011, 9:49 AM), http://blogs.law.harvard.edu/corpgov/files/2011/10/The-Williams-Act-A-Truly-Modern-Assessment.pdf [http://perma.cc/7GYE-WFHV]

developed a reputation for being highly aggressive, self-interested, short-term investors—"barbarians at the gate," so to speak.[113] Since that time, however, activist investors have been forced to change their approach due to fundamental changes to the corporate governance landscape.[114] Perhaps the most important change was the arming of corporate managers with takeover defenses such as poison pills and staggered board terms.[115] These defenses, in combination with the development of state antitakeover statutes, made gaining control of a target company virtually impossible for activist investors.[116] Thus, activist investors like hedge funds no longer rely on control for influence.[117]

To influence corporate management and strategy today, hedge fund activism takes many forms. These forms include exerting public pressure on company executives, running proxy contests to gain seats on the board of directors, and engaging in litigation.[118] One recent (and amusing) example of an activist hedge fund using public pressure involved a hedge fund called Third Point and a heating oil distribution company known as Star Gas.[119] Third Point, having accumulated a 6 percent stake in Star Gas, became dissatisfied with then-CEO Irik Sevin's management of the company and went about not only criticizing his management but also openly questioning his personal character:

> [H]ow is it possible that you selected your elderly 78-year-old mom to serve on the Company's Board of Directors and as a full-time employee providing employee and unitholder services? We further wonder under what theory of corporate governance does one's mom sit on a Company board. Should you be found derelict in the performance of your executive duties, as we believe is the case, we do not believe your mom is the right person to fire you from your job.[120]

Sevin resigned one month later.[121]

(archived Jan. 31, 2015); Note, *Cash Tender Offers*, 83 HARV. L. REV. 377, 377 (1969) [hereinafter *Cash Tender Offers*].

[113] *See* Stevenson, *supra* note 105 (discussing evolving attitudes toward activist shareholders over time).

[114] *See* Vollmer & Wolfson, *supra* note 112, at 7–8.

[115] *See id.* at 8–12. It should be noted that many companies have since dropped their staggered board provisions, due in part to Lucian Bebchuk's Shareholder's Rights initiative at Harvard Law School.

[116] *See id.*

[117] *See id.* at 8.

[118] *See* Kahan & Rock, *supra* note 90, at 1029.

[119] *See* Letter from Daniel S. Loeb, Chief Exec. Officer, Third Point LLC, to Irik P. Sevin, Chairman, President & Chief Exec. Officer, Star Gas Partners L.P., *available at Third Point Demands That Star Gas CEO, Irik Sevin, Resigns and Returns Keys to Company Car*, PR NEWSWIRE (Feb. 14, 2005), http://www.prnewswire.com/news-releases/third-point-demands-that-star-gas-ceo-irik-sevin-resigns-and-returns-keys-to-company-car-54051747.html [http://perma.cc/MV9E-4WYH] (archived Feb. 24, 2015).

[120] *Id.*

[121] *See* Heather Wilson, *Star Gas CEO Irik Sevin Resigns, Replacement Named*, MKT. WATCH (Mar. 7, 2005, 6:19 PM), http://www.marketwatch.com/story/star-

Over time, court approval of takeover defenses like poison pills and federal and state disclosure requirements have worked to gradually constrain the *modus operandi* of investors intent on agitating for change in corporate boardrooms. Ultimately, this dynamic produced what we now know as activist investors, or more commonly, activist hedge funds. Often unable to go around corporate boards to achieve desired results, activist hedge funds specialize in going through them. Activist hedge funds frequently seek board representation in addition to exerting pressure on boards publicly through mass, or even social, media.[122]

D. *Rational Reticence and Activism*

Hedge funds have taken an active role leveraging institutional governance rights in the context of transactions involving potential changes in control.[123] Although institutional investors lack incentive for active engagement and stewardship, a great deal of empirical evidence indicates that institutional investors are "rationally reticent."[124] Rational reticence refers to the propensity of institutional investors to respond to governance proposals rather than propose them.[125] Put simply, owing to the nature of institutional investors, institutional funds are responsive, not proactive.[126] Activist investors are therefore well-situated to serve as governance intermediaries. Activist interests are often closely aligned with the interests of individual shareholders of their target companies.[127] Unlike mutual funds, hedge funds are structured and regulated in such a way that activism is nearly always feasible and profitable. There are latent economies of scale between rationally reticent institutional investors and activist hedge funds in the exercise of governance rights.

gas-ceo-irik-sevin-resigns-replacement-named [http://perma.cc/9QB4-HFAV] (archived May 24, 2015).

[122] *E.g.*, Aaron Pressman, *Carl Icahn's Multibillion-Dollar Tweet Boosts Apple Stock*, YAHOO FIN. (Aug. 13, 2013, 4:59 PM), http://finance.yahoo.com/blogs/the-exchange/carl-icahn-multibillion-dollar-tweet-boosts-apple-stock-205938760.html [http://perma.cc/RE6K-3MVR] (archived Feb. 24, 2015); *Icahn Tweets He Will Send Open Letter to Apple*, REUTERS (Oct. 8, 2014, 3:58 PM), http://www.reuters.com/article/2014/10/08/us-apple-icahn-tweet-idUSKCN0HX25S20141008 [http://perma.cc/L963-YUEJ] (archived Jan. 31, 2015).

[123] *See* Kahan & Rock, *supra* note 90, at 1034.

[124] *See* Coffee, *supra* note 27, at 1281 ("[A]gents controlling institutional investors . . . have little reason to become active participants."); Gilson & Gordon, *supra* note 3, at 867 (discussing the structural shift from individual shareholders to institutional shareholders and the role of activist shareholders in this new dynamic).

[125] *See* Gilson & Gordon, supra note 3, at 867.

[126] *See id.*

[127] *See id.* ("The role of a new entrant into the governance story, the activist shareholder, is to increase the value of the vote held by the institutions by teeing up the intervention choices at low cost to the institutional owners. If the intervention is successful, the activist's equity position will increase in value, as will that of the institutions.").

Consider, as an example, the proposed acquisition by Deutche Borse (DB) of the London Stock Exchange (LSE). DB proposed a bid for LSE at the end of 2004,[128] and, not to be outdone, Euronext (a competing exchange) announced its interest in LSE soon after.[129] But the Children's Investment Fund Management (TCI), [130] having accumulated a 5 percent stake in DB, opposed the deal.[131] TCI argued that DB had other, more promising avenues of value creation for its shareholders with its excess cash.[132] Soon, Atticus Capital, a U.S.-based fund that owned roughly 2 percent of DB's shares, joined TCI in opposition. [133] By February 2005, several mutual funds, spearheaded by TCI and Atticus, held roughly 35 percent of DB's stock and overtly opposed the deal.[134]

Ultimately, with between 40 percent and 60 percent of its shareholders opposing the bid, DB abandoned the acquisition attempt and promised to pursue a plan to distribute the cash to shareholders. [135] After DB abandoned its bid, one institutional investor's representative said,

> The hedge funds have done a marvelous job. No matter how we feel about companies, traditional managers simply cannot move as fast to achieve our aims. We were right behind [the hedge funds], but we couldn't have done it without them.[136]

III. THE CURRENT DEBATE

A. *Activist Shareholders As Governance Intermediaries*

Because hedge funds are largely unregulated, they possess substantial economies of scale compared to similarly-sized

[128] Norma Cohen, Jeremy Grant & Patrick Jenkins, *Deutsche Börse Courts LSE for European Exchange Union*, FIN. TIMES (U.K.), Dec. 14, 2004, at 23.

[129] Norma Cohen, *LSE War Looms as Euronext Confirms Intent*, FIN. TIMES (U.K.), Dec. 21, 2004, at 22.

[130] Until 2014, this London-based hedge fund paid to the Children's Investment Fund Foundation one third of its 1.5 percent management fee and 0.5 percent of any profits exceeding 11 percent. *See* Andrea Gerlin, *Ex-Wife of TCI's Hohn to Get $530 Million in London Divorce Case*, WASH. POST (Nov. 27, 2014, 12:33 PM), http://washpost.bloomberg.com/Story?docId=1376-NANFPG6KLVRL01-1AJML6IRE1685DGODSP3NK505O [http://perma.cc/8G8C-JAEE] (archived Jan. 31, 2015).

[131] Martin Waller, *Fund Says Opposition to Börse's LSE Bid Is Mounting*, TIMES (U.K.), Jan. 18 2005, at Bus. 43; Richard Wray, *Börse Rebel Threatens To Derail LSE Bid*, GUARDIAN (U.K.), Jan. 17, 2005, at 21.

[132] *See* Wray, *supra* note 131.

[133] Norma Cohen, *Deutsche Börse 'Empire Building,'* FIN. TIMES (U.K.), Jan. 17, 2005, at 19.

[134] Louise Armitstead, *Shareholders Revolt in Bid to Topple Seifert*, SUNDAY TIMES (U.K.), Feb. 20, 2005, at Bus. 1.

[135] Louise Armitstead, *Saved by the Growing Power of Hedge Funds*, SUNDAY TIMES (U.K.), Mar. 13, 2005, at Bus. 14.

[136] *Id.*

institutional owners.[137] There are over 8,500 hedge funds in the United States managing $1.74 trillion in assets.[138] This figure indicates that the average hedge fund has assets of around $200 million, with the largest hedge funds managing assets over $20 billion.[139] These numbers may be understated, though, because unlike mutual funds and pension funds, hedge funds frequently use hard-to-quantify leverage and investment derivatives.[140] As a result, hedge funds can concentrate a significant portion of their assets in a single position, unlike a mutual fund with comparable net assets.[141]

Hedge funds have significantly more flexibility in their operations than mutual funds and pension funds. Unlike mutual funds and pension funds, hedge funds need only comply with regulatory laws that apply to investors generally. These laws include disclosure requirements of section 13(d) of the Securities Exchange Act[142] as well as the short-swing profit rules under section 16(b).[143] Hedge fund managers must also make quarterly disclosures about their holdings, pursuant to Section 13(f) of the Securities Exchange Act.

In practice, most small- and many medium-sized hedge funds can avoid making any disclosures as long as they keep a substantial portion of their holdings in nonregistered derivatives and debt instruments. Under 13(f), hedge fund managers need only disclose holdings of "registered equity securities"—i.e., traded shares and options listed on an exchange.[144] Therefore, holdings of other options and derivatives do not need to be disclosed. The result is that hedge funds can use derivatives to accumulate large economic positions in target companies without disclosure, unless they cross the 5 percent threshold under Section 13(d). Moreover, holdings of "13(f) securities"[145] less than $100 million need not be disclosed at all.[146]

Incentives for hedge funds to monitor portfolio companies are quite different from those of traditional institutional investors,

[137] *See* Kahan & Rock, *supra* note 90, at 1062–63.

[138] *See* PREQIN SPECIAL REPORT: US HEDGE FUND INDUSTRY 3 (2013), *available at* https://www.preqin.com/docs/reports/Preqin_Special_Report_US_Hedge_Fund_Industry_Sep_13.pdf [https://perma.cc/74DL-XRUP] (archived Jan. 31, 2015).

[139] *See Bridgewater, J.P. Morgan Top List of 100 Largest Hedge Funds*, MKT. WATCH (May 12, 2014, 4:20 PM), http://blogs.marketwatch.com/thetell/2014/05/12/bridgewater-j-p-morgan-top-list-of-100-largest-hedge-funds/ [http://perma.cc/57T7-4MFC] (archived Feb. 24, 2015).

[140] *See* Kahan & Rock, *supra* note 90, at 1063.

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

[142] *See* 15 U.S.C. § 78m(d) (2012) (requiring disclosure when an investor owns more than 5 percent of the equity securities of a public company).

[143] See Securities Exchange Act of 1934, § 16(b), which applies to officers, directors, and 10 percent shareholders of a company under § 16(a).

[144] 17 C.F.R. § 240.13f-1 (2014).

[145] 17 C.F.R. § 240.13f-1(c).

[146] *See* 17 C.F.R. § 240.13f-1(a)(1).

rendering hedge funds a more capable corporate monitor. As discussed above, institutional investors, such as mutual funds, lack incentive to engage and monitor portfolio companies.[147]

Unlike mutual fund managers, hedge fund managers are not typically evaluated based on returns relative to a benchmark.[148] Rather, hedge funds focus on absolute returns when assessing a fund's performance and determining manager compensation.[149] Thus, the higher the absolute returns achieved by the fund, the greater the benefit to both managers and investors. Naturally, like mutual fund managers, hedge fund managers do want to retain and attract investors through their performance, and some level of performance benchmarking relative to an index is inevitable because that is what investors generally expect. [150] However, hedge fund portfolios resemble indices much less than mutual funds.[151] In fact, hedge funds rarely even resemble one another. [152] Therefore hedge fund managers generally do not need to worry about competitor funds free-riding on governance activism. [153] The relatively high level of sophistication among investors in hedge funds may lead them to ignore any fear of free riding and allocate their investments specifically to activist funds.[154]

Hedge fund fee structures provide further monitoring incentives. These fee structures are weighted heavily based on profits earned and reward managers for maximizing returns to fund investors. [155] Generally, the base percentage fee charged for assets under management is low, and the fee for bottom line profits is high, often in the range of 20 percent.[156] Moreover, most hedge fund managers have a substantial portion of their own personal wealth invested in the fund.[157] The performance-based fee structure, combined with the hedge fund manager's personal wealth maximization incentives, both serve to align the hedge fund manager's interests with the fund's shareholders.

In general, activist hedge funds tend to accumulate positions in target companies for the purpose of engaging in activism; some commentators have come to refer to this sort of activism as "offensive"

[147] *See supra* Part II.B.

[148] *See* FIN. SERVS. AUTH., DISCUSSION PAPER 05/4, HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT 10 (2005), *available at* http://www.fsa.gov.uk/pubs/discussion/dp0504.pdf.

[149] *See id.*

[150] *See* Kahan & Rock, *supra* note 90, at 1065.

[151] *See id.*

[152] *See id.*

[153] *See id.* at 1066.

[154] *Id.* at n.216.

[155] *See id.* at 1064.

[156] *Id.*

[157] *Id.*

activism.[158] This, of course, presents a significant departure from the nature of institutional investors such as mutual funds and pension funds. If mutual funds or pension funds engage in activism at all, it tends to be from a "defensive" posture.[159] That is, an institutional investor may become active in a portfolio company in which it has a preexisting position that it has identified as underperforming.[160] As noted previously, however, institutional fund managers are much more likely to simply sell the underperforming position.[161]

These different approaches to activism among hedge funds and institutional investors reflect fundamentally different profit-making strategies. Activist hedge funds, on one hand, actually use activism as their profit strategy by accumulating toehold positions in target companies that allow them to agitate for change, and ultimately, profit from their activism.[162] On the other hand, institutional investors do not use activism as a profit-making strategy—i.e., they do not take positions in portfolio companies for the purpose of profiting from activism.[163]

This fundamental strategic difference should not be surprising in light of the fact that institutional investors hold themselves out as a low-cost conduit for diversification. Indeed, one factor cited by commentators as to why institutional investors have proven to be ineffective corporate monitors is excessive diversification.[164] But diversification and activism do not mix. Intrinsically, activism requires a targeted approach in which a fund takes a large position in only a few companies.[165]

B. *The Nature of Hedge Fund Activism*

The inherently confrontational nature of hedge fund activism can make life difficult for corporate managers and their advisors, not to

[158] *See* Brian Cheffins & John Armour, *The Past, Present and Future of Shareholder Activism by Hedge Funds* 7–9, 15–16 (Legal Studies Research Paper Series, Paper No. 38/2011, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1932805 [http://perma.cc/UTP6-S6SG] (archived Jan. 31, 2015).

[159] *See id.* at 8.

[160] *See id.*; *see, e.g.*, Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227, 231–32 (1996) (outlining selection criteria).

[161] *See, e.g.*, Gilson & Gordon, *supra* note 3, at 893.

[162] *See id.* at 904; Cheffins & Armour, *supra* note 158, at 8; Kahan & Rock, *supra* note 90, at 1068.

[163] *See* Jeffrey Ubben & David Haarmeyer, *With Activism Comes Accountability*, INSTITUTIONAL INVESTOR'S ALPHA 60, 60 (July/Aug. 2006) (contrasting activist investor returns with the performance of traditional money managers).

[164] *See, e.g.*, Wong, *Stewardship*, *supra* note 1, at 407.

[165] *See* Kahan & Rock, *supra* note 90, at 1070; Ubben & Haarmeyer, *supra* note 163, at 60.

mention produce some highly entertaining anecdotes.[166] It comes as no surprise, then, that on the basis of such anecdotes, long-standing proponents of incumbent management—preeminent corporate law firm Wachtell Lipton—are petitioning the SEC to adopt measures that they believe will make life more difficult for activist hedge funds.[167]

As discussed above, activist hedge funds are in a substantially better position to monitor corporate boards than mutual funds.[168] But is Wachtell Lipton right? Are activist hedge funds more trouble than they are worth? Are they abusing Section 13(d)'s current ten-day disclosure window to harm companies in the long run?[169]

Activist hedge funds are often anecdotally accused of being excessively myopic, sacrificing the long-term interests of companies for a quick buck.[170] The empirical evidence, however, indicates that this perception is not only unwarranted but also contrary to the realities of hedge fund activism. Activist hedge funds do not choose their targets at random or based on factors such as the number of takeover defenses a company has in place.[171] Rather, activists tend to target firms that are underperforming relative to their peers, with low market value relative to book value.[172] Moreover, activist hedge funds are not excessively short-term in nature as is often claimed; their median holding period is around one year.[173]

The arrival of an activist shareholder is widely viewed by the market as good news. Indeed, abnormal returns around the day an activist crosses the 5 percent threshold are about 6 percent.[174] The

[166] *See* discussion *supra* Part II.C.

[167] Wachtell, Lipton, Rosen & Katz, Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, at 1–2 (Mar. 7, 2011) [hereinafter Wachtell Petition], *available at* http://www.sec.gov/rules/petitions/2011/petn4-624.pdf [http://perma.cc/FJX7-28YG] (archived Jan. 31, 2015) (petitioning the SEC to "shorten the reporting deadline and expand the definition of beneficial ownership under the reporting rules" under the 1934 Act).

[168] *See supra* Part II.

[169] *See* Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FIN. REGULATION (Feb. 26, 2013, 9:22 AM), http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/ [http://perma.cc/HJD4-2PFW] (archived Jan. 22, 2015) (scrutinizing Harvard Law School Professor Lucian Bebchuk's theory of "shareholder democracy").

[170] *See, e.g.*, *id.*

[171] *See* Brav, Jiang, Partnoy & Thomas, *supra* note 16.

[172] *See id.*; Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-term Effects of Hedge Fund Activism*, 114 COLUM. L. REV. (forthcoming June 2015) (manuscript at 5), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291577 [http://perma.cc/Z87D-8DMJ] (archived Jan. 22, 2015).

[173] *See* Brav, Jiang, Partnoy & Thomas, *supra* note 16, at 1731.

[174] *See* Lucian A. Bebchuk, Alon Brav, Robert J. Jackson, Jr. & Wei Jiang, *Pre-Disclosure Accumulations By Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1, 18 (2013) (examining empirical data contradicting many factual premises included in

claim has always been that the tactics employed by' activists to generate such short-term returns cause significant harm to the company in the long run.[175] According to a recent study by Lucian Bebchuk, Alon Brav, and Wei Jiang, however, this claim is also false. To the contrary, the operating performance of companies targeted by activist interventions improves during the five years following the intervention.[176] This is also the case for adversarial interventions, which account for around 22 percent of activist interventions but generate the large majority of media coverage.[177] Moreover, there is substantial empirical evidence indicating that activists are not abusing 13(d)'s ten-day disclosure window to accumulate large blocks of stock nor are they utilizing advances in trading technology to accumulate larger pre-disclosure positions than they used to.[178]

The empirical evidence indicates that, overall, activist hedge funds do not deserve the popular perception attributed to them and perpetuated by proponents of incumbent management. Tightening the disclosure rules under Section 13(d) would be potentially harmful to investors. To the extent that such tightening discourages activists from accumulating outside blockholdings, shareholders would not receive (a) the significant abnormal returns associated with the arrival of an activist and (b) the reduced agency costs associated with possibility that an activist will emerge.[179]

C. *The Williams Act*

A brief analysis of the passage of Williams Act, and its accompanying fundamental changes to the corporate governance landscape, demonstrates why changes to tighten the rules under 13(d) are unnecessary and potentially harmful to the overall economy.

The Williams Act was intended to protect individual shareholders from "corporate raiders" of the time who launched

Wachtell Lipton's rulemaking petition requesting that the Commission shorten the ten-day window established by section 13(d) of the Williams Act).

[175] But even the case for favoring long-term shareholders in general is not clear cut. *See generally* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 125 YALE L.J. (forthcoming 2015).

[176] *See* Bebchuk, Brav & Jiang, *supra* note 172, at 61–65 ("We do not find any evidence that such interventions produce long-term declines in operating performance thereby 'sacrificing the future for a quick buck.' To the contrary, such interventions tend to produce improvements in operating performance during the five-year period following them.").

[177] *Id.* at 65–69 ("We conclude that the alleged adverse effect on long-term performance is not found when one focuses on adversarial interventions, either.").

[178] *See* Bebchuk, Brav, Jackson & Jiang, *supra* note 174, at 14–18.

[179] *Cf. id.* at 18 ("First, reducing the incidence and magnitude of outside investments in large blocks of public-company stock will impose direct costs because shareholders will no longer enjoy the superior returns long associated with the arrival of an activist, five-percent blockholder.").

takeover attempts, often through the use of coercive cash tender offers.[180] While corporate control contests had previously been conducted by proxy fights or consensual share-for-share exchanges, the 1960s saw the proliferation of the unsolicited cash tender offer as a "legal device to effect takeovers."[181] In a standard 1960s cash tender offer, the offeror sought to acquire control of the target corporation by publicly proposing to buy a stated percentage of the target's outstanding equity securities.[182] The offeror would publish newspaper advertisements soliciting current shareholders to tender their shares at a set offer price, including a premium over the current market price.[183]

In extreme cases, the tender offer would only be open for a couple days, affording investors and company management very little time to weigh the pros and cons of the offer.[184] In short, the main problem with cash tender offers, unlike proxy fights or share-for-share exchanges, was that they enabled the corporate raider to "operate in almost complete secrecy concerning their intentions."[185]

The Williams Act was intended to fill the regulatory gap that existed at the time (into which cash tender offers fell),[186] by stating an exception to the general rule that outside stockholders of a company may invest anonymously.[187] Federal securities laws already provided protection for individual investors and company management from proxy fights and share-for-share exchanges, but no such disclosure requirements existed for cash tender offers.[188] Senator Williams voiced particular discomfort with the disparate protections afforded to investors subject to a cash takeover bid, as compared with investors affected by an exchange offer or proxy fight.[189]

[180] *See* Vollmer & Wolfson, *supra* note 112, at 5.

[181] *See id.*

[182] *See Cash Tender Offers*, *supra* note 112, at 377–78 (explaining the mechanics of cash tender offers in the 1960s).

[183] *See id.* ("The offeror's obligation to purchase (take up) tendered shares [was] typically conditioned on the tender of a set minimum number of securities." (footnote omitted)).

[184] Vollmer & Wolfson, *supra* note 112, at 5.

[185] 113 CONG. REC. 855 (daily ed. Jan. 18, 1967) (statement of Sen. Harrison Williams).

[186] *See* Edgar v. Mite Corp., 457 U.S. 624, 632 (1982) (considering whether an Illinois Act was pre-empted by the Williams Act and whether it violated the Commerce Clause).

[187] *Cf.* Bebchuk & Jackson, *supra* note 108, at 43–45 (noting that disclosure rules required by the Williams Act do not apply to investors).

[188] *See* Vollmer & Wolfson, *supra* note 112, at 5.

[189] *See* 113 CONG. REC. 855 (daily ed. Jan. 18, 1967) (statement of Sen. Harrison Williams) ("The failure to protect investors in connection with a cash takeover bid is in sharp contrast to the regulatory requirements applicable where one company offers to exchange its shares for those of another, or the protections applicable to a proxy fight for corporate control.").

As the originally drafted bill made its way through Congress, it was met with significant opposition,[190] primarily due to the concern that its onerous disclosure requirements would make it too difficult for shareholders to hold corporate managers accountable.[191] After revision and reintroduction, Senator Williams framed the intent of the bill, remarking that he had "taken extreme care with this legislation to balance the scales equally to protect the legitimate interests of the corporation, management, and shareholders . . . . Every effort has been made to avoid tipping the balance of regulatory burden in favor of management or in favor of the offeror."[192] Thus, the Williams Act reflects a deliberate decision by Congress to balance the interests of outside blockholders and incumbent managers.[193] Senator Williams ultimately resolved that outside blockholders "should not be discouraged, since they often serve as a useful purpose by providing a check on entrenched but inefficient management."[194]

As a result of the Williams Act, section 13(d) of the Securities Exchange Act currently requires disclosure by any person acquiring more than 5 percent of a registered company's stock within ten days of acquisition.[195] Senator Williams justified the 5 percent threshold in 1970 on the grounds that in many instances, a 5 to 10 percent interest in a company was a controlling interest, and therefore, disclosure of such an interest was necessary for investor protection.[196] Likewise, another congressman noted that an interest in excess of 5 percent in some companies gives the holder substantial control.[197]

The SEC has opened the door for further downward revision of both the disclosure threshold percentage and the disclosure window.[198] Section 13(g) of the Act now defines beneficial ownership

[190] *See* 112 CONG. REC. 19,004 (daily ed. Aug. 18, 1966).

[191] *See* 90 CONG. REC. 134 (daily ed. Jan. 12, 1944).

[192] 113 CONG. REC. 854 (daily ed. Jan. 18, 1967) (statement of Sen. Harrison Williams).

[193] *See generally* Bebchuk & Jackson, *supra* note 108, at 41 ("The drafters of the Williams Act made a conscious choice not to impose a hard 5% limit on pre-disclosure accumulations of shares, instead striking a balance between the costs and benefits of disclosure of blockholders' activities to avoid excessive deterrence of the accumulation of these outside blocks.").

[194] 113 CONG. REC. 24,664 (1967).

[195] Securities Exchange Act 13(d)(1), 15 U.S.C. § 78m(d) (2014).

[196] *See* 116 CONG. REC. 3024 (daily ed. Feb. 10, 1970).

[197] *See* 116 CONG. REC. 40188 (daily ed. Dec. 7, 1970).

[198] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929R(a), 124 Stat. 1376, 1866 (2010) (amending section 13 of Securities Exchange Act of 1934 and specifically authorizing SEC to reduce the trigger period for disclosure); Mary L. Shapiro, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the Transatlantic Corporate Governance Dialogue (Dec. 15, 2011), *available at* http://www.sec.gov/news/speech/2011/spch121511mls.htm [http://perma.cc/2V4R-MRY8] (archived Feb. 24, 2015) (remarking that the SEC planned to review and modernize beneficial

to include "security-based swap[s]."[199] This more restrictive definition has taken away one method activist hedge funds previously used to accumulate substantial positions in portfolio companies without disclosure. Even so, many are calling for the SEC to follow the UK's lead by further reducing the ownership threshold and reporting window.[200] The United Kingdom now imposes an ownership disclosure threshold of 3 percent and a two-day reporting window.[201]

Such measures by the SEC, which may stifle activism that substantially benefits individual shareholders, are not the solution, and fail to take into account changes in the market for corporate governance since the enactment of the Williams Act.[202] Moreover, such proposals are inconsistent with the Williams Act's aim to avoid tipping the balance in favor of incumbent management.[203]

IV. THE PRINCIPLE 5 COMPROMISE

The SEC is under considerable pressure to follow the UK's lead in reducing the 13(d) reporting threshold and window.[204] But, reforms like those adopted in the United Kingdom are generally justified by false preconceptions of the nature of activist hedge funds and discount the valuable role that hedge funds serve in the market for corporate governance. If the SEC adopts additional restraints, such changes should be accompanied by a compromise for activist hedge funds: the maintenance and public disclosure by domestic institutional investors of policies for collective action.

ownership reporting rules, including whether to shorten ten-day window and whether to include use of cash-settled equity swaps).

[199] Securities Exchange Act 13(g), 15 U.S.C. § 78m(g) (2014).

[200] *See, e.g.*, Wachtell Petition, *supra* note 167, at 1.

[201] *See* FIN. SERVS. AUTH., DISCLOSURE RULES AND TRANSPARENCY RULES §§ 5.1.2, 5.8.3 (2013), *available at* http://media.fshandbook.info/content/full/DTR.pdf [http://perma.cc/7GVP-TFRX] (archived Jan. 22, 2015) (requiring shareholders to notify the UK issuer of the percentage of shareholder's voting rights when it "reaches . . . 3% . . . and each 1% threshold thereafter up to 100%" in no later than two trading days). The Wachtell petition points to several foreign jurisdictions that have reduced their disclosure windows to suggest that the United States is "falling behind." Wachtell Petition, *supra* note 167, at 4.

[202] *Cf.* Bebchuk & Jackson, *supra* note 108, at 45–47 (identifying the criticisms of the SEC's proposed reporting period window); Vollmer & Wolfson, *supra* note 112, at 7–19 ("The market for corporate governance has changed dramatically since the Williams Act was passed, in three principal respects: A. the proliferation of state antitakeover statutes and takeover defenses; B. the rise of institutional shareholders; C. growth of active shareholder engagement.").

[203] *See* discussion *supra* Part III.C.

[204] *See, e.g.*, Wachtell Petition, *supra* note 167, at 1–7 (offering reasons why the current reporting deadlines are deficient).

A. *The UK Stewardship Code's Principle 5 as a Compromise for Activist Hedge Funds*

Activist hedge funds serve an important role in the market for corporate governance by leveraging the enormous governance rights held by rationally reticent institutional investors.[205] Additional reforms under consideration by the SEC may negatively impact the ability of activist hedge funds to serve in this role. Institutional investors have proven to be ineffective corporate monitors because to do so would be contrary to their nature.[206] As such, adoption of an entire best practices code, such as the Stewardship Code, which attempts to force institutional investors to monitor and engage portfolio companies, is unlikely to result in a meaningful system of corporate accountability. Activist hedge funds have often stepped up to assume the role of corporate monitor, and their interests should continue to be balanced with the interests of incumbent management, just as they were when the Williams Act was enacted.

The SEC should promulgate the language and rationale of the Stewardship Code's Principle 5 as a regulation under the Investment Company Act of 1940. Principle 5 encourages institutional investors to maintain and disclose policies for collective action. Within the context of the domestic market for corporate governance, disclosure of such policies by institutional investors could prove useful to activist hedge funds that are attempting to evaluate which opportunities for activism to pursue.

In 2013, SEC Commissioner Luis Aguilar emphasized the important role institutional investors should play in corporate governance, calling on institutional investors to lend their collective voice to the ongoing corporate governance conversation.[207] Development and disclosure of collective action policies by institutional intermediaries would indeed give voice to institutions, within a context where they can actually be effective—that is, through the combination of highly concentrated governance rights and activist investor proposals. Additionally, this solution would contain agency costs by keeping incumbent managers on notice of the circumstances in which outside discipline by shareholder owners is a distinct possibility.

[205] *See supra* Parts II.C–D.

[206] *See supra* Part II.B.

[207] Luis A. Aguilar, Comm'r, Sec. Exch. Comm'n, Address at the Georgia State University Center for the Economic Analysis of Risk (CEAR) Workshop (Apr. 19, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171515808#.VD1-Pb6YZUQ [http://perma.cc/M2B9-QVLT] (archived Jan. 22, 2015) ("We need to hear their views on the benefits of transparency through disclosure, corporate governance, appropriate compensation structures and amounts, and other important issues.").

The success of activist proposals is often predicated on the support they are able to obtain for their proposals from large institutional investors.[208] This dynamic has always implicated a substantial cost-benefit analysis by activists on the front end of any potential activism. The costs to activists, however, have already been magnified by the recently adopted, more restrictive definition of beneficial ownership. Activists are no longer able to obtain meaningful toehold positions in target companies through the use of security-based swaps without disclosure. Lowering the reporting threshold and shortening the disclosure window will further compound the difficulty activist hedge funds will face in carrying out their strategies.

Institutional investor disclosure of collective action and voting policies may alleviate some of the additional strain that recent reforms and proposals have, and propose to have, on activist hedge fund effectiveness. Through public disclosure of collective action and voting policies, activist hedge funds will be able to gain a sense of the institutional investor support they are likely to receive for a given proposal, before undertaking any action or expense. Moreover, they will be able to incorporate a more meaningful measure of likelihood of success into their cost-benefit analyses. Activist hedge funds will thus be better equipped to formulate activism strategies *ex ante* that are contingent on the support and strength of institutional investors.[209] As a result, the chilling effects of a lower ownership threshold or disclosure window on hedge fund activism will be mitigated to a degree.

B. *Changed Circumstances: Activist Hedge Funds Are the Superior Corporate Monitor*

In resolving to allow activist hedge funds to continue serving their role as governance intermediaries, it is important to recognize that the current corporate governance landscape looks nothing like it did over four decades ago. As discussed above, the Williams Act (and its corresponding ownership threshold and disclosure window) was enacted for the protection of a diffuse shareholder base, in response to a wave of (sometimes coercive) cash tender offers, against which company management was virtually powerless to defend.

The canonical theory of a widely dispersed ownership base no longer exists. American equity ownership is now highly concentrated in the hands of large, highly sophisticated institutional investors,

[208] *See* discussion *supra* Part II.D.

[209] Even if a mutual fund simply had a policy of voting with the recommendation of Institutional Shareholder Services (ISS), such information would be helpful to activist hedge funds.

such as mutual funds and pension funds, and activist hedge funds need their support to affect corporate change.[210]

To an extent, management now has the upper hand in a corporate governance contest due to numerous takeover defenses that have been developed in the time since the Williams Act's passage.[211] Perhaps due in part to the proliferation of takeover defenses, activist hedge funds have been constrained to operate through starkly different tactics and strategies than the corporate raiders of decades past. There is a growing body of empirical evidence that demonstrates that activist hedge funds overall do not seek control and are no more aggressive or short-term focused than any other type of investor.[212]

Activist hedge funds should not be prevented from serving their role as governance intermediaries because they are superior corporate monitors to rationally reticent institutional investors.[213] Institutional investors make for inadequate corporate monitors because engaging in long-term corporate strategy with portfolio company management is contrary to their business model.[214] Activist hedge funds, on the other hand, specialize precisely in monitoring corporate management and possess advanced expertise in doing so. As such, it would be counterproductive to attempt to force institutional investors to monitor portfolio companies while relegating activist hedge funds to the corporate governance sideline. Therefore, new constraints on the ability of activist hedge funds to monitor corporate management should be balanced with requiring institutional investor development and disclosure of collective action policies. This will mitigate the significant rise in managerial agency costs that can be expected to accompany further tightening of the disclosure rules under Section 13(d).

V. CONCLUSION

Institutional investors in the United States and in the United Kingdom have come to possess a massive share of equity ownership and governance rights. As a result, individual investors find

[210] *See supra* Part I.

[211] Poison pills, staggered boards, and advance notice for shareholder proposal bylaws are now commonplace in American corporate charters. *See* Vollmer & Wolfson, *supra* note 112, at 5.

[212] *See, e.g.*, Brav, Jiang, Partnoy & Thomas, *supra* note 16; Katelouzou, *supra* note 108, at 462–63; Bebchuk, Brav & Jiang, *supra* note 172; Bebchuk & Jackson, *supra* note 108.

[213] *See* Gilson & Gordon, *supra* note 3, at 867 ("[T]he activist shareholder . . . increase[s] the value of the vote held by the institutions by teeing up the intervention choices at low cost to the institutional owners.").

[214] *See* Wong, *Stewardship*, *supra* note 1 (discussing obstacles to institutional investor adoption of a "long-term oriented" attitude toward investing).

themselves an additional step removed from the companies in which their money is ultimately invested. Over time, however, institutional investors have shown themselves to be ineffective corporate monitors because the role is fundamentally contrary to their nature. Institutional investors specialize in delivering comparatively superior investment performance over short periods of time while minimizing costs and risk.

Institutional investors do not regularly exercise the vast governance rights that come with huge equity ownership; institutional investors are rationally reticent. That is, they are responsive to governance proposals, although not proactive in introducing them. This sort of "latent activism" presents both the problem and opportunity of undervalued governance rights and inflated agency costs.

Activist shareholders, and activist hedge funds in particular, have come to provide a market-based solution by leveraging the enormous governance rights possessed by institutional investors, thereby reducing agency costs. Activist hedge funds have proven themselves capable of disciplining corporate management and filling the monitoring gap created by rationally reticent institutional investors.

Recently proposed amendments to Section 13(d) of the Securities Exchange Act threaten to hamstring activist hedge funds in filling this role. These changes appear to be premised on flawed and outdated perceptions of activist shareholders and the legislative intent behind the Williams Act.

Enacting amendments to the Williams Act that have a chilling effect on hedge fund activism is likely to harm individual investors instead of help them. Current data suggests that concerns over activist hedge fund short-termism, aggressiveness, and desire for control are overstated. Activist hedge funds have provided a market-based solution that institutional investors are not likely to provide.

Regulatory changes impacting shareholder activism should be minimal, and perhaps follow a "soft law" approach, like those the United Kingdom introduced in the wake of the global financial crisis of 2008–2009 through the Stewardship Code. The Stewardship Code is a set of best practice principles aimed at encouraging institutional investors to engage in stewardship of their portfolio companies and is enforced on a "comply or explain" basis. The Code ultimately seeks to foster the long-term success of companies through active engagement by institutional investors. Because institutional investors in the United States lack incentive to engage corporate boards, the Code overall is ill-fit for the United States. Principle 5, however, may prove a useful counterbalance to a reduced ownership reporting threshold or a shortened block-holder disclosure window.

This Note proposes that any amendments to Section 13(d) be coupled with incorporation of The Stewardship Code's Principle 5 into

SEC regulations. Principle 5 invites institutional investors to develop and disclose policies for collective engagement. Activist hedge funds are often dependent on the support of institutional investors for the success of their proposals. Access to institutional investors' policies for collective engagement would empower activist hedge funds to gauge the likelihood of success of their activist activities at the outset and formulate their activism strategies accordingly. Ultimately, activist hedge funds will be enabled to continue to serve their vital role as governance intermediaries in the market for corporate governance.

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