Vanderbilt Law Review

Volume 61 | Issue 2 Article 1

3-2008

The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation

Randall S. Thomas

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Part of the Business Organizations Law Commons

Recommended Citation

Randall S. Thomas, The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation, 61 *Vanderbilt Law Review* 299 (2019)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol61/iss2/1

This Symposium is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

VANDERBILT LAW REVIEW

VOLUME 61 MARCH 2008 NUMBER 2

The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation

*Randall S. Thomas**

I. EXECUTIVE COMPENSATION 301
II. THE PROPOSED SHAREHOLDER NOMINATION RULE 303
III. STATE LAW LITIGATION AS A MECHANISM TO ENFORCE FIDUCIARY DUTIES 305
IV. PRIVATE SECURITIES CLASS ACTIONS: CURRENT DEVELOPMENTS WITH THE LEAD PLAINTIFF PROVISION 307
V. THE LIMITS ON INSTITUTIONAL ACTIVISM 310
CONCLUSION 312

This Symposium volume of the Vanderbilt Law Review, sponsored by the Institute for Law and Economic Policy ("ILEP"), focuses on the critical role of institutional investors in the modern American corporation. The agency cost model of the corporation tells us that in a dispersed ownership system, such as the U.S. system, large, motivated shareholders can play an important role in reducing the agency costs of equity by closely monitoring the actions of corporate management.[1] Activist investors can use their voting

* My thanks to James Cox, Jesse Fried, Jeffrey Gordon, Lyman Johnson, Robert Thompson, and Elliott Weiss for their comments. All errors are, of course, my responsibility.

1. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

powers, their power to file suit, and their power to sell their interests in the firm, to align the interests of managers and shareholders more closely.[2] In this volume, seven different articles by a total of ten authors explore the theory and reality of institutional investors acting as monitors of corporate management.

Beginning in the early 1990s, institutional investor shareholder activism was praised as a promising means of reducing managerial agency costs.[3] The theory was simple: if shareholder monitoring could limit managers' divergence from the goal of shareholder wealth maximization, then institutional shareholders were well positioned to act as effective monitors. Institutions held larger blocks of stock than most other investors and collectively held well over fifty percent of the stock of most large public companies. Acting together, these shareholders would have the power and the incentives to push for good corporate governance and to nudge managers to pursue wealth-maximizing strategies.

Criticisms of institutional activism quickly emerged. Many institutions were reluctant to incur the expenses of engaging in monitoring activities because this could depress portfolio returns, whereas any benefits would be shared with their competitors. Thorny collective action problems arose as the costs of communication and coordination were higher than hoped. Other institutions engaged in free riding on the efforts of the activists, and some institutions refused to engage in activism at companies where they had significant conflicts of interest arising out of pre-existing (or hoped for) commercial relationships.[4] Furthermore, certain institutions, such as public pension and labor union funds, suffered their own agency cost problems and were accused of pursuing their own self-interested agendas at the expense of other shareholders.[5] Overall, it was unclear whether these costs would outweigh the benefits so that the great potential for activism by institutional investors would ever be realized.

Today, a significant number of institutional investors are active participants in the U.S. corporate governance debate. This is displayed most prominently by institutional investor lead plaintiffs in

---

2. Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell and Sue*, 62 LAW & CONTEMP. PROBS. 215, 216-18 (1999).

3. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

4. Edward Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

5. Roberta Romano, *Public Pension Fund Activism in Corporate Governance*, 93 COLUM. L. REV. 795 (1993).

securities fraud class actions, but also in a broad range of other forms of activism, such as institutionally sponsored shareholder proposals, withhold the vote campaigns, majority vote initiatives, and a host of other actions. Each of the articles in this volume explores different ways that institutional investors have acted, should act, or do not act, as monitors of corporate management. The articles share the common belief that institutional investors have the power to bring down managerial agency costs, even when they differ over their views about the willingness or the ability of institutions to exercise that power.

In this introduction to the volume, I organize the different articles according to the topics that they raise, then situate them within the current debate related to that topic, and finally relate them to the overall theme of institutional investor activism. To the extent possible, I follow the conference program's organizational framework. In my concluding remarks, I raise the question whether hedge fund shareholder activists may be the new wave of activist shareholders and ask how institutional investors should respond to their activities.

I. EXECUTIVE COMPENSATION

CEO pay levels have been a hot topic for corporate governance activists in recent years. Professors Lucian Bebchuk and Jesse Fried's well-known book, *Pay Without Performance*,[6] lays out a stinging indictment of current executive pay practices in this country. That book's thesis is that executive compensation practices in the United States benefit corporate executives at the expense of shareholders. It argues that CEO employment contracts are bad for shareholders because they are the product of "managerial power." Managerial power arises, the authors claim, because boards of directors at public companies are beholden to the firm's top executives, largely due to management's control over the director nomination process. A weak compensation committee thus does little to protect the firm in its pay negotiations with the CEO, leading to levels of executive pay that both are inappropriately high and have inappropriately low levels of incentives. The only constraint on this process is investor and public "outrage." This outrage constraint, however, only polices extreme cases of executive overcompensation.

In this Symposium, Professor Fried continues his work in the area with his article, *Hands-Off Options*. In this piece, Fried proposes

6. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

a new approach to executives' equity compensation arrangements that would remove managers' ability to schedule freely the disposition of their stock. He argues that top corporate executives at public companies currently can choose the timing of their stock sales and sell substantial blocks of stock over a short time period. Managers' ability to choose when to sell permits executives to use inside information to time their sales and their ability to sell large amounts of stock at once give them an incentive to manipulate the stock price before selling in order to maximize their gains at substantial cost to other shareholders. He points out how existing legal rules and compensation arrangements do little, or nothing, to solve this problem, which can lead to distorted corporate decisionmaking.

Fried suggests that institutional investors urge firms to adopt a policy of issuing "hands-off options." Under this approach, firms would continue to issue stock options (or restricted stock) in appropriate situations to their top executives. However, at the time of an equity grant, a firm would announce a fixed and gradual schedule under which the executive's options or stock would be cashed out in the future. By implementing a fixed and pre-announced sales program, firms would remove executives' control over the timing of equity sales and thereby make it impossible for them to generate insider trading profits while unwinding their equity positions. And by depriving managers of the ability to unload large stock positions at one time, the arrangement would give executives much less incentive to manipulate the stock price than they currently have.

Institutional investors are very concerned about the current levels of executive compensation. They have tried a variety of techniques to limit CEO pay increases, including shareholder proposals, advisory shareholder votes (sometimes called "say on pay"), voting against stock option plans, and in a few prominent cases, withhold the vote campaigns. None of these efforts has had more than a temporary, isolated impact on CEO pay levels and composition in this country. If implemented, Fried's proposal could dramatically impact CEO pay and stock ownership levels.

How would institutional investors get boards to adopt hands-off options? Consistent with his belief in managerial power, Fried does not expect this new form of stock option to be adopted willingly by corporate boards. Institutional investors would need to exert strong pressure on boards, presumably through informal meetings with corporate directors, shareholder proposals urging companies to adopt this type of option, and withhold the vote campaigns against targeted

boards that refuse to move in this direction.[7] Given the response to prior shareholder initiatives on executive compensation, it is likely that institutional shareholders will be more successful with indirect pressure on directors; that is, by relying on the explicit or implicit threat of using their voting power if boards are unresponsive to their requests.

II. THE PROPOSED SHAREHOLDER NOMINATION RULE

The Securities and Exchange Commission's ("SEC's") proposed shareholder nomination rule, although it ultimately failed, was considered seriously as a result of pressure from institutional investors. The concept of shareholders having the right to nominate directors through the company's proxy has a long history, but it came to a head four years ago at the SEC at the initiative of then-Chairman William Donaldson. During Donaldson's tenure, the SEC considered a variety of proposals related to whether certain large shareholders should have the ability to nominate board candidates using the company's proxy materials.[8] Unfortunately from the institutions' perspective, these proposals never came to a vote before the SEC. Instead, only in 2007, in reaction to the Second Circuit's decision in *AFSMCE v. AIG*,[9] were two proposals related to the issue of shareholder access to director nominations brought to a vote at the Commission.[10] After a bitter debate, the SEC voted three to one to adopt a rule broadly denying shareholders this right. The vote split along party lines, with all of the Republican nominees voting against and the sole Democrat voting in favor of, allowing shareholders to make these nominations. Chairman Cox has stated that he intends to reconsider the issue again in the near future.

Jeff Gordon's contribution to the Symposium claims that institutional investors should be happy that the SEC did not adopt an access rule. He argues that the current debate over proxy access is a "side show," diverting attention away from more important questions about the appropriate level of disclosure that shareholders should

---

7. Neither suing nor selling appear likely avenues for institutions to pursue in the near future, as there is nothing illegal about the current form of stock options and virtually all corporations distribute them to their executives.

8. Neal Lipschutz, *SEC Chairman Cox's proxy-access good deed will be punished*, DOW JONES NEWSWIRES, Nov. 28, 2007, *available at* http://blogs.rockymountainnews.com/denver/material_disclosures/archives/2007/11/columnist_defen.html.

9. 462 F.3d 121 (2d Cir. 2006).

10. Carrie Johnson, *SEC Proposal Raises Profile of Investors; Divided Panel Tackles Issues of Pay, Board Membership*, WASH. POST, July 26, 2007, at D01.

have to make when they seek to place candidates on corporate boards of directors. Gordon first traces the history of modern shareholder activism and the origins of the proposed shareholder nomination rules. He then moves to a discussion of the new e-proxy rules that permit soliciting investors to post their materials on web sites and to provide electronic access to their fellow shareholders. He points out that the lower costs associated with this form of solicitation should markedly reduce the cost of a dissident shareholder proxy solicitation, without any need for access to the issuer's proxy statement.

Gordon frames the crucial question to be: How much disclosure should shareholder nominator's have to make, both in terms of content and potential liability risk? The federal proxy rules spell out quite carefully what is required both of the nominator and the nominee when a shareholder engages in a proxy solicitation. However, according to Gordon, what was widely overlooked in the debate over the SEC's proposed proxy access rules is that the SEC would have required much more intrusive disclosures for shareholder nominators seeking proxy access than it does for shareholders that engage in traditional solicitation campaigns. These more extensive disclosures are not only costly, but they also increase the litigation risk for proponents. So, Gordon concludes, institutional investors should stop seeking to persuade the SEC to change the rules for proxy access and instead focus on engaging in e-proxy solicitations when they wish to nominate director candidates.

Gordon's thesis is supported by data on recent proxy contests. Hedge funds have been very active in using short slate contests to obtain positions on corporate boards.[11] Most of these solicitations seek to elect a minority of the board of directors without using the target company's proxy materials. Clearly, it is possible for institutional investors to engage in this type of solicitation as well, or at least to support hedge fund activists if the institution believes that corporate change is in order.

When all else fails, institutional investors always can choose to sue corporate managers. A variety of causes of action are available in different venues. Two broad types of claims can be made: (1) cases based on alleged breaches of fiduciary duties and (2) claims arising out of defective disclosures. The articles in the next two Parts examine

11. Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. (forthcoming 2008) (finding 140 proxy fights initiated by hedge funds over the period 2001-2006).

some of the issues that arise for institutional investors in derivative suits and in cases arising out of the Investment Company Act of 1940.

III. STATE LAW LITIGATION AS A MECHANISM TO ENFORCE FIDUCIARY DUTIES

Derivative actions, in which one shareholder sues in the name of, and on behalf of, the corporation, were initially lauded for their impact on agency costs.[12] However, states soon began focusing on their potential to be used as strike suit litigation, passing statutes requiring plaintiffs in derivative actions to post bonds to insure that they could pay corporate defendants' attorneys' fees and expenses in frivolous suits.[13] More recently, state legislatures have added procedural hurdles, such as the demand requirement and provisions that allow special independent litigation committees comprised of selected directors to recommend to courts that they terminate derivative suits.[14] As a result of these restrictions and the availability of other types of remedies for investors, the number of derivative suits has declined markedly in recent years. Empirical studies show that compared to federal securities class actions, or to state court acquisition-oriented class actions, derivative suits are running a weak third in terms of their importance to shareholders.[15]

Against this backdrop, Dean Kenneth Davis argues in favor of reviving derivative litigation in U.S. corporate law in his article, *The Forgotten Derivative Suit*. His thesis is that derivative suits are primarily playing a role at publicly held corporations in transactions involving control shareholders abusing their dominant positions, or at closely held corporations, but not at larger capitalization firms where investors are claiming that the board is being sued for some wrongful act at the corporate level. He argues that the availability of alternatives to, or substitutes for, the derivative suit is driving this phenomenon. He uses both doctrinal analysis and an empirical survey of judicial decisions to support these claims.

---

12. Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949) (noting that derivative suits have "long been the chief regulator of corporate management").

13. N.Y. GEN. CORP. LAW § 61-b (1944) (current version at § 627). This statute followed a critical report about derivative litigation by Franklin Wood, for a committee of the Chamber of Commerce of the State of New York. FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS (1944).

14. *See, e.g.*, George W. Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of Derivative Suits*, 75 NW. U. L. REV. 96 (1980).

15. Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747 (2004).

Davis begins by reviewing and explaining the reasons for the historical shift toward the use of independent directors as monitors of corporate conduct and the accompanying, more restrictive approach by courts and legislatures toward derivative litigation through the creation of a variety of procedural barriers to plaintiffs in these cases. He then divides derivative suits into three categories by type of defendant and, in some cases, by type of claim as well: first, claims of all types against closely held corporations; second, public companies where the plaintiff's claim is that the board has engaged in some improper conduct; and finally, public companies where the allegations in the complaint focus on abuse of control by a control shareholder. For each of these groups, he examines the outcomes of judicial opinions in the cases, the availability of other avenues of relief for plaintiffs, and the public policy reasons for permitting, or curtailing, derivative suits on the particular type of claims being made.

For closely held firms, Davis finds little evidence that the demand requirement is a major obstacle to plaintiffs, but he does see standing issues successfully raised by defendants in some cases. He concludes that derivative suits have had some success in this context, but careful contracting by the parties in these smaller firms can substitute for these suits. The improper conduct cases at public companies, featuring claims such as the board's failure to establish proper internal controls, demonstrate very low success rates. The one exception is cases involving claims of excessive executive compensation. Davis suggests that the presence of many alternative avenues of relief, such as SEC enforcement actions or private securities class actions, may underpin the courts' willingness to dismiss derivative suits raising similar claims. Finally, in derivative cases challenging control shareholder abuses, Davis finds a relatively high success rate with demand a weak barrier, although standing issues frequently arise in change-of-control-related cases. He sees fewer good substitutes for investors who bring these cases and some important policy arguments for supporting them.

In addition to investors' state court rights to enforce director fiduciary duties, the 1940 Investment Company Act contains an express federal cause of action—section 36(b)—that uses the concept of directors' duties. Lyman Johnson's article examines the possibility of reinvigorating private litigation over excessive mutual fund fees, using an expanded perspective on director independence under the 1940 Investment Company Act. Johnson begins by talking about the agency conflicts between investors and mutual fund advisors, and the importance of independent board negotiations plus private litigation

as a means of addressing any divergences in their interests. He then moves to summarizing the existing empirical evidence on the effect of board independence at mutual funds and finds that when independence is defined broadly, independent directors appear to get investors a better deal.

The second half of the article critiques the Second Circuit's 1982 *Gartenberg* decision,[16] which has effectively precluded successful investor litigation over excessive fees, and examines how a concept of director independence borrowed from corporate law might better serve the courts in determining when advisory fees are excessive. In particular, Johnson suggests that the federal courts use the more fluid, evolving notion of director independence applied in state corporate law as part of a more searching analysis under section 36(b)(2) of the Act of the meaning of independent director approval of the advisory contract. This would permit courts to give deference to such approval only when truly independent directors approve these agreements and thereby provide mutual funds with strong incentives to adopt stronger independence standards for their directors.

Although neither Davis nor Johnson focuses exclusively on institutional investor rights, the size of institutional stockholdings makes their articles very relevant to these investors. In both cases, institutional investors must be willing to get involved in these suits in order to make them more effective mechanisms for reducing agency costs. A relevant example could be drawn from the federal class action area, where such institutional investor involvement expressly was contemplated by Congress in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Indeed, just as institutions assuming the role of lead plaintiffs in securities class actions have enabled those suits to gain dignity in the eyes of the courts and policymakers, the same effect may be achieved if institutions assume a similar role in derivative suits.

IV. PRIVATE SECURITIES CLASS ACTIONS: CURRENT DEVELOPMENTS WITH THE LEAD PLAINTIFF PROVISION

The lead plaintiff provision in the PSLRA introduced procedures for courts to apply in choosing a lead plaintiff for the class from among competing petitioners. Institutional investors widely were seen as the most desirable candidates for this position. Under these rules, the investor with the largest financial losses in a securities

16. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982).

fraud class action is presumed to be the most adequate plaintiff. In this way, the lead plaintiff provision overrides the traditional "first to file" rule for selecting the suit's plaintiff in an effort to use an institutional lead plaintiff's economic self-interest to reduce the agency costs of lawyer-driven class action litigation. Moreover, by eliminating the race to be the first to file, the lead plaintiff provision cuts down on poorly drafted, hastily filed complaints by overly eager plaintiffs' counsel.

To evaluate the impact of the lead plaintiff provision, who better to ask than one of its creators? Elliott Weiss, whose seminal article with John Beckerman launched the lead plaintiff provision, reflects back on the enduring logic of their work, the enactment of that statutory requirement, and its intended and unintended consequences. His article begins with an interesting summary of the authors' thinking behind that article, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*,[17] and how Congress came to incorporate its recommendations into the Private Securities Litigation Reform Act of 1995. Weiss then makes three contributions to the literature: first, he summarizes empirical research on the lead plaintiff provision's effects; second, he examines some of the practical issues that courts have grappled with as they have tried to implement its provisions; and finally, he asks the policy question whether we can do better.

Weiss concludes that the evidence shows that the lead plaintiff provisions have had several beneficial effects, including increasing institutional investor involvement in managing securities fraud class actions, particularly in large cases, with resultant increased recoveries and lower levels of attorneys' fees. He finds that courts generally have done a good job interpreting the statutory requirements of the lead plaintiff provision over the years, although he has reservations about their initial preference for groups of investors over institutional investors. He also points out the practical difficulty courts face in determining which investor has the largest loss. Weiss finishes by noting that no one has suggested a superior alternative to the current provisions and by suggesting three ways in which those provisions should be fine-tuned.

The importance of the lead plaintiff provision has led to a flurry of empirical articles that seek to assess its success.[18] James Cox,

---

17. 104 YALE L.J. 2053 (1995).

18. Stephen J. Choi, Jill E. Fisch & A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869

Lynn Bai, and I add to that body of work in *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*. We begin with an overview of the current calls for further narrowing of the scope of securities fraud class actions in the United States. We examine reports issued by three different groups—the Committee on Capital Markets Regulation, the Commission on the Regulation of U.S. Capital Markets in the 21st Century, and McKinsey & Company—each of which argues that securities fraud class actions are one of the principal causes for U.S. capital markets being placed at a competitive disadvantage to foreign markets. We analyze the changes proposed in each of these reports and conclude that, with a couple of exceptions, they do not seek wholesale changes to securities fraud class actions.

We next turn to the issues that we believe are central to determining whether further reforms to securities class actions are warranted. In particular, we start our empirical evaluation by looking at whether the lead plaintiff provision is operating satisfactorily. We find that, overall, institutional investor lead plaintiffs get greater dollar settlements for investors, although this effect is only positive and significant for labor union pension funds and public pension funds. This suggests that the lead plaintiff provision is operating in the manner that Congress intended when it enacted the PSLRA and that continued encouragement of institutional participation as lead plaintiffs would be good policy.

The second part of our empirical analysis focuses on the question of whether securities class actions are so-called strike suits. We try to answer this question by focusing on those cases in our sample with settlements of less than $2 to $3 million. We find that these settlements produce statistically significantly lower recoveries as a percentage of estimated provable losses. We interpret this to be consistent with the hypothesis that these are strike suits.

The lead plaintiff provision is one of the success stories of PSLRA and institutional investor activism. However, in the next Part, we turn to some of the limitations on these investors' activist efforts.

(2005); James D. Cox & Randall S. Thomas with Dana Kiku, *Does The Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587 (2006); Michael A. Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* (St. John's Legal Studies Research Paper Series, 2006).

V. THE LIMITS ON INSTITUTIONAL ACTIVISM

The empirical evidence on the effects of institutional investor activism is quite mixed. As noted above, several studies have shown that institutional lead plaintiffs add value in securities fraud class actions. However, other forms of corporate governance oriented activism seem to produce less value for shareholders. For example, beginning in the mid-1980s, public pension funds and other activist investors began engaging in shareholder activism using Rule 14a-8, which permits shareholder proposals on a variety of topics. Their efforts had little effect on firm value or performance however.[19] Larger public pension funds tried a variety of other techniques to influence corporate management, but these also had little impact on operating performance or stock price.[20] As several surveys have shown, the results of this type of activism by non-hedge fund institutions have been disappointing: they caused small changes to firms' corporate governance structures but no measurable effects on stock prices or earnings.[21]

In a useful addition to the existing empirical research on institutional investor activism, Stephen Choi and Jill Fisch's contribution to the Symposium critically examines how active institutional investors really are on corporate governance issues. Using a combination of interviews, survey evidence, and publicly available information, Choi and Fisch construct a fuller, more textured picture than previously available of what public pension fund investors do, and more importantly don't do, as activists. They begin by summarizing survey data that they collected from a group of forty public pension funds. Their first main finding is that many of these funds delegate their portfolio's management, their voting decisions,

19. Jonathan Karpoff et al., *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 J. FIN. ECON. 365 (1996).

20. Willard T. Carleton et al., *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335 (1998); Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293 (1999); Sunil Wahal, *Pension Fund Activism and Firm Performance*, 31 J. FIN. & QUANTITATIVE ANALYSIS 1 (1996). *But see* Brad M. Barber, Monitoring the Monitor: Evaluating CalPERS' Shareholder Activism (Nov. 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890321 (finding positive stock price reaction to CalPERS corporate governance activities).

21. Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (Peter Newman ed., 1998); Stuart Gillan & Laura Starks, *The Evolution of Shareholder Activism*, 19 J. APPLIED CORP. FIN. 118 (2007); Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174 (2001).

their claims filing, and their litigation monitoring to outside advisors. This suggests that it is very important to examine the incentives of the various agents that are exercising these powers on behalf of institutions to make sure that they are aligned with those of their principals.

Furthermore, contrary to the claim that institutions' portfolios are indexed, they find that less than a third of these funds' assets are indexed.[22] This raises doubts about the claim that institutions own the market and therefore must engage in activism if they wish to improve corporate performance, because they cannot sell their stock if they are dissatisfied with corporate management.

Using their survey data, they unpack the types and amount of activism in which these public funds engage. They divide activist behavior into two categories: "non-litigation oriented activism," such as filing shareholder proposals or withholding votes from selected directors, and "litigation-oriented activism," where funds act as lead plaintiffs in securities fraud class actions or are significantly involved in other forms of litigation. They find substantial variations in the overall levels of activism between public funds. On average, public funds engage in a limited spectrum of non-litigation oriented activism, mostly centered on supporting other types of activist investors, following advice from their proxy voting advisors in withhold vote campaigns, or similar low-cost activities.

They find that larger funds demonstrate much higher levels of non-litigation forms of activism than smaller sized public funds, but there is no such relationship for litigation-oriented activism. Funds of all sizes on average appear to be relatively active in litigation. The authors offer three possible explanations for this result: first, political pressure from groups such as state attorneys' general; second, the lack of costs to the fund from participation in these cases because plaintiffs' law firms take them on a contingent fee basis and pay the out of pocket costs associated with the cases; or third, that the institutions may expend very little effort in monitoring the cases so that there are no real costs to their involvement in the action.[23] In sum, Choi and Fisch's evidence on the low level of institutional investor activism suggests that if shareholder activism is to be an important monitoring

22. They do not provide similar statistics indicating what percentage of the institutions' stock portfolios are indexed.

23. Unfortunately, they lack data to test the hypothesis that funds participate in litigation, irrespective of the fund's overall size, because they have large underlying losses on their investments in the firms they are suing.

force in U.S. firms, we may need to look elsewhere to find investor activists.

CONCLUSION

If Choi and Fisch are right, then shareholder activism will need to look beyond public pension funds in its quest to locate active monitors of corporate management. In fact, we need not look far to find some powerful investor activists. Beginning roughly in 2000, there has been a marked uptick in the level of hedge fund shareholder activism. Recent research on these investors has found that these activists have pressured corporate directors to remove underperforming managers, to stop value destroying mergers and acquisitions, to disgorge excess cash and optimize capital structure, and to press for a sale of the company, all of which are designed to increase shareholder value.[24] These papers have concluded that hedge funds are better positioned to act as informed monitors than most institutional investors, and their activism has been well perceived by the market.

Hedge funds benefit from friendly interaction with management, like large block holders, but they have stronger incentives to add value, and they can capture the benefits of multiple stakes. Although there is enormous cross-sectional variation, hedge fund activism generates value on average, not merely because activists are good stock pickers, but because they credibly commit upfront to intervene at undervalued firms on behalf of shareholders and then follow through on their commitments. Thus, activist hedge funds have the potential to fill some of the governance gaps left by other large institutional investors during recent decades. In practice, institutional investors frequently have supported the hedge funds in their activism and adapted themselves to the rapid evolution in investor monitoring.

Each of the articles in this Symposium sheds new light on the ever-changing role of institutional investors in U.S. corporate governance and corporate litigation. They cover a broad range of topics, including institutional investor activism on executive compensation, proxy access initiatives at the SEC, state and federal litigation, and the current levels of activism by public pension funds.

24. William W. Bratton, *Hedge Funds and Governance Targets*, GEO. L.J. (2007); Brav et al., supra note 11; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

The data and the theoretical contributions of these articles provide important foundation for the ongoing discussion about the role of institutional investors.

***