An old & new hope

- EU Green Paper (2011): “Shareholders – the corporate governance framework is built on the assumption that shareholders engage with companies and hold the management to account for its performance. However, there is evidence that the majority of shareholders are passive and are often only focused on short-term profits. It therefore seems useful to consider whether more shareholders can be encouraged to take an interest in sustainable returns and longer term performance, and how to encourage them to be more active on corporate governance issues.”
My bottom line

• Reducing barriers to institutional investor activism is a good idea:
  – But it is unlikely to result in traditional institutions taking the lead
  – because the incentive problem is too fundamental.

• Imposing affirmative obligations to participate is a bad idea.

• Different systems are different: beware of comparisons and transplants
The US: where we are & how we got here

• Late 1980s: The end of hostile tender offers
• The hope of institutional investor activism
• The earlier literature: legal barriers to institutional investor activism
Shareholder Passivity Reexamined

Bernard S. Black

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Legal barriers


- Investment Company Act: a “diversified” mutual fund may not invest
  - More than 5% of fund assets in one company
  - More than 10% of portfolio company’s stock

- Limitations on Insurance Companies under state law:
  - e.g.,
    - NY: max 20% of assets in stock; max 2% of assets in equity of any one company; no control

- Pension funds
  - ERISA liability
A puzzle

But institutional investors were not pressing up against the limits!

Reforms affecting institutional investors:

– 1992: Reform of Proxy Rules
– 2000: Regulation FD (Fair Disclosure)
– 2002: Sarbanes Oxley
– 2003: Disclosure of Mutual Fund Voting
– 2003: Global Research Settlement
– 2010: Dodd Frank
Modest gains

• Despite changes, and ever greater concentration of holdings, institutional investors still don’t do very much.
  – They do not take the lead in governance.
  – But they no longer reflexively support management.

• Why don’t they do more?
Institutional Investors: incentives

• Big institutional investors are nearly all effectively indexed.
• And they hold 1000s of companies in their portfolios
• Competition on returns $\rightarrow$ competition to be low cost.
• Even worse: the incentives created by “underweighting”:
  – Fund A: 2% of Ford; 4% of GM
  – Fund B: 4% of Ford; 4% of GM.
• Conflicts of interest
  – Access to management
  – Service providers to firms
Can we force institutional investors to be free?

• 1988: DOL “Avon Letter”: proxy voting rights are plan assets subject to the same fiduciary standards as other plan assets
• 2003: SEC required mutual funds to disclose voting records on proxy proposals
• Result:
  – More voting but not better voting
  – ISS as “ERISA insurance.”
The basic limitations of institutional investors

• Engagements: incidental and ex post
  – For the typical fund, tough way to make money.
  – When added to the regulatory barriers, the conflicts of interest, etc. → not much activism.

• Given this, only institutions with other motivations are active:
  – Public pension funds
  – Union funds

• Voting as a “compliance function” in most funds
The new players: activist hedge funds

• Hedge fund activism model:
  – strategic and ex ante
  – Activist funds buy a stake in order to be active
  – High powered and targeted incentives: 2 + 20

• Incentives work:
  – Activism despite barriers
  – Catalysts for institutional investors

• Traditional institutional investors are willing to support HFs.
The new players: activist hedge funds

• Limits in relying on hedge funds
  – Public image?
  – Quick fixes
  – Mostly active in small public companies
    (exception: Icahn and Ackman)
  – Incentives: maximizing IRR
    • Question: was a large dividend in 2007 funded by debt beneficial to long term shareholders?
    • Conflicts of interest, empty voting, etc.
The key features of the US system

  - Managements with huge equity incentives largely think like shareholders.
  - Activist hedge funds with huge financial incentives are active.
  - Institutional investors tag along.

- Expensive, imperfect, politically vulnerable to an “outrage constraint.”
Shareholder duties?

• A temptation, to be resisted: impose duties on shareholders to vote in the interests of the corporation, at least when their votes are decisive.

• Hypo: Hewlett Packard/Compaq merger: did HP overpay?
  – How should an index fund vote its shares?
  – Vanguard: 3.5% in HP; 3.5% in Compaq
  • Fiduciary duties to fund investors
The “cultural” side

• The US v. UK
  – Boards
  – Shareholders
  – Different understandings of roles
• Fidelity US v Fidelity UK