Strine: Stop shareholder activism from hurting American investors

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By Alison Frankel
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This country's most important arbiter of corporate law – Chief Justice Leo Strine of the Delaware Supreme Court – believes that shareholder democracy has run amok. In a startling new essay for the Columbia Law Review, "Can We Do Better by Ordinary Investors?" Strine outlines the deleterious long-term effects of subjecting corporate decision-makers to shareholder votes dominated by short-term investors. These ill consequences range, according to Strine, from the outright dollars corporations must spend to educate shareholders about everything they're entitled to vote on all the way to excessive risk-taking and regulatory corner-cutting by executives and directors worried about delivering quick returns lest they be ousted by shareholders. Strine is deeply worried about a divergence of interests between money managers, who wield the power of shareholder votes, and ordinary investors in their funds, who are typically saving for retirement or their kids' education. He's convinced that the entire American economy will suffer unless short-term investors are reined in.

Strine's diagnosis is interesting enough, though he's previously written about what he considers to be the cancer of short-term investing. In the new essay, though, he also suggests a cure: eight actual suggestions to restore power to corporate boards and long-term investors (plus a pie-in-the-sky fantasy about changing the U.S. tax code to encourage shareholders to take a long view of their investments). Strine, who calls himself "someone who embraces the incrementalist, pragmatic, liberal tradition of addressing the world as it actually is," argues that his proposals do not roll back shareholders' hard-won rights to a voice in corporate affairs. Instead, he says, he's "trying to create a system for use of those rights that is more beneficial to the creation of durable wealth for them and for society as a whole."

The proposals make Strine's paper indispensable reading if you run a corporation or advise corporate decision-makers. Even if you're put off by his somewhat tedious rhetorical device of styling the essay as a response to Harvard Law professor Lucien Bebchuk – who advocates relentlessly for expanding shareholders' franchise and apparently plays Dungeons & Dragons – or by the 154 dense footnotes in Strine's 54-page article, you should take a look at his suggestions, which begin on page 29. Strine has done more thinking, reading and writing about the real-world consequences of shareholder power than anyone I can think of. He spent 16 years, after all, as a judge in Delaware Chancery Court, three of them as chancellor, before ascending to the Supreme Court this year. And based on those 154 footnotes, Strine seems to have devoted most of his time off of the bench to reading academic papers on corporate governance and shareholder rights. (Or, at least, whatever he could spare from keeping abreast of pop culture.)

The biggest problem Strine seeks to solve is that, in his view, shareholders saving for faraway goals like retirement and education don't have a real say about corporate decision-making. They invest through index funds, which often have to cast too many votes – thousands a year, Strine says – to make independent decisions or else have conflicting objectives in shareholder votes. Sometimes, Strine points out, funds have been known to vote both yes and no on the same

merger when they hold shares in both the target and the acquirer – an oddity he calls "incoherent, stupid and reflective of a lack of judgment being exercised by the index fund on behalf of its specific investors and their interests."

Many of Strine's suggestions are intended to assure that funds are voting to promote the interests of investors with long-term goals. He would, for instance, require mutual funds to conduct independent analysis and preclude them from relying on broad proxy advisories and mandate. Strine would also require funds that accept contributions from investors saving for retirement or education "have voting policies that take into account the long-term focus of their investors." (Okay, that idea isn't so concrete.) To increase the likelihood that mutual fund advisors invest for the long term, Strine suggests that they be paid in restricted shares of their funds, just like corporate executives whose compensation is tied to their corporation's share price.

More controversially, Strine contends that shareholders are called upon to cast too many votes. If they didn't have to vote so often, he says, they could make better-informed decisions and preserve the corporate resources wasted on unnecessary democracy. For instance, Strine argues, it's expensive and counterproductive to conduct advisory say-on-pay votes every year since the votes encourage short-term decision-making. Instead, he says, say-on-pay votes should take place only every three or four years. And shareholders who want to put an issue up for a non-binding vote on corporate ballots should have to put their money where their mouth is. Right now, Strine says, an investor need only hold $2,000 of a company's shares to get an issue before shareholders. That's not a big enough stake to justify the expense to the corporation of these ballot initiatives. To bring their issue to a vote, Strine says, shareholders should have to hold a $2 million investment and to pay a filing fee of between $2,000 and $5,000 to cover some of the corporation's costs.

Strine also wants to require shareholders affirmatively to vote for alternative directors rather than to have a right to fire existing board members through what amount to no-confidence votes. He suggests corporations could facilitate the nomination of alternative directors by adopting bylaws to reimburse candidates who mount credible proxy contests that attract at least 35 percent of the shareholder vote. (I have a hard time imagining directors voting for a bylaw amendment to cover the cost of a challenger's campaign.)

Two of Strine's more amorphous proposals target activist hedge fund investors, whom the chief justice is well known to regard skeptically. Strine recounts the debate over whether the Securities and Exchange Commission ought to require earlier disclosure when an investor amasses a big ownership stake. He doesn't exactly say yes but argues that shareholder rights advocates like Bebchuk "should support requirements to make sure that up-to-date, complete information about the (acquirer's) economic holdings and interests is available" to ordinary shareholders. Strine also says that because Bebchuk and his allies have succeeded in persuading corporations to get rid of staggered board seats – an outcome the chief justice isn't happy about – institutional investors ought to "get smart and learn to love the (poison) pill." Shareholders, he says, should demand that corporations have in place anti-takeover devices so that boards have time to determine the best interests of the business if the company is put into play.

My personal favorite of Strine's proposals is that ordinary folk with long-term investment interests somehow be permitted to invest in private equity funds. Private equity buys companies

with a view toward the long term, Strine argues, so its interests are aligned with those of retirement investors, who are pouring billions of dollars a year into 401(k) plans. Supply ought to meet demand, according to Strine. The private equity industry, he concedes, would have to figure out how to structure a vehicle to put that 401(k) money to work, perhaps through a fund of funds, but Strine believes both sides have strong incentives to make the idea work.

If we're going to be realistic, most of the chief justice's proposals have as much chance of actually happening anytime soon as the promises of a sixth-grader running for student council president. On the other hand, as Strine has learned from the example of his straw man Bebchuk, radical ideas can only find a way to acceptance once they've entered circulation – especially when they're being advanced by the chief justice of the Delaware Supreme Court.