ISSN 1936-5349 (print)
ISSN 1936-5357 (online)

HARVARD

JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS

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Forthcoming in *Yale Law Journal*, Vol. 126, No. 2, 2017

Discussion Paper No. 899

02/2017

Harvard Law School
Cambridge, MA 02138

THE YALE LAW JOURNAL

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Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System

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The author is grateful to Christine Balaguer, Yulia Buyanin, Peter Fritz, Alexandra Joyce, Fay Krewer, and Peggy Pfeiffer for their help. The author also thanks Bill Anderson, David Berger, Jim Cheek, Joele Frank, Ron Gilson, Andy Green, Jim Griffin, David Katz, Rob Kindler, Lou Kling, Don Langevoort, Travis Laster, Marty Lipton, Ted Mirvis, Bob Mundheim, Sabastian Niles, Eileen Nugent, Miguel Padro, Frank Partnoy, Roberta Romano, Bill Savitt, Brian Schorr, Randall Thomas, Antonio Weiss, and Josh Zoffer for the excellent feedback and incisive comments on the draft.

Few topics are sexier among commentators on corporate governance now than whether activist hedge funds are good for, a danger to, or of no real consequence to public corporations and the people who depend upon them. As befits tradition in this space, catchy pejoratives caught on, and the phenomenon of concerted action by hedge funds and other more traditional money managers, such as actively traded mutual funds who often encourage and support the investment strategy of the alpha wolf, to influence public companies' business plans has been deemed "wolf pack activism."

For a term so evocative of dangers to the flesh, the debates over wolf packs, and more generally the topic of hedge fund activism, have a surprisingly bloodless quality—one that uses abstraction and distancing to obscure what may be really at stake. In the back and forth about short-term effects on stock price, Tobin's Q, survivorship bias, and the like, the flesh-and-blood human beings our corporate governance system is supposed to serve get lost.

But, unless we consider the economic realities of these ordinary human investors and how those realities bear on what is best for them, we are not focused on what is most important in assessing the public policies shaping our corporate governance system. Stated in a somewhat crude but generally accurate way, we started with a system that reflected some implicit assumptions, including that:

- stockholders had a long-term stake in the company's best interests; most stockholders owned their shares directly, for their own benefit, and held them for lengthy periods;
- the stockholders who were most active and vocal were those who had the longest-term stake in the corporation;
- when corporations became more profitable, they tended to create more jobs, pay workers better, and create positive externalities for the communities within which they operated;
- corporations had a national, and often regional focus, and their managers, directors, employees, lenders, and even stockholders often had ties of loyalty to those communities; and, finally,
- corporate managers were well but not lavishly paid, a plan of internal succession was common, and corporate managers tended to live in the community where the corporation was headquartered and be engaged in community affairs.

In recent decades, these assumptions have been undermined and often turned upside down:

- corporate stockholder bases turn over rapidly;
- most stock is owned by institutional investors, but represents the capital of largely silent human investors, and many of these institutional investors engage in much greater portfolio turnover;
- the actual human investors whose capital is ultimately at stake are bystanders and do not vote;
- the most vocal and active stockholders tend to be the ones with the investment strategies most in tension with the efficient market hypothesis, and often involve hedge funds who only became stockholders after deciding to change the company and who have no prior interest in the company's well-being;
- the tie between increasing corporate prosperity and the best interests of corporate workers has been sharply eroded, with corporations not sharing productivity gains with workers in their pay and focusing on offshoring and job and wage cuts as methods to increase profits;
- corporations increasingly have no national, much less community, identity and are willing to not only arbitrage their communities against each other, but also to abandon their national identity for tax savings; and, finally,
- top corporate managers have been promised pay packages way out of line with other managers, but in exchange must focus intently on stock price growth and be willing to treat other corporate constituencies callously if that is necessary to please the stock market's short-term wishes.

Indeed, as we shall see, these human investors are not so much citizens of the corporate governance republic as they are the voiceless and choiceless many whose economic prospects turn on power struggles among classes of haves who happen to control the capital—of all kinds—of typical American investors. And for all the talk of creating an ownership society, close to half of Americans do not have any investments in equity securities, even in the form of 401(k) and individual retirement account (IRA) investments in mutual funds. As or even more important to the current topic, typical Americans who are investors in the equity markets remain primarily dependent on wage employment for their wealth, and the wealth they can deploy as owners of equity capital is not controlled directly by them. Instead, the power of their capital is wielded by others. Most traditionally, of course, we focus on corporate managers as exemplifying that reality, the so-called separation of own-

ership from control. But now most Americans' direct investments in equities and debt are controlled by professional money managers,[1] from whom escape is virtually impossible. I have called this phenomenon the "separation of ownership from ownership."[2] The republic upon which typical Americans depend is one where the debate is between corporate-manager agents and money-manager agents, both of whom have different interests than ordinary human investors.

The nature of this republic must be understood if we are to assess how to address the emergence of activist hedge funds as a powerful force acting upon public companies. Assuming or pretending that the proxy voting units of institutional investors will reliably identify what is in the best interest of human investors hardly instills peace of mind. Nor is ignoring the "do as I say, not as I do" quality of those who wield power within our corporate governance system, in which claims to have the same perspectives as ordinary Americans are confounded by actions such as rapid-fire portfolio turnover, abandoning ship when you've piloted it into rock-filled waters, and demanding the right to do things you then say you don't have the time or resources to do well.

Most fundamentally, one can't fail to consider the oddity of a system where the loudest voices mostly represent one interest, that of equity capital, but are not representing the viewpoint of those human investors who entrust their capital to the corporations whose futures are at stake. Now, the voice of equity capital is represented most loudly by those whose investment philosophy the efficient market hypothesis argues is most likely to fail—active speculators trying to outguess the market. Many hedge funds themselves fly a reckless flight plan under the efficient market hypothesis and purport to be good at building long-term engines of economic growth, but are public-spirited enough to leave the resulting growth powerhouses after a few years, even though their influence on the corporation will last far beyond that. Because ordinary

1. By "money manager," I mean the mutual funds, pension funds, other investment funds, and others whose business is deciding how to invest someone else's money to achieve a return, as opposed to corporate managers who run businesses that make products and deliver services to their customers.

2. Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 6-7 (2007) [hereinafter Strine, *Toward Common Sense and Common Ground*]. *See generally* Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449 (2014) (discussing the "separation of ownership from ownership" and its implications).

Americans are stuck in the market for years and depend on its long-term, sustainable growth for jobs and portfolio gain, they are exposed to a corporate republic increasingly built on the law of unintended consequences. That republic is one where those with electoral power—the money managers with direct control over the shares purchased with human investors' money—act and, one would thus infer, *think* based on considerations of gains over periods of one to two years. If out of this debate among those with short-term perspectives comes optimal policy for human investors with far longer time horizons, that happy coincidence would be remarkable.

To shed light on how hedge fund activism, including so-called wolf pack activism, affects human investors, Part I of this Feature highlights the flesh-and-blood attributes of typical American investors—the real people, which this Feature refers to as human investors, who use the capital markets to invest and save for important life events like retirement or college education for their children. Then Part II explains what is meant by the confusing terms "activist hedge fund" and "wolf pack" activism. From there, Part III will describe the corporate republic upon which human investors are dependent but in which they are largely bystanders to a power struggle among two classes of agents, corporate managers and professional money managers. Part IV then explains the two ways in which human investors are subjected to whatever benefits and risks activist hedge funds may cause to our corporate governance system, both as indirect investors in hedge funds and as workers dependent on pension funds, and, more importantly, as human beings who derive most of their wealth from the ability of our economy, including its public companies, to create good jobs and raise wages. Sections IV.A and IV.B will explore these subjects and highlight the critical issues raising doubts that hedge fund activism is likely to be materially beneficial to human investors. Section IV.C discusses how the current corporate governance debate imperfectly addresses these potential harms to human investors.

The Feature finishes in Part V with some modest policy proposals to ameliorate the risks that hedge fund activism poses while still retaining its potential benefits. Notably, these proposals do not involve ascribing to the hedge fund industry itself any opprobrium; rather, as to the hedge fund industry itself, they mostly rest on the proposition that when economically powerful forces are acting on important societal institutions like public companies and taking funds upon which human investors and institutions like charities and universities depend, they should be required to disclose accurate and timely information about their opera-

tions and interests. Most fundamentally, this Feature recognizes that it is not hedge funds themselves that pose the major risk to human investors, it is the failure of our overall corporate governance system to represent faithfully the rational, long-term perspective of ordinary American investors who can only gain if public corporations make money the old-fashioned way, by implementing sustainable strategies to sell products and services and not through edgy practices, accounting gimmickry, or never-ending cycles of spin-offs and mergers.

I

Human investors are the least-discussed participants in our corporate governance republic, a reality made more important by the menacing valence the term "wolf pack" takes on when the prey might be human—investor, worker, or otherwise. In this context, the term "wolf pack" was, I suppose, not one adapted by environmentalists who dabble in corporate governance and are seeking to advance their desire to reintroduce a viable population of wolves into the American wild by associating them with a popular group of activist investors. Rather, the term calls on a scarier lineage, in which wolves are seen as dangerous predators capable of ruthless and concerted action to bring down and devour their prey. Visions of cowering children, vulnerable livestock, and half-eaten chickens come to mind,[3] or sailors forced to fight for survival in the great deep.[4]

But, when we talk of wolf packs in the sense of activist hedge funds and their fellow travelers that seek to propose changes in policies at public companies, much of the academic consideration has a bloodless quality, in which the reality that how public companies manage their businesses has an effect on actual human beings is obscured. Lost in

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3. Actual wolf packs menaced travelers in the American north before the twentieth century. *See, e.g.*, JACK LONDON, WHITE FANG 34 (MacMillan Co. 1906) ("[H]e was not destined to enjoy that bed. Before his eyes closed the wolves had drawn too near for safety. . . . He kept the fire brightly blazing, for he knew that it alone intervened between the flesh of his body and their hungry fangs."). A single wolf can be scary enough, as Little Red Riding Hood could attest. *See* JACOB GRIMM & WILHELM GRIMM, GRIMM'S COMPLETE FAIRY TALES 96-99 (2011).

4. Wolf packs of German U-boats, i.e., groups of attack submarines, prowled the Atlantic and Mediterranean during World War II to tremendous effect. *See, e.g.*, Robert P. Post, *British Sink Three U-Boats, Save Convoy, Lose 4 Ships*, N.Y. TIMES, Jan. 4, 1942, at 1 (heralding the successful arrival of a British convoy stalked by a German wolf pack after "a five-day running battle").

the regressions[5] and the rote references to stockholder democracy[6] are the people most affected by our corporate governance system, in no small part because those people mostly have to live with the outcomes of a system of corporate governance in which they have almost no direct voice.

In this back and forth, terms like "owner" are used as appellations by those who control the capital of others—the money managers at institutional investment firms—and use vehicles to acquire ownership of equity securities.[7] These "owners" are not sole proprietors responsible financially for all the costs and risks of a business, nor are they even "owners" in the sense of bearing all the risks of a human being who owns a share of stock in a public company. Money managers' incentives and risks are materially different than those whose capital they control. Claiming to be an owner may just be the money manager speak equivalent of a wolf putting on sheep's clothing. Therefore, if the focus when considering the effect of activist hedge funds is on the relative gain sharing among corporate managers, activist hedge funds, and

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5. *E.g.*, Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015); Alon Brav et al., *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 REV. FIN. STUD. 2723, 2753 (2015).

6. *E.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 837 (2005) ("The U.S. corporation can be regarded as a 'representative democracy' . . . ."); John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 605-06 (2016) ("[T]here is no alternative to shareholder democracy.").

7. *E.g.*, Press Release, California State Teachers' Retirement System, CalSTRS Achieves Shareholder Victory at Freeport-McMoran (Aug. 2, 2013), http://www.calstrs.com/news-release/calstrs-achieves-shareholder-victory-freeport-mcmoran [http://perma.cc/S94D-9874] (quoting Anne Sheehan, CalSTRS director of corporate governance, as saying that "[w]hile we applaud the company's willingness to engage, we as shareholders and owners have the right to give input on strategic decisions and to debate the appropriateness of deals that impact the long-term performance of the company"); *Apple Stock Rated Best of Wors*t, CNET (Feb. 11, 1997, 12:00 PM), http://www.cnet.com/news/apple-stock-rated-best-of-worst [http://perma.cc/FF6A-8MBB] (quoting CalPERS general counsel as saying that "[a]s shareholders—and owners of this company—we believe that dedication of all of Apple's directors and personal incentives are critical to recovery"); *see also* Meena Krishnamsetty, *Transcript of Bill Ackman's Super Fast Speech at the Ira Sohn Conference*, INSIDER MONKEY (June 6, 2011, 7:05 AM), http://www.insidermonkey.com/blog/transcript-of-bill-ackmans-super-fast-speech-at-the-ira-sohn-conference-3793 [http://perma.cc/9QD9-FTLC] ("By the way, I never consider any bid on something I [through Pershing Square] own hostile. You're welcome to make an offer.").

other forms of institutional investors, something fundamental will inevitably be slighted, which is that these inquiries involve a summing up among the agents of the real human beings whose wealth and well-being is supposed to be the focus of our society's economic policies. The real humans get lost in the shuffle.

If we are to consider in a prudent fashion how our corporate governance system should regulate activist hedge funds or address other analogous matters, we must humanize our lens and remind ourselves of the realities of who living, breathing investors are, the ways in which they are allowed to participate in the system, and the effect these realities have on what corporate governance system would be best for them.

Most essential in this humanizing process is realizing that most Americans owe almost all of their wealth to their ability to hold a job and to secure gains in wages. This is not simply true among the poorer half of Americans; it is true of 99% of Americans. On average, Americans derive 64% of their income from wages and another 15% from either retirement payments or other transfer payments.[8] For the middle and upper-middle class, jobs are even more important, as wages comprise 70% or more of income.[9] But the importance of labor does not stop there. Those in the eightieth to ninetieth percentiles derive over 75% of their income from their labor, and those in the ninety-fifth to ninety-ninth percentiles still get over 60% from their labor.[10] Importantly, the extent to which transfer payments—such as food stamps, unemployment insurance, and the like—comprise an important percentage of ordinary Americans' annual income underscores the points because it illustrates that in many cases the employment that workers get is not enough to provide for their families, and that others lack consistent employment at

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8. Joseph Rosenberg, *Measuring Income for Distributional Analysis*, URBAN-BROOKINGS TAX POL'Y CTR. 4-5 (July 25, 2013), http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/412871-Measuring-Income-for-Distributional-Analysis.PDF [http://perma.cc/C2SJ-AE5B]. The Urban-Brookings study classifies taxable distributions from IRAs and both taxable and nontaxable distributions from pension plans as retirement income. *Id*. at 4. Social Security benefits are classified as transfer payments. *Id*.

9. *Id*. at 5. Compensation constitutes 70% of income for those in the middle quintile and 73% for those in the fourth, i.e., second-to-top, quintile. *Id*. "Compensation is the largest source of income for all but the highest income group." *Id*. at 4. Only 11% of Americans' expanded cash income came from investments. *Id*. at 5.

10. *Id*.

all.[11] Jobs, jobs, jobs—they still drive American wealth creation for all but the super-rich.

Now, it is also true that many Americans are now "forced capitalists"[12]—forced by public retirement policies and market developments to turn over a portion of their paycheck every month to the money management industry.[13] Under the predominant approach, though, American workers are not able to buy securities in public companies directly. Instead, they are given an option to invest in the funds of whatever mutual fund families with which their employer contracts.[14] Although these families may have a seeming breadth of options because the invest-

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11. Transfer payments constitute 40% of income for those in the bottom quintile and 22% for those in the second quintile. *Id*. at 5.

12. *See* Strine, *Toward Common Sense and Common Ground*, *supra* note 2, at 4-5.

13. *See* Peter Brady et al., *The Success of the U.S. Retirement System*, INV. CO. INST. 30 (2012), http://www.ici.org/pdf/ppr_12_success_retirement.pdf [http://perma.cc/2BG6-82LP] (describing an increase in the number of active participants in 401(k) plans from seventeen million in 1989 to fifty-one million in 2010); John Broadbent et al., *The Shift from Defined Benefit to Defined Contribution Pension Plans—Implications for Asset Allocation and Risk Management*, BANK FOR INT'L SETTLEMENTS 13-17 (2006), http://www.bis.org/publ/wgpapers/cgfs27broadbent3.pdf [http://perma.cc/X2GG-SP7N]; *Frequently Asked Questions About 401(k) Plans*, INV. CO. INST. (Sept. 2014), http://www.ici.org/policy/retirement/plan/401k/faqs_401k [http://perma.cc/6YDW-DPJP] (describing an increase in 401(k) plan assets from $0.7 trillion in 1994 to $4.4 trillion in the second quarter of 2014); *see also* JOHN C. BOGLE, THE CLASH OF THE CULTURES: INVESTMENT VS. SPECULATION 226-38 (2012) (praising the shift from defined benefit to defined contribution plans, but arguing for reforms to the defined contribution system); U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-408, RETIREMENT SECURITY: LOW DEFINED CONTRIBUTION SAVINGS MAY POSE CHALLENGES 2 (2016), http://www.gao.gov/assets/680/676942.pdf [http://perma.cc/KVT6-P8NR] *(*finding that 40% of all U.S. households had some savings in a defined contribution plan*)*.

14. Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans*, 124 YALE L.J. 1476, 1485 (2015) ("The most common type of investment options in 401(k) plans are mutual funds or similar investment vehicles that pool funds managed by a professional fund manager."). One important reason investment options are restricted is the structure of the liability safe harbor that plan sponsors can take advantage of by offering only certain investments. *See* 29 U.S.C. § 1104(c)(1) (2012); 29 C.F.R. § 2550.404c-1 (2015). Thus it is perhaps not surprising that 43% of American households own mutual funds. Alan R. Palmiter, The Mutual Fund Investor 3 (2016) (unpublished manuscript), http://ssrn.com/abstract=2853506 [http://perma.cc/D8QV-MZBM]. Mutual funds also constitute a large proportion of household wealth—the median mutual-fund-owning household holds two-thirds of its financial assets in mutual funds. *Id*. Most of those mutual funds are held in defined-contribution retirement accounts or IRAs. *Id*. at 4.

ment choices are numerically diverse, those choices in reality consist only of the menus of funds of the fund families their employer has selected.[15] The workers' version of the Wall Street rule[16] involves not being able to sell one stock in the Russell 3000 and buy another, or to move into particular bonds. Instead, it involves being able to move from one fund to another, often of the same fund family. And yes, of course, there is a kind of liquidity, in the sense that the worker is entitled to withdraw her money at any time at the fund's net asset value.[17] But this is not liquidity that allows a worker to live off the proceeds. Rather, for most Americans, once funds are invested in a 401(k) plan, the funds are out of their effective reach until they reach age fifty-nine and a half.[18] To withdraw before that time subjects the worker to Castro-like expropriation in the form of confiscatory taxes.[19] For this reason, most workers have a substantial interest in the durable appreciation of their portfolio, and do not benefit in any way from stock bubbles arising from gimmicks or unsustainable strategies because these gains will go away and if those bubbles result in economic recessions and diminutions in economic growth, the worker will suffer both at the time of retirement, and perhaps more importantly, during their working careers, as economic slowdowns that result in job losses and wage stagnation threaten their most important source of wealth.

I admit to focusing on 401(k) funds,[20] and I do so for good reason. Most Americans are not wealthy enough to buy a lot of securities[21] out-

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15. Ayres & Curtis, *supra* note 14, at 1485 ("The menu of mutual funds from which employees choose is ultimately constructed by the employer . . . ."). "In the largest 200 defined-contribution plans, the average number of funds on the menu is twenty-two." WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND 143 (2016).

16. Coffee & Palia, *supra* note 6, at 553 (defining the "Wall Street Rule" under which, if institutional investors were dissatisfied with management, they sold their stock and moved on); *see also* Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1734 (2008) ("[T]he 'Wall Street Rule' often becomes the default form of institutional shareholder activism.").

17. *See* 17 C.F.R. § 270.22c-1 (2015). An open-end fund must sell its shares based on the net asset value, which must be calculated at least once daily. *Id*.

18. I.R.C. § 72(t)(2)(A)(i) (2012). This is also true for IRAs. *Id*. § 408A(d)(2)(A)(i).

19. *Id.* § 72(t)(1) ("If any taxpayer receives any amount from a qualified retirement plan . . . the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 [%] . . . .").

20. By 401(k) investors, I also include workers who, by virtue of their employment by a government agency or non-profit, invest in analogous 403(b) and 457(b) plans. *See*

side of retirement and college savings accounts under 26 U.S.C. § 529.[22] In fact, most Americans are not wealthy enough to come near

I.R.C. § 403(b) (2012); *Id.* § 457(b); *IRC 457(b) Deferred Compensation Plans*, I.R.S. (July 28, 2016), http://www.irs.gov/retirement-plans/irc-457b-deferred-compensation-plans [http://perma.cc/4DEA-QZWA]; *Plan Feature Comparison Chart: Choose a Retirement Plan*, I.R.S. 4 (Feb. 2015), http://www.irs.gov/pub/irs-pdf/p4484.pdf [http://perma.cc/M3BZ-E8AM] (comparing plans); *Publication 571: Tax-Sheltered Annuity Plans (403(b) Plans)*, I.R.S. (Jan. 2016), http://www.irs.gov/publications/p571 [http://perma.cc/MF5H-FXTG] (describing 403(b) plans for employees of public schools and certain tax-exempt organizations). Many, but not all of these investors, can be said to have a defined contribution or "DC" plan in the sense that the employer puts an amount into the plan on their behalf each paycheck but does not guarantee a future set pension (a defined benefit such as in a traditional pension plan). Some 401(k) investors, however, get an employer contribution and, of course, it must be remembered that whether the plan is called a defined contribution or defined benefit plan, it comprises one element of the employees' compensation for their labor. IRAs are also closely linked to what happens with 401(k)s because the bulk of IRA money comes from rollovers from employer plans, not direct contributions. Palmiter, *supra* note 14, at 4 ("Defined-contribution plans and IRAs are intricately linked, as most of the money flowing into IRAs comes from rollovers from employer-based retirement plans, not direct IRA contributions.").

21. *See* Rosenberg, *supra* note 8, at 5.

22. Like 401(k) plans, most 529 plans provide participants with a choice of mutual funds in which to invest and, if those funds are withdrawn except for specific purposes set forth in the tax code, they are subject to tax penalties. *See An Introduction to 529 Plans*, SEC. & EXCH. COMMISSION (Jan. 6, 2014), http://www.sec.gov/investor/pubs/intro529.htm [http://perma.cc/9BRD-ZQ3X] ("Investment options often include stock mutual funds, bond mutual funds, and money market funds . . . "); *Common 529 Questions*, C. SAVINGS PLANS NETWORK, http://www.collegesavings.org/common-529-questions/#question15 [http://perma.cc/CCH9-88ZC] ("Earnings in a 529 plan grow tax-deferred and are free of federal income tax when used for qualified higher education expenses under Internal Revenue Code Section 529."); *What Is a 529 Plan?*, C. SAVINGS PLANS NETWORK, http://www.collegesavings.org/what-is-529 [http://perma.cc/R7X6-UY5X]. As a result, most 529 investments go ultimately into the same kinds of mutual funds as workers' 401(k) plans. Simona Hannon et al., *Saving for College and Section 529 Plans*, BOARD GOVERNORS FED. RES. SYS. (FEB. 3, 2016), http://www.federalreserve.gov/econresdata/notes/feds-notes/2016/saving-for-college-and-section-529-plans-20160203.html [http://perma.cc/WW7W-L2CK] ("529-college-savings-plan administrators typically offer a selection of investment portfolios to their clients. Each portfolio includes either one or several mutual funds."). I say ultimately because many 529 plans market target date funds based on the age of the child for whom the funds are invested and when that child is likely to go to college. Those target date funds invest in specific blends of equity and debt funds that move from a more equity-based approach when the child is more distant from college and into a more liquid, debt-based fund approach

hitting the annual limits for what they may set aside in a 401(k) retirement account. That annual limit is $18,000 per worker,[23] or 32% of the median household income in 2015.[24] For most people, savings outside of college savings and retirement accounts have to be available in liquid and non-risky form to meet events of life like house and car down payments, air conditioners that need to be replaced, auto catastrophes not covered by warranty, children getting married or needing help, school tuition, or other issues in the general category of "stuff happens."

And for most Americans, how much they have to invest is singularly a function of how much they can make from their labor. The equity and debt capital they acquire comes originally from sweat. Because most of us don't have a large surplus, it is not surprising that a majority of Americans have relatively little saved for retirement in the form of an ownership interest in funds invested in equity securities.[25] "[N]early half of all working-age families have zero retirement savings . . . ."[26] This results in dire aggregate savings rates: the median family with a head of

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as the child nears college and is likely to need the funds in the near term for tuition. *See Common 529 Questions*, *supra* ("The most common investment option is the age-based allocation strategy in which the age of the beneficiary determines the specific mix of investments.").

23. Press Release, I.R.S., IRS Announces 2016 Pension Plan Limitations; 401(k) Contribution Limit Remains Unchanged at $18,000 for 2016 (Oct. 21, 2015), http://www.irs.gov /uac/newsroom/irs-announces-2016-pension-plan-limitations-401-k-contribution-limit -remains-unchanged-at-18-000-for-2016 [http://perma.cc/969T-KH6R]. The contribution limit for an IRA for 2016 remained unchanged at $5,500. *Id*.

24. *Real Median Household Income in the United States*, FED. RES. BANK ST. LOUIS (Sept. 13, 2016), http://fred.stlouisfed.org/series/MEHOINUSA672N [http://perma.cc/K8RF-6DMW].

25. *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 13, at 13 n.30 ("[T]he overall median balance of DC savings for all working, prime-age (age 25-64) households in 2013 was just $3,000.").

26. Monique Morrissey, *The State of American Retirement: How 401(k)s Have Failed Most American Workers*, ECON. POL'Y INST. 15 (Mar. 3, 2016), http://www.epi.org/files/2016/state-of -american-retirement-final.pdf [http://perma.cc/QB7Y-CQ2D]. There is some variation by age. In a 2015 report, the Government Accountability Office noted that 52% of households in the fifty-five and older category have no retirement savings in 401(k)s or IRAs. U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-419, RETIREMENT SECURITY: MOST HOUSEHOLDS APPROACHING RETIREMENT HAVE LOW SAVINGS 7 (2015), http://www.gao.gov/assets/680/670153.pdf [http://perma.cc/BG7Y-SUCQ]. About half of those in households aged sixty-five and up are mostly dependent on Social Security. *Id*.

household between the ages of thirty-two and thirty-seven has $480 across all of its retirement accounts.[27] If households without any retirement savings are excluded, the picture is a little better: working-age households that do save have a median retirement account balance of $41,900.[28] Even among households whose members are retirement age and have retirement savings, those savings are capable of generating only a modest annuity.[29] Not surprisingly, these balances largely track family income.[30] But, even the comfortably middle class—American households earning between $88,100 and $133,900 annually—have median account balances of only $60,900.[31] Only when looking at the top quartile of American households—earning more than $135,000—do median account balances exceed six figures, demonstrating how critical it is to continue to make good wages through access to a quality job.[32] Yet, even for more affluent Americans well above the median, these savings produce a relatively small amount of their total income.[33] And regrettably, the wealth gap between white and black Americans that has resulted from our society's history of racial oppres-

27. Morrissey, *supra* note 26, at 11. The situation is slightly better for older households: median retirement savings rises to $4,200 for ages 38-43, $6,200 for ages 44-49, $8,000 for ages 50-55, and $17,000 for ages 56-61. *Id*.

28. U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 13, at 13 n.30. This study used the 25-64 age range to stand for working-age people. *Id*. On that broader measure, the median household balance including those with no retirement savings at all is $3,000. *Id*.

29. U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 26, at 15 (noting that the median retirement savings amount for the 48% of households age 65-74 with retirement savings is $148,000, which is "comparable to an insured, inflation-protected annuity of $649 per month for a 70-year-old").

30. Morrissey, *supra* note 26, at 5; *see also* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 13, at 13 (low-income households had less savings in retirement plans than other income groups).

31. U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 13, at 14 (measuring working households that have at least some retirement savings).

32. *Id*. It is worth reiterating that when looked at from the perspective of income, the importance of wages for almost all Americans cannot be overstated—only the top 1% of Americans derive less income from wages than from other sources. *See supra* text accompanying notes 8-11.

33. *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 13, at 15 (showing that the top quarter of retirement-age households have retirement savings sufficient to generate less than $2,000 a month in an insured, inflation-protected annuity for a 70-year old); *id*. at 18 fig.3 (indicating that for even those retirement-age households with retirement savings, retirement savings constitute only a quarter of retirement income).

sion shows up in a huge way in 401(k) savings assets.[34] For starters, black and Hispanic households are less likely than households generally to have access to a 401(k)-type plan through their workplace.[35] Where plans are available, black and Hispanic workers have lower account balances.[36]

A declining but still sizable number of Americans have their wealth invested indirectly in equity and debt capital markets through a more traditional means—a pension plan.[37] Every paycheck, part of their effective wage is put toward a supposed guarantee of a defined pension based on years of work and other factors such as salary level. These other factors underscore the importance of wages as driving the pension payments a worker will receive, thus linking the worker's ability to live comfortably in retirement with her access to good wages during her working career.[38] For pensioners, in contrast to 401(k) savers, no investment choices typically must be made. Rather, the trusting pensioners find themselves in the hands of their pension fund and dependent upon considerations such as whether the pension fund is annually funded in an actuarially sound manner and whether the pension fund is investing its assets in a prudent manner that will enable it to meet its promises to its beneficiaries. Even more obviously than 401(k) investors, workers who have been promised a pension should rationally want a corporate governance system focused on sustainable wealth creation. Investments must grow durably and be there when it counts. Not only that, unless the approach to economic growth is one that benefits workers, by generating good jobs and wage growth, the prospective pensioner risks unattractive fates like non-vesting if a job is lost, or minimal growth in pension prospects if promotions and other wage growth options that will generate a higher pension are limited.

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34. *Id.* at 52 tbl.5.

35. *Id*. at 18.

36. Morrissey, *supra* note 26, at 6. Account balances for black and Hispanic workers also declined more than for whites in the 2007-13 period. U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 13, at 19-20.

37. Brady et al., *supra* note 13, at 28-29 fig.7; William J. Wiatrowski, *The Last Private Industry Pension Plans: A Visual Essay*, MONTHLY LAB. REV. 3, 4 fig.1 (Dec. 2012) (describing the overall decline in defined benefit pensions and noting that only around 20% of workers had defined benefit pension plans by 2011).

38. *Types of Retirement Plans*, U.S. DEP'T LAB., http://www.dol.gov/general/topic/retirement/typesofplans [http://perma.cc/RNR4-HZ53](noting that defined benefit plans "commonly" have a benefit calculated based on amount of salary and length of service).

Precisely because human investors save for college and retirement, they are also likely to have substantial investments in debt securities and not just equities.[39] Why? Because as college and retirement loom, it is prudent that more of your portfolio be in a form less vulnerable to losses in principal.[40] For this reason, human investors are particularly vulnerable if the corporate governance system allows excessive leverage, which can threaten jobs through insolvencies, economic shocks such as financial crises, and a reduction in the value of debt securities.

These realities are buttressed by corporate finance theory itself. The mainstream of that theory teaches that the current value of an asset should be based on its expected future cash flows.[41] It also teaches that when assets such as stocks are traded in a liquid market with a rich information flow about corporate prospects, an active trading strategy dependent on outguessing the collective judgments of the market is unlikely to succeed.[42] That does not mean that you can't guess right sometimes or over some period, but that the ability to do so durably and consistently over time is slim to non-existent.[43]

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39. Palmiter, *supra* note 14, at 3 (noting that bond funds constitute almost a quarter of mutual fund assets).

40. *E.g.*, *Retirement Portfolio Allocation*, CHARLES SCHWAB, http://www.schwab.com/public/schwab/investing/retirement_and_planning/retirement_income/portfolio_allocation [http://perma.cc/Y22Z-7894] (advising a shift from stocks to debt securities and cash as investors age or want greater stability).

41. William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 693 (2010) ("The corporation is a collection of assets and its value is the free cash flow that those assets are expected to generate into the indefinite future."); *see generally* RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 115 (9th ed. 2008) (observing that net present value is the preferable metric for investment decisions and concluding, "[g]uess what? NPV, properly interpreted, wins out in the end").

42. Bratton & Wachter, *supra* note 41, at 692 (noting that one implication of the semi-strong form of the efficient capital market hypothesis is that "no trading strategy based on public information can regularly outperform the market" (footnote omitted)); *see also* BREALEY ET AL., *supra* note 41, at 358-63 (describing the three forms of the efficient market hypothesis and observing that "in competitive markets easy profits don't last"); *id.* at 373 (stating that "in an efficient market, there is no way for most investors to achieve consistently superior rates of return").

43. BREALEY ET AL., *supra* note 41, at 361 ("Tests of the strong form of the hypothesis have examined the recommendations of professional security analysts and have looked for mutual funds or pension funds that could predictably outperform the market. Some researchers have found a slight persistent outperformance, but just as many have concluded that professionally managed funds fail to recoup the costs

For human investors, these aspects of theory seem to counsel in favor of a corporate governance system that encourages investment in the development of useful products and the delivery of useful services because it is the purchase of products and services that must ultimately be the source of sustainable profits. Over the long term, you must sell something customers need or want. Whether you are a pure play or have a strong stock buyback program won't matter if you can't do that. Simply squeezing the corporate lemon to get the most juice right now at the expense of growing future lemons does not help human investors build wealth, as they risk employment opportunities and cuts in long-term portfolio growth. Offshoring jobs to nations with pitiful wages and little protection for labor as shortcuts to more immediate profits, rather than making profits in an ethical, sustainable manner that does not involve externalizing the real costs of business, hurts human investors. Corporate finance gimmicks won't generate jobs or a retirement fund for workers outside the industry space coming up with the gimmicks, and gimmicks have a way of getting found over time. And over time is how human investors build wealth.

This is not to say that human investors do not want to hold corporate managers accountable. Of course they do. Human investors don't want self-dealing that diverts profits from the corporation unfairly to insiders. They don't want empire building that simply makes a corporation larger for its own sake, and does not make it more profitable in the long term. But what human investors are concerned with is not quarter-to-quarter earnings. Rather, they are also concerned when managers and others with power to influence corporate policies can gain substantially if corporations show paper profits that are not indicative of economic reality or leverage themselves up to make immediate payments at the cost of future insolvency or lower returns. If the very economy that human investors count on to provide them with jobs is hollowed out at the insistence of those who wield the power that comes with managing human

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of management."); Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59, 77 (2003) ("A remarkably large body of evidence suggests that professional investment managers are not able to outperform index funds . . . ."); *see also* BOGLE, *supra* note 13, at 301-07 (arguing that attempts to outguess the market are irrational and showing that even eight actively managed funds considered to be highly successful had returns that tended to revert to that of the market overall and to have poorer returns, when their higher costs were considered); BREALEY ET AL., *supra* note 41, at 362 fig.14.5 (showing that "mutual funds underperform the market in approximately two-thirds of the years" from 1962-2006).

investors' equity capital, human investors will likely end up less wealthy in the long run.

In sum, human investors are creatures with special attributes, distinct (as we shall see) from other participants in our corporate governance system. Specifically, human investors are true Benjamin Graham-style long-term investors.[44] Their time horizon is the twenty-some years from the birth of a child until college or the even lengthier period from entering the workforce until retirement. The vast majority of human investors are also not *primarily* investors—most of their wealth is derived from labor and wages, not capital appreciation and dividend income. These two attributes distinguish what is in the best interest of human investors from what is in the best interest of other market participants. Bubbles disproportionately harm human investors because their time horizon means they not only ride the bubble up, but they also ride it back down to a bottom that may be lower than would have been the case but for the inflated egos that caused it. Human investors are also likely to have investments in both equity and debt and so are sensitive to value transfers from debt to equity. Most materially, human investors are exposed to the broader real world consequences of changes in corporate behavior influenced by stock market forces such as hedge fund activism: a short-term increase in productivity and stock price at the expense of long-term reinvestment and wage growth will likely harm the overall "portfolio" of the human investor.[45] The point of this Feature is not to vilify hedge funds but to ask questions about basic assumptions by using the perspective of the too-often-ignored human beings for whom the system is supposed to work. If you were one of the many—the average or above average below the ninety-fifth percentile—how would you want the corporate governance system designed? Even if you were way more fortunate than the many, in the ninety-fifth to ninety-ninth percentile, how would you want it designed?

Keeping a close eye on these flesh-and-blood investors, it is time to clarify what exactly terms like "hedge fund" and "wolf pack activism" mean in this context and begin to explore how activists' incentives and strategies act on the real-world companies they target.

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44. *See* BENJAMIN GRAHAM, THE INTELLIGENT INVESTOR 188-207 (HarperCollins Publishers 2005) (1949) (espousing a long-term buy-and-hold philosophy).

45. *See* discussion *infra* Parts III, IV.

II

The term "hedge fund activism" is an odd one. Hedge funds were originally associated more with the tempering, the "hedging," of risk.[46] And that remains true. Many, if not indeed most, hedge funds are involved in trading strategies that do not involve the subject of this Feature.[47] Many of them still focus on strategies combining leverage, "long" equity investments, and "short" downside-protecting hedges that gave hedge funds their name.[48] But, for purposes of this Feature, I focus on

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46. *See* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1382-83 (2007) (summarizing traditional hedge fund strategies).

47. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1046 (2007) (stating that only around 5% of all hedge fund assets are used for activism); *Activist Funds: An Investor Calls*, ECONOMIST (Feb. 7, 2015), http://www.economist.com/news/briefing/21642175-sometimes-ill-mannered-speculative-and-wrong-activists-are-rampant-they-will-change-american [http://perma.cc/H7UW-G54Z] ("[O]f about 8,000 hedge funds activists number just 71 . . . ."). Of the fifty largest hedge funds as measured by equity assets, only nine are also on FactSet's SharkWatch 50 list of "significant activist investors." *Hedge Fund Ownership*, FACTSET (Aug. 23, 2016), http://www.factset.com/websitefiles/PDFs/hedgefund_ownership/hedgefund_ownership_8.23.16 [http://perma.cc/2QKZ-H7UA]. Only one of the SharkWatch 50, Icahn Associates, is in the top ten hedge funds by equity assets. *Id*. This probably overstates the actual prevalence of activist funds because the report looks at firm-level equity assets, and some of the SharkWatch 50 firms engage in multiple strategies. *See, e.g.*, *Philosophy*, CARLSON CAP., http://www.carlsoncapital.com/default.aspx [http://perma.cc/4CVN-4BAU] ("We believe that superior risk-adjusted returns can be achieved by the use of thoughtful, targeted hedging strategies and diversification, across multiple strategies and multiple decision makers.").

48. Of the 100 top performing hedge funds, based on a three-year measurement, forty were pure equity long-short funds; more used some variation of that strategy. *Barron's 2016 List: Best 100 Hedge Funds*, BARRON'S (June 18, 2016), http://www.barrons.com/articles/best-100-hedge-funds-1466223924 [http://perma.cc/S4UE-2MGJ]; *see also* Sebastian Mallaby, *Learning To Love Hedge Funds*, WALL ST. J. (June 11, 2010), http://www.wsj.com/articles /SB10001424052748703302604575294983666012928 [http://perma.cc/8F36-85LQ] (describing Alfred Winslow Jones, the founder of the first hedge funds, and his first funds that had a long-short structure). But, the term "hedge fund" is applied to a broad set of investment strategies. *See* Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, *in* NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES 114 (Yasuyuki Fuchita & Robert E. Litan eds., 2007) (observing that "[t]here is no generally agreed-upon definition of a hedge fund"); *id*. at 115 (setting out four charac-

the more oxymoronic part of the industry, which rather than primarily acting to hedge risk, takes an aggressive investment interest in the stock (and other securities and more exotic interests tied to the value of that stock) of a public company and seeks to make returns by influencing the corporation to change its capital structure or business plan. The funds that do this make up a minority of the overall hedge fund industry,[49] but they have an outsized role in the debate about corporate governance because they have had an important effect on the manner in which public companies operate. And however attractive it is for politicians to talk about small business being the engine for job growth, the reality remains that public companies are the most vital source of jobs in our economy. Directly, they provide employment for more than 22% of Americans.[50] That understates their effect because countless small businesses are profitable because they operate in communities where

teristics of hedge funds, none of which relate to investment strategy other than a general focus on public, rather than private, markets).

49. *See supra* note 47 and accompanying text.

50. The companies comprising the S&P 500 employ approximately twenty-four million people, which is approximately 70% of the overall workforce employed by Russell 3000 companies. *See* Justin Fox, *Big Companies Still Employ Lots of People*, BLOOMBERGVIEW (Apr. 20, 2016, 4:54 PM), http://www.bloomberg.com/view/articles/2016-04-20/big-companies -still-employ-lots-of-people [http://perma.cc/VSG3-GGMN]. That results in an overall public company employment figure of around thirty-four million. The civilian labor force is approximately 157 million people. *Economic News Release, The Employment Situation – July 2016*, BUREAU OF LAB. STAT., tbl.A-1 (Aug. 5, 2016), http://www.bls.gov/news.release/empsit.nr0.htm [http://perma.cc/8DQL-MP6V]. Thus, public company employment as measured using the Russell 3000 as a proxy constitutes approximately 22% of the labor force. 22% is likely both underinclusive and overinclusive. For one thing, that uses the Russell 3000 index as a proxy for U.S. public companies. The index measures the performance of the 3,000 largest companies, which represent 98% of the investable U.S. stock market. *Russell 3000 Index Fund Institutional Shares (VRTTX)*, VANGUARD, http://advisors.vanguard.com/VGApp/iip/site/advisor/investments/productoverview?fundId=1854 [http://perma.cc/99Y8-ZBNZ]. This both excludes a small portion of the U.S. market and includes companies that may have a relatively large proportion of employees outside the U.S.—for example, Yum! Brands, the corporate owner of Kentucky Fried Chicken among other brands, with over half of revenue coming from China alone in recent years. Yum! Brands, Inc., Quarterly Report (Form 10-Q), at 12 (July 19, 2016). At the same time, of course, many public companies from other nations—who increasingly face hedge fund activism in their own corporate domiciles—employ many American workers. *See* Micheline Maynard, *A Lifeline Not Made in the U.S.A.*, N.Y. TIMES (Oct. 17, 2009), http://www.nytimes.com/2009/10/18/business/18excerpt.html [http://perma.cc/EXS6-TBGY].

public company operations exist; they play a role in acting as suppliers of goods and service providers to the public company and its employees.

The information that is available regarding hedge funds is much more limited than about investment firms registered under the Investment Company Act, also known as the "40 Act."[51] Until recently, hedge funds were not registered[52] and can only take investments from "accredited investors,"[53] also sometimes known by the moniker of "sophisticated investors." Because of the lack of disclosure required of hedge funds,[54] less-than-ideal information exists about how the hedge fund industry has performed in comparison to traditional mutual funds or market indices. Hedge fund track records are notoriously difficult to assess because the survival rates of hedge funds are much lower than for traditional mutual funds,[55] and it is not clear that studies assessing hedge

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51. Institutional investors such as mutual funds are required to provide in depth disclosure of their holdings on a semiannual basis, among other disclosure requirements. *See* Investment Company Act of 1940 § 30(e)(2), 15 U.S.C. § 80a-29(e)(2) (2012); Kahan & Rock, *supra* note 47, at 49-50.

52. Frank Partnoy, *U.S. Hedge Fund Activism*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 104 (2015) (describing new reporting requirements promulgated by the SEC in response to Dodd-Frank's mandate). In fact, lack of registration was often used as all or part of the definition of hedge fund. *See* Kahan & Rock, *supra* note 47, at 1024 n.1 (explaining that "in general, hedge funds are funds exempt from regulation under the Investment Company Act" and citing the definition used in an SEC report on hedge funds (citation omitted)).

53. 17 C.F.R. § 230.501(a) (2016) (defining "accredited investor"); Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 88-89 (2011) (describing the SEC safe harbor, which allows funds exempt from the Investment Company Act such as hedge funds to skip determinations of investor suitability beyond confirming that they are "accredited").

54. Even though the SEC receives more information through hedge fund registration and Form PF than it used to, this information is not available to the public other than in summary form. Partnoy, *supra* note 52, at 104.

55. MARK J.P. ANSON, CAIA LEVEL I: AN INTRODUCTION TO CORE TOPICS IN ALTERNATIVE INVESTMENTS 241 (2009); Mila Getmansky, *The Life Cycle of Hedge Funds: Fund Flows, Size, Competition, and Performance* 34 (May 7, 2012) (unpublished manuscript), http://ssrn.com/abstract=2084410 [http://perma.cc/A336-CRXJ] ("Compared to mutual funds, hedge funds have a very large probability of liquidation."); *id*. at 1 ("[A]longside the tremendous growth, there has also been a significant attrition in the industry."); *id*. at 4 ("25% of funds have been in business between 5 and 7 years. Only 5% of funds survived past 15 years, and over 35% of funds did not make it after 3 years of operation."). If the initial performance of a fund is poor, it is to the managers' advantage, if it is able to do so, to terminate the fund and start a new one rather than to try and dig out of its bad performance, Robert C. Pozen,

fund performance consistently capture the negative returns of funds that have gone out of business for lack of positive returns.[56] The lack of reliable information about hedge fund performance and its effect on the ability of pension funds and other fiduciary investors to protect their beneficiaries also extends to private equity, leading to calls for legislative action to increase the disclosure of issues like the terms of private equity funds' contracts with investors.[57] Of special concern to human in-

Curbing Short-Termism in Corporate America: Focus on Executive Compensation, GOVERNANCE STUD. BROOKINGS 7 (2014), http://www.brookings.edu/~/media/research/files/papers/2014/05/06-pozen/brookings_shorttermismfinal_may2014.pdf [http://perma.cc/6TZB-FL2C], and, according to market participants, often with the same investors.

56. *See* ANDREW W. LO, HEDGE FUNDS: AN ANALYTIC PERSPECTIVE 31 (2010) (citing studies finding that survivorship bias affects measurement of hedge fund returns); *Hedge Fund Survivor Bias and the Flaws of Blind Fund-Following Strategies*, ALPHABETAWORKS INSIGHTS (Mar. 26, 2015) http://abwinsights.com/2015/03/26/hedge-fund-survivor-bias [http://perma.cc/9JZT-JA47] (analyzing hedge fund portfolios and performance statistics and finding "[h]istorical performance of surviving hedge funds overstates actual average returns by a fifth," and "survivor bias boosts 10-year nominal returns by 26%"); *see also* William Fung & David A. Hsieh, *Hedge-Fund Benchmarks: Information Content and Biases*, 58 FIN. ANALYST J. 22, 25 (2002) ("When the fund's track record is satisfactory, the fund manager markets the fund to investors, which often includes asking to be in a hedge-fund database."); *id*. at 23 ("Survivorship bias . . . arises when a sample of hedge funds includes only funds that are operating at the end of the sampling period and excludes funds that have ceased operations during the period."). Fung and Hsieh also observe that, assuming funds cease operation because of poor performance, the "historical return performance of the sample is biased upward and the historical risk is biased downward relative to the universe of all funds." Fung & Hsieh, *supra*, at 23; *see also* Vikas Agarwal et al., *Hedge Funds: A Survey of the Academic Literature* 91-92 (Founds. & Trends in Fin., Working Paper, Aug. 25, 2015), http://ssrn.com/abstract=2650919 [http://perma.cc/3F63-K3DK] (describing biases in databases of hedge fund performance). Other biases associated with hedge fund performance reporting are selection bias, ANSON, *supra* note 55, at 241 (finding that better-performing hedge funds are less likely to report results), backfilling bias, *id*. (describing a practice of databases that creates an "instant history of hedge fund returns" dating back to the beginning of a fund's operation that may be based on a particularly high-performing time period), liquidation bias, *id*. (explaining that hedge funds which are about to shut down will not report their poor performance), and stale price bias, Agarwal et al., *supra*, at 95 (describing how rarely priced illiquid assets can skew performance measures).

57. *See* Gretchen Morgenson, *Private Equity Funds Balk at Disclosure, and Public Risk Grows*, N.Y. TIMES (July 3, 2016), http://www.nytimes.com/2016/07/03/business/private-equity-funds-balk-at-disclosure-and-public-risk-grows.html [http://perma.cc/34R5-FU4J].

vestors is the reality that nonregistered funds can strike different deals with different investors, and that those funds most likely to be acting on behalf of human investors may be, on balance, those less likely to benefit from, and thus most likely to suffer from, preferential arrangements.[58]

Like their tactics, the targets of hedge fund activism cannot be put in one category.[59] Scholars and commentators may underestimate the effect that industry growth has in considering this issue in particular. Some of the examples used as characterizing hedge fund success involved companies with rather serious ethical and legal difficulties, which

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58. Co-investment—where an investor is able to invest more money alongside the hedge fund but not through the hedge fund's own structure—is one such special deal. *See Aligning Interests: The Emergence of Hedge Fund Co-Investment Vehicles*, J.P. MORGAN 6-7 (2014), http://www.managedfunds.org/wp-content/uploads/2014/05/JPMorgan_PB_Perspectives-Co-Investment_1Q2014.pdf [http://perma.cc/Q74P-646L] (describing types of co-investment structures); *id*. at 5 (describing benefits for investors). Some investors may also negotiate fee terms for the money invested in the hedge fund directly than the traditional 2 and 20. *See Down to 1.4 and 17*, ECONOMIST (Feb. 8, 2014), http://www.economist.com/news/finance-and-economics/21595942-cost-investing-alternative-assets-fallingslowly-down-14-and-17 [http://perma.cc/CKG6-EP8Y] (describing negotiating power of certain hedge fund clients to obtain better fee terms). Sovereign wealth funds are known to be adept at using their bargaining position granted by large amounts of capital ready to deploy to extract favorable fee terms. *Id*. The story for American public pension funds is varied. Certainly, some of the larger funds are sophisticated hedge fund consumers and have reportedly been able to obtain favorable terms for themselves. Darrell Preston, *Hedge Funds Leave U.S. Pensions with Little To Show for the Fees*, BLOOMBERG (Dec. 9, 2015), http://www.bloomberg.com/news/articles/2015-12-09/hedge-fund-rout-leaves-pensions-with-little-to-show-for-the-fees [http://perma.cc/EHV2-D6NS] (citing a market participant's observation that "some pensions have used the lackluster returns [of recent years] to push for lower fees and more information about investment strategies"). But, more often than not, it seems likely that public pension funds, particularly the many with fewer assets than the few heavyweights, have not been able to negotiate with fund managers from a position of strength.

59. For a reader who wants an excellent summary of the existing academic research regarding the impact of activist hedge fund investing, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance* by Professors John C. Coffee, Jr. and Darius Palia is a thorough, evenhanded overview. *See* Coffee & Palia, *supra* note 6. I am grateful to its authors and do not intend to replicate their impressive distillation of the existing data, but do draw heavily on their balanced conclusions about overall trends because of their commitment to objectivity.

were dealt with on account of unrest by investors (and aid from regulatory revelations).[60] This sort of activism is not typical, however, and has become even less so as the industry has grown.[61] Although scholars are not in full agreement about how to characterize the companies targeted by hedge funds, with some calling them underperforming,[62] and others calling them profitable companies undervalued by the market,[63] some common characteristics have emerged. In contrast to when activist hedge funds first emerged as a force, hedge funds now tend to tar-

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60. One prominent example is the role Cardinal Value Equity Partners played in drawing attention to wrongdoing at Hollinger International, Inc., including its suit against Hollinger's controlling stockholder and CEO for breach of his fiduciary duties. *See* Kahan & Rock, *supra* note 47, at 1032-33; Elena Cherney, *Cardinal Suit Against Hollinger Details Payments to Executives*, WALL ST. J. (Jan. 5, 2004), http://www.wsj.com/articles/SB107314585612540700 [http://perma.cc/9HBW-X967]. Third Point targeted heat-oil distributor Star Gas, in part due to suboptimal governance practices that included the CEO's 78-year-old mother serving as a member of the board. *See* Kahan & Rock, *supra* note 47, at 1029. The fund successfully caused both the CEO and his mother resign. Judy McDermott, *What Now For Star Gas?*, LEVERAGED FIN. NEWS (Mar. 14, 2005), http://www.leveragedfinancenews.com/issues/2005_11/154579-1.html [http://perma.cc/3YLH-DDRP]. An activist investor was also one of the first to finger Enron for accounting misdeeds. Bratton, *supra* note 46, at 1384-85.

61. Brav et al., *supra* note 16, at 1742 (summarizing study of activists' stated goals that suggest a little over 5% of campaigns demand "[m]ore information disclosure/potential fraud" and about the same proportion look to unseat the CEO or chairman, as compared to 12-16% of campaigns that seek to improve operational efficiency, sell the target to a third party or improve the target's capital structure); *see also* Bratton, *supra* note 46, at 1398 (observing that an activist intervention at Sovereign Bancorp—a firm engaged in ethically dubious related-party dealing—stood out in a sample of activist interventions because the activist's reasons to intervene were purely predicated on edgy practices, not firm performance); *id*. at 1401 (summarizing the findings and listing four typical attributes of activist targets, none of which involved dubious management practices).

62. Bebchuk et al., *supra* note 5, at 1090 ("[A]ctivists tend to target companies that are underperforming relative to industry peers . . . .").

63. Brav et al., *supra* note 16, at 1730 ("Hedge fund activists tend to target companies that are typically 'value' firms, with low market value relative to book value, although they are profitable with sound operating cash flows and return on assets."); *id*. at 1752 ("[I]n about two-thirds of our cases, the hedge fund explicitly states that it believes the target is undervalued . . . ."); Cheffins & Armour, *supra* note 53, at 57 ("Hedge funds that engage in offensive shareholder activism typically rely on the 'value approach' when identifying targets . . . ."); Coffee & Palia, *supra* note 6, at 582 (summarizing studies and noting targets tend to have relatively high book-to-market ratios).

get companies that are profitable, not ones that are not.[64] But the companies that they target tend to pay out less of their profits than the industry average and have strong cash flows and balances.[65] Some

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64. Coffee & Palia, *supra* note 6, at 582 (activist targets are more profitable than control sample); *see also* April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 189 (2009) (hedge funds target more profitable firms); *id*. at 226; Bratton, *supra* note 46, at 1398-99 & 1399 fig.IV (studying a sample of hedge fund interventions from 2002-2006, showing that targets were heavily weighted toward firms underperforming the market in 2002 and less so by the end, and that the interventions overall resulted in above market returns—"poor performance ma[de] for a better target"); Brav et al, *supra* note 16, at 1754 (target firms are profitable and enjoy handsome cash flows); *cf*. Coffee & Palia, *supra* note 6, at 554 ("Historically hedge fund activism focused on smaller cap companies . . . [b]ut this has changed. In 2013, for the first time, almost one third of activist campaigns focused on companies with a market capitalization of over $2 billion."); *id*. (considering the tremendous increase in activist campaigns and funds and articulating the possibility that "more and more hedge funds are pursuing fewer and fewer legitimate opportunities"); *id*. at 573 (observing that underperforming companies are easier to identify than simply undervalued companies); *Activist Funds: An Investor Calls*, *supra* note 47 ("Given the size of activist funds and their pace of intervention, they collectively need to find 100 large target companies over the next three years. Only 76 firms in the S&P 500 are currently showing persistently poor returns on equity . . . and only 29 trade at below their liquidation value . . . ."). As a sophisticated practitioner indicated:

> [A]ctivists have had to turn to better run companies given that there are fewer targets overall for them. There are very few conglomerates for them to after and break-up (like Fortune Brands). And the market no longer gives much credit to buy-backs and return of capital—many institutions, like Blackrock, have said they prefer investing in the business. I have never thought buy-backs did anything, and the return of capital platform is a lot less credible now. Activists then are left with "sell the company"—not the most actionable plan. The fact is that the so-called activists are now just stock pickers, and they are not good at it. Bill Ackman's investment in Valeant [which was initially done to facilitate a tax inversion transaction by which Valeant would have moved its tax domicile to low-tax Ireland] had nothing to do with activism. I said over a year ago I would short the activist asset class—too much money chasing too few ideas.

E-mail to Leo E. Strine, Jr. (Sept. 7, 2016, 6:08 PM) (on file with author). *But see* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296, 299 (2016) ("On average, the targets in our sample were not profitable before intervention.").

65. Brav et al., *supra* note 16, at 1730, 1753-57 (hedge funds target value firms that tend to have low market to book value, "sound operating cash flows and return on assets," are actually "profitable," and "enjoy handsome cash flows," but have relatively low dividends or relatively high CEO pay); Klein & Zur, *supra* note 64, at 188-89, 203-05 (hedge funds target profitable firms with cash on hand); *see also* Brat-

might view the typical target of a hedge fund to therefore be a "value buy," the kind of fundamentally profitable, but undervalued, firm that someone like Benjamin Graham might have said was a good part of a solid portfolio.[66] When going active against these firms, hedge funds will commonly argue that the firms are engaging in excessive expenditures (using executive compensation when possible as a high-saliency example).[67] The activists argue that, instead, the firms could reorganize their capital structure to provide higher payoffs to stockholders in the near-term, without long-term cost, because they are merely targeting slack unnecessary to future growth.[68]

What is commonly accepted about activist hedge funds is that they do not originally invest in companies they like and only become active when they become dissatisfied with the corporation's management or business plan.[69] Rather, activist hedge funds identify companies and take an equity position in them only when they have identified a way to change the corporation's operations in a manner that the hedge fund believes will cause its stock price to rise. The rise that most hedge funds seek must occur within a relatively short time period, because many activist hedge funds have historically retained their positions for only one to two years at most.[70] As shall be discussed, there is some

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ton, *supra* note 46, at 1395 ("As more money flows into more funds pursuing double-digit gains from activist strategies, the funds relax their financial standards, pursuing less appropriate targets.").

66. *See generally* GRAHAM, *supra* note 44 (describing a long-term approach to investing based on a deep analysis of company fundamentals).

67. *See* Brav et al., *supra* note 16, at 1742 (noting that close to 5% of hedge fund interventions in their sample specifically targeted excess executive compensation); *supra* note 63 and accompanying text. *But see* Coffee & Palia, *supra* note 6, at 582-83 (summarizing studies and noting that while a minority support the idea that activists are in fact cutting back on wasteful expenditures, the "majority do not report evidence of changes in real variables consistent with this free cash flow hypothesis").

68. Brav et al., *supra* note 16, at 1742 (finding that close to 20% of hedge fund interventions specifically focused upon the target firm's payout policy and capital structure).

69. *Compare* Kahan & Rock, *supra* note 47, at 1069 (observing that "activist hedge funds usually accumulate stakes in portfolio companies *in order to engage in activism*"), *with id*. at 1042-45 (describing "activism" by traditional institutional investors).

70. Brav et al., *supra* note 16, at 1749 (noting that the median holding period for activist funds in their database was 556 days by one measure, and twenty-two months by another); Coffee & Palia, *supra* note 6, at 567 (summarizing studies showing that most interventions do not last for long); *id*. at 572 ("Few activist hedge funds have held their stock for anything approaching three years . . . ."); *see also* Yvan Allaire &

evidence that the more successful activist funds are the ones more likely to take a fiduciary position, by seating a representative on the target board and hold their investments for five to ten years.[71] There is also some evidence suggesting that hedge fund holding periods overall have lengthened in recent years.[72] One major reason that most hedge funds have relatively short holding periods is that hedge funds have contracts with their investors that allow investors to get their money back after

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François Dauphin, *"Activist" Hedge Funds: Creators of Lasting Wealth? What Do the Empirical Studies Really Say*?, INST. FOR GOVERNANCE PRIV. & PUB. ORGS. 15 (2014) http://igopp.org/wp-content/uploads/2014/07/IGOPP_Article_Template2014_Activism_EN_v6.pdf [http://perma.cc/9E4V-UU39] (noting that half of activist investments last slightly less than nine months).

71. Nelson Peltz, cofounder of Trian Partners—an activist fund with a reputation for constructive engagement—observed that Trian's average investment lasts five years, but "[a]t Fidelity it's 18 months." Kerry A. Dolan, *Trian's Nelson Peltz on Why He's a Nicer Investor than People Think*, FORBES (June 21, 2016, 9:00 AM), http://www.forbes.com/sites/kerryadolan/2016/06/21/trians-nelson-peltz-on-why-hes-a-nicer-investor-than-people-think [http://perma.cc/6MG8-Q9AK]. *But see* Julie Jargon, *A Bite at a Time, Peltz Reshapes Food Industry*, WALL ST. J. (Nov. 7, 2007), http://www.wsj.com/articles/SB119439562423884571 [http://perma.cc/HG6Y-2MN9] (noting that compensation arrangements for Trian-affiliated directors, including Peltz himself, at some of Trian's targeted companies have come in for criticism); Leslie Patton, *Wendy's Paid Chairman Peltz $657,514 for Security in 2012*, BLOOMBERG (Apr. 12, 2013, 12:00 AM), http://www.bloomberg.com/news/articles/2013-04-11/wendy-s-paid-chairman-peltz-657-514-for-security-in-2012 [http://perma.cc/LW4H-42JG] (citing less favorable views of Peltz's effect on one of his target companies).

72. In 2012, hedge funds' portfolio turnover was the slowest it has been for ten years, although this takes into account hedge funds as a whole, not just activist funds. *See* Tabinda Hussain, *Hedge Fund Portfolio Turnover at Record Low of 29%: Goldman*, VALUEWALK (Nov. 21, 2012, 11:30 AM), http://www.valuewalk.com/2012/11/hedge-fund-portfolio-turnover-at-record-low-of-29-goldman [http://perma.cc/FL3Y-HL2A]. Generally, hedge fund holding periods have gradually increased since 2008. *See* Matt Turner, *Hedge Fund Managers Are Waiting for the World To Change*, BUS. INSIDER (Aug. 21, 2016, 5:09 PM), http://www.businessinsider.com/hedge-fund-manager-turnover-and-concentration-2016-8 [http://perma.cc/7GPW-9NS5] (reviewing a recent Goldman Sachs research report on hedge fund behavior). It is worth noting that other investors trade even more frantically. K.J. Martijn Cremers & Antti Petajisto, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, 22 REV. FIN. STUD. 3329, 3344 (2009) (finding that the portfolio turnover for the average mutual fund is 95% per year). By some measurements, annualized turnover in U.S. stock markets as a whole is well above 100%. *See* Lawrence E. Mitchell, *Who Needs the Stock Market? Part I: The Empirical Evidence* 5 (Oct. 30, 2008) (unpublished manuscript), http://ssrn.com/abstract=1292403 [http://perma.cc/QE43-GE82]

lock-up periods of typically six months to two years.[73] A useful contrast is private equity's typical five- to ten-year lock-up.[74] The compensation system for hedge fund managers, which has been the focus of much public debate[75] and is not the obsession of this Feature, also creates an incentive for a near-term focus.[76] The so-called "2 and 20"[77] approach provides a great deal of benefit to a hedge fund manager that can lock in a lucrative gain, and is not designed to compensate the manager for

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73. See Coffee & Palia, *supra* note 6, at 573 (hedge funds are constrained by a short-term horizon because investors "can withdraw their funds at regular intervals," and will switch to fund managers who have recently earned above-market returns if a current fund lags).

74. Bratton, *supra* note 46, at 1384 ("Contracts governing private equity investment tend to lock up investments for five years, with some contracts going as far as ten years . . . . In contrast, the hedge funds' shorter durations, when coupled with the large, illiquid positions, invite aggression and impatience."); *see also id*. at 1383-84 (contrasting typical hedge fund restrictions on investors removing money to private equity); Kahan & Rock, *supra* note 47, at 1063-64.

75. *E.g.*, Paul Krugman, Opinion, *Now That's Rich*, N.Y. TIMES (May 8, 2014), http://www.nytimes.com/2014/05/09/opinion/krugman-now-thats-rich.html [http://perma.cc/BP3W-T7VX] (calling hedge fund managers "oligarchs" and criticizing hedge fund managers' arguments that it is unfair and socially unproductive to make them pay the same tax rates as workers do); *Rich Managers, Poor Clients*, ECONOMIST (Dec. 22, 2012), http://www.economist.com/news/leaders/21568740-investors-have-paid-too-much-hedge-fund-expertise-better-focus-low-costs-star [http://perma.cc/SK69-R8DZ] (noting that hedge fund fee structures make it more likely the managers will get rich than that their clients will).

76. *See* Pozen, *supra* note 55, at 7 (describing how incentive fees—the "20" in "2 and 20"—can reward a short-term outlook inasmuch as big gains early in the measurement period are disproportionately beneficial to the manager, even if investors might be indifferent or even prefer gains distributed differently); *see also* Kahan & Rock, *supra* note 47, at 1064-66 (describing typical compensation structures for hedge fund managers).

77. The phrase "2 and 20" refers to the traditional hedge fund compensation structure in which fund managers earned 2% of assets under management as well as 20% of profits. *See* Bratton, *supra* note 46, at 1384. Although investors have had some success in decreasing the percentage "take," the basic structure of charging a percentage of total assets and a higher percentage of performance seems untouched. *See, e.g.*, Tom DiChristopher, *CalSTRS CIO: The 2 and 20 Hedge-Fund Model Is Dead*, CNBC (May 2, 2016, 11:35 AM), http://www.cnbc.com/2016/05/02/calstrs-cio-the-2-and-20-hedge-fund-model-is-dead.html [http://perma.cc/7UXT-CS4V] (quoting the chief investment officer of a large pension fund saying the percentages have come down in many cases); *Down to 1.4 and 17*, *supra* note 58 (fee trend moving closer to 1.4% on assets and 17% on profits for all but the highest performing funds). Apparently Alfred Winslow Jones, the founder of the first hedge funds, picked 20% "invoking the Phoenician sea captains who kept a fifth of the profits from successful voyages." Mallaby, *supra* note 48.

a mere market rate of return.[78] The high fees are supposed to be justified by the delivery of far superior returns than a buy-and-hold strategy.

Although it is, of course, true that wealthy individuals are the source of a material amount of capital invested in the hedge fund industry, the industry's growth cannot be attributed solely to the super-wealthy. Rather, institutions upon which ordinary Americans rely—such as pension funds, university endowments, and charitable foundations—have entrusted large amounts of capital to the hedge fund industry. By way of example, institutional investor money constituted 25% of hedge fund assets in 2001, and pension funds were poised to raise their allocations to hedge funds sharply.[79] By 2015, one source estimated that pension funds constituted about 40% of the capital invested in hedge funds.[80] At the same time as the composition of hedge fund investors has

78. *See* Coffee & Palia, *supra* note 6, at 573 (in exchange for the "generous" 2 and 20 structure, "hedge fund investors expect quick returns that outperform the market"). Although many hedge fund managers cannot treat their income as "carried interest," as many private equity managers can (because hedge fund profits, unlike private equity profits, are typically short-term capital gains), other tax deferral strategies are available, including ones that can transform hedge fund profits into long-term capital gains. *See* Victor Fleischer, *Why Hedge Funds Don't Worry About Carried Interest Tax Rules*, N.Y. TIMES (May 14, 2014), http://dealbook.nytimes.com/2014/05/14/why-hedge-funds-dont-worry-about-carried-interest-tax-rules [http://perma.cc/YLY3-6KGS].

79. Cheffins & Armour, *supra* note 53, at 90, 97; Tamar Frankel, *Private Investment Funds: Hedge Funds' Regulation by Size*, 39 RUTGERS L.J. 657, 666 (2008) ("Before the year 2000, most hedge fund investors were wealthy individuals. Since then, institutional investors, such as pension funds, endowment funds, and sovereign wealth funds, have invested in hedge funds."); *see also* LO, *supra* note 56, at 1 ("Long the province of foundations, family offices, and high-net-worth investors, alternative investments are now attracting major institutional investors such as large state and corporate pension funds, insurance companies, and university endowments, and efforts are underway to make hedge fund investments available to individual investors through more traditional mutual fund investment vehicles."); Cheffins & Armour, *supra* note 53, at 89 (changes to the Investment Company Act facilitated institutional investor participation in hedge funds); Summer A. LePree, *Taxation of United States Tax-Exempt Entities' Offshore Hedge Fund Investments: Application of the Section 514 Debt-Financed Rules to Leveraged Hedge Funds and Derivatives and the Case for Equalization*, 61 TAX LAW. 807, 810-12 (2008) (describing investments by pensions in hedge funds).

80. *2015 Preqin Global Hedge Fund Report*, PREQIN 10 fig.6.23 (2015), http://www.preqin.com/docs/samples/2015-Preqin-Global-Hedge-Fund-Report-Sample-Pages.pdf [http://perma.cc/6ASF-XVUF].

changed, so too have activist hedge funds developed a distinct investment strategy.

In recent decades, hedge fund activism has increased considerably. Although hedge fund activism campaigns display some diversity, basic patterns have emerged. First, the hedge fund must secure an equity position that allows it to make sizable gains if its activism succeeds in whole or in part. It can be expensive to get active, particularly if the fund ultimately has to get its way through a proxy fight or similar battle, and the fund must secure enough equity not just to have credible influence, but more importantly to make gains justifying its risky investment with material upfront expenses. Using the antiquated disclosure regime under Section 13 of the Securities Exchange Act, hedge funds can acquire as much equity as they can, so long as they disclose their interests within ten days of reaching a 5% ownership threshold.[81] Even then, though, the disclosure regime is incomplete and does not capture all the derivative positions the hedge fund can take.[82] These positions must be understood if one is able to tell just how "long"—exposed to increases in equity value—the hedge fund is on the public company.[83]

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81. 15 U.S.C. § 78m(d) (2012); 17 C.F.R. § 240.13d-1 (2015).

82. Cheffins & Armour, *supra* note 53, at 65-67 (describing situations where activists have used derivatives such as total return swaps to build positions while avoiding reporting); Kahan & Rock, *supra* note 47, at 1063 (noting that options and derivatives are excluded from hedge fund quarterly reporting requirements as well as the fact that no disclosure is required at all if the hedge fund's 13(f) securities are under $100 million). Even so, one recent study found call options used in 6.6% of its sample of interventions and put options used in 3.1% of its sample. Krishnan et al., *supra* note 64, at 300 tbl.1. Another potentially relevant reporting requirement, the Hart-Scott-Rodino Antitrust Improvements Act of 1976, requires, assuming the jurisdictional bases are satisfied, filings and waiting periods before acquiring voting securities in excess of approximately $200 million. 15 U.S.C. § 18a(2)(A) (2012); 16 C.F.R. § 801.1(h) (2016) (defining notification thresholds). It is, however, the acquisition of the right to vote that counts. 16 C.F.R. § 801.13 to .14. Obtaining a right to acquire shares does not count until the actual voting rights are obtained.

83. *See* David A. Katz & Laura A. McIntosh, *13(d) Reporting Inadequacies in an Era of Speed and Innovation; Corporate Governance*, N.Y.L.J. (Sept. 24, 2015) (arguing that current disclosure of derivatives and synthetic positions is inadequate); Theodore N. Mirvis et al., *Beneficial Ownership of Equity Derivatives and Short Positions—A Modest Proposal to Bring the 13D Reporting System into the 21st Century*, WACHTELL, LIPTON, ROSEN & KATZ (Mar. 3, 2015), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.15395.08.pdf [http://perma.cc/2XBJ-QBVM] (arguing that current disclosure of derivatives and synthetic positions is inadequate). Although the Dodd-Frank Act did authorize measures to increase reporting by private funds, the ultimate rulemaking had little effect on public position reporting. *A Closer Look: The Dodd Frank Wall Street Reform and Con-*

Although in some instances a lead hedge fund has come public with ownership stakes of 20% or more—such as in the J.C. Penney situation in 2010 when activist Pershing Square, working with Vornado Realty Trust, surfaced owning 26.4% of J.C. Penney[84]—the median ownership interest of a lead hedge fund when it goes public has been reported at 6.3% in one study[85] and 8.3% in another, more recent study.[86]

The wolf pack imagery comes in at this stage. There is evidence that when an alpha wolf—the primary moving hedge fund—has begun accumulating shares but has not yet gone public with a Schedule 13D filing, other wolves move into the stock.[87] Thus, when the alpha wolf emerges with its teeth into a good-sized piece of its prey, other wolves are also grabbing chunks for themselves.[88] This, naturally, has led to suspicion that the alpha wolf has been organizing the hunt with the other wolves.[89] Professors Coffee and Palia summarize other studies by observing that "tipping and informed trading appears to characterize both the formation of the 'wolf pack' and transactions during the window period preceding the filing of the Schedule 13D."[90]

Understanding wolf pack behavior is further complicated because hedge funds are not subject to some important market regulations.

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sumer Protection Act: Impact on Alternative Asset Managers, PwC 15-18 (Aug. 2010), http://www.pwc.com/us/en/financial-services/regulatory-services/publications/dodd-frank-closer-look.html [http://perma.cc/7PZQ-U6RS].

84. *See* Michael J. de la Merced, *J.C. Penney Gives Board Seats to Roth and Ackman*, N.Y. Times (Jan. 24, 2011), http://dealbook.nytimes.com/2011/01/24/penney-to-give-board-seats-to
-pershing-and-vornado [http://perma.cc/BB33-JCTM]; *see also* Coffee & Palia, *supra* note 6, at 567 n.79 ("Much attention earlier focused on the acquisition of 26.7% in J.C. Penney by Pershing Square and Vornado Realty Trust, most of which occurred during the ten-day window period after they crossed 5%.").

85. Lucian A. Bebchuk et al., *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. Corp. L. 1, 4-5, 15 (2013).

86. Krishnan et al., *supra* note 64, at 300 tbl.1.

87. Coffee & Palia, *supra* note 6, at 562-64; *see also* Alon Brav et al., *Wolf Pack Activism* 4-7 (Robert H. Smith Sch. Research Paper No. RHS 2529230, 2016), http://ssrn.com/abstract=2529230 [http://perma.cc/MPR8-WJB5] (modeling wolf pack behavior).

88. Coffee & Palia, *supra* note 6, at 565 (noting that unusual trading volumes suggest "many other institutional investors" buy target company stock before the lead activist files a Schedule 13D); *see also id*. at 567 n.79 (collecting instances where insurgents collectively acquired material amounts of target stock in a short period).

89. *See id.* at 565-66.

90. *Id*. at 565.

Hedge funds are not subject to Regulation FD—a regulation requiring issuers to disclose material non-public information broadly to the market, if the information is disclosed at all.[91] Moreover, stockholders do not normally have duties to companies in which they invest and that is almost always true of hedge funds in the stake-building period itself because they typically had no ownership position before and no representation on the board.[92] Thus, so long as they are not disclosing nonpublic information which they obtained as a result of an insider's breach of duty, hedge funds are normally free to tip third parties about their own plans or intentions without running afoul of Rule 10b-5.[93] Thus, as a result of the inapplicability of Regulation FD and Rule 10b-5,[94] there is often the potential for entirely legal tipping that accompanies activists investing in a target company. The failure of the disclosure laws to demand a full accounting of all interests compounds the complexity of understanding the economic interests of the various activist hedge funds who simultaneously or concurrently move into the target's stock with the alpha wolf.[95] Not only may some wolves own fewer than 5%, so too may disclosing wolves have additional interests not captured by an outdated disclosure regime.

Whether the alpha wolf consciously forms a pack or the other wolves are just good at sniffing blood and being present to get their share of the kill is also not so much the focus of this Feature. But the reality is that, given the lack of stringency in Section 13(d) and its limited reach to concerted activity, it is not uncommon for a public corporation to find itself with a sudden change in investment profile that in-

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91. *See* General Rule Regarding Selective Disclosure, 17 C.F.R. § 243.100(a) (2015) ("Whenever an *issuer* . . . discloses any material nonpublic information regarding that *issuer* or its securities . . . the *issuer* shall make public disclosure of that information . . . ." (emphasis added)).

92. *See, e.g.*, Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) ("Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation." (citation omitted)).

93. *See* Coffee & Palia, *supra* note 6, at 566 & n.75.

94. SEC Rule 10b-5 is "the federal securities laws' principal antifraud prohibition." Donald C. Langevoort, *Theories of liability—Principal Theories Under the Federal Securities Laws—Abstain or Disclose*, 18 INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 1:8 (Westlaw 2016).

95. *See* Coffee & Palia, *supra* note 6, at 562-64.

volves 10 to 25% or more of its stock ending up in the hands of various activist hedge funds without prior public disclosure.[96]

When viewed from an objective perspective, and not through the lens of anti-activist zealotry, the wolf pack in the more important, high-salience activist campaigns is likely to include not just fellow hedge funds, but actively traded mutual funds. Many sophisticated practitioners note that the fund managers of actively traded mutual funds, who are frustrated with corporate managers who do not listen to their input, share their frustrations and their ideas about improving the corporation with activists whom they find credible.[97] Even more commonly, active long-only funds often provide voting and, as important, private (in terms of communicating to the target's management and board that advisability of listening to the activist) and public support to activist initiatives.[98]

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96. *See id*. at 567-68.

97. For understandable reasons, market participants and practitioners are reluctant to be quoted to this effect. But it is commonly understood to be true. Many leading practitioners have commented to me that, generally, there is a great deal of communication among actively traded mutual fund managers, stock analysts, and activists, which includes mutual funds directing activist hedge funds to good targets for intervention. That communication happens in both directions. An experienced practitioner noted that Nelson Peltz, the leading activist behind Trian, once said he could control a company with five phone calls to traditional money managers, including mutual funds. This phenomenon has received some wider attention. *E.g.*, David Benoit & Kirsten Grind, *Activist Investors' Secret Ally: Big Mutual Funds*, WALL ST. J. (Aug. 9, 2015), http://www.wsj.com/articles/activist-investors-secret-ally-big
-mutual-funds-1439173910 [http://perma.cc/M5Q2-8ZPD] (describing activist intervention at Microsoft involving discussions between activist and long-only mutual fund families that already held a material amount of the target's stock). In fact, one market participant indicated that because actively traded mutual funds have been underperforming—resulting in a shift of asset allocation to passive index funds—actively managed funds are now beginning to act more like activists themselves to try to generate higher returns.

98. Coffee & Palia, *supra* note 6, at 572 (activists have the potential to increase their influence over target boards by partnering with pension funds and mutual funds); Benoit & Grind, *supra* note 97 (describing situations where activists were backed with "serious muscle" in the form of large mutual funds); *see also* William D. Cohan, *Starboard Value's Jeff Smith: The Investor CEOs Fear Most*, FORTUNE (Dec. 3, 2014, 7:00 AM), http://fortune.com/2014/12/03/starboard-capitals-jeff-smith-activist-investor-darden-restaurants [http://perma.cc/ZA7L-M6R2] (describing evidence that the mutual fund and long-only fund family Capital Research "work[ed] hand and glove" with Starboard during its intervention at Darden). Long-only mutual funds may provide more subtle support to activists in the form of an unwillingness to back efforts by the managers of public companies to undertake potentially very value-enhancing, but risky transitions in business strate-

Without the support of these mainstream funds, the activist hedge fund leader would not have the clout to extract favorable concessions in a settlement, much less to prevail in a contested proxy fight.[99]

The strategies that hedge funds advocate are not diverse. In a few situations, hedge funds have claimed to have innovative strategies to improve the operations of companies in challenging industries, such as department stores.[100] As will be discussed, there are not many stories of this sort of operational innovation systematically creating value. An example of an unusual story along these lines involves Starboard Value's intervention at Darden Restaurants. Its three-hundred page presentation identified numerous operational improvements including practice changes to ensure only fresh breadsticks came to the table at Olive Garden and to decrease table wait times.[101] Some evidence is

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gy when an easier M&A sale option is available. As one experienced practitioner related:

> In three [situations] companies were trying to deal with technology changes . . . and were led by founders who . . . wanted to try and turn the company around in the public markets. In each case the CEOs went to their largest institutional investors, and essentially sought the guidance of these investors, who were long-term investors in the company, and asked would they support a risky transition that might or might not succeed—although of course management and the CEOs believed it would succeed and had a track record of success—and lead to a stronger company and higher stock price in 3-5 years or would they prefer to sell the company now for a certain premium. The answer in all three cases was the same—sell.

E-mail to Leo E. Strine, Jr. (Oct. 18, 2016, 12:14 PM) (on file with author).

99. *See* Coffee & Palia, *supra* note 6, at 572. ("Thus, [activist hedge funds] will need allies among traditional institutional investors, who are largely indexed and have held their investments in most companies for multiple years.").

100. *See infra* notes 127, 261, 276 (describing interventions at J.C. Penney, Macy's, and Sears, respectively). Pershing Square's intervention at Target Corp. was another notable attempt, albeit heavy on financial engineering objectives such as placing Target's land (on which its stores sit) into a separately traded real estate investment trust and selling credit card receivables to third parties. Zachery Kouwe, *Target's Shareholders Strongly Reject Dissident Slate, Ending Divisive Proxy Battle*, N.Y. TIMES (May 28, 2009), http://www.nytimes.com/2009/05/29/business/29target.html [http://perma.cc/TM5P-K6W7].

101. *Transforming Darden Restaurants*, STARBOARD VALUE (Sept. 11, 2014), http://www.shareholderforum.com/dri/Library/20140911_Starboard-presentation.pdf [http://perma.cc/BW9E-6XWN]. In the two years following the start of Starboard's intervention, Darden's stock price rose around 47%. Julie Jargon & David Benoit, *How a Shareholder Coup at Olive Garden's Owner Sparked a Turnaround*, WALL ST. J. (Apr. 5, 2016), http://www.wsj.com/articles/activists-reap-olive-garden-bounty-1459902161 [http://perma.cc/Z6UR-4HLS]. Whether or not this intervention was

emerging that when longer-term hedge funds succeed in seating experienced, successful corporate executives on target boards as a result of a settlement or election, the target's performance improves.[102] But, many of the gains from even these longer-term funds have come from putting targets into a sale in whole or in part,[103] and, what is missing is a matching of a number of actual stories about management improve-

successful, what can at least be said is that Starboard focused on specific business strategy changes that were rationally designed to draw in more customers and thus increase revenue.

102. *See* Krishnan et al., *supra* note 64, at 296 (arguing that the success of certain hedge fund activists appears to result more from board representation, improved performance, and monitoring management than from capital structure or dividend policy changes).

103. Coffee & Palia, *supra* note 6, at 588 (summarizing studies that tend to suggest "expected takeover premium, more than operating improvements" constitute the majority of stock price gain found in both short-term and long-term studies of shareholder activism); *Activist Investing: An Annual Review of Trends in Shareholder Activism*, ACTIVIST INSIGHT & SHULTE ROTH & ZABEL 11 (2016) [hereinafter *Activist Investing*], http://www.activistinsight
.com/amp/issues
/The%20Activist%20Investing%20Annual%20Review%202016._260.pdf [http://perma.cc/WXD7-9E7F] ("[I]n a bumper year for M&A, activists both pushed for deals and higher valuations."); *see also* Marco Becht et al., *Hedge Fund Activism in Europe* 3 (Corp. Governance Inst. Fin. Working Paper No. 283/2010, 2010), http://ssrn.com/abstract_id=1616340 [http://perma.cc/DW98-WR5B] (studying returns from hedge fund activism in Europe and finding similar results). Indeed, in one of the purest forms of this strategy, many notable funds have built stakes in two companies and pushed them to merge.

Mitel Networks's acquisition of Polycom was the product of an activist taking a stake in both. Anne Steele, *Mitel Networks To Acquire Polycom for Nearly $2 Billion*, WALL ST. J. (Apr. 15, 2016), http://www.wsj.com/articles/mitel-networks-to-acquire-polycom-for-1-8
-billion-1460718185 [http://perma.cc/W7HL-J7ZM].

Another fund took stakes in Baker Hughes and Halliburton to encourage their merger, a merger that was later halted on antitrust grounds. David Benoit, U.S. v. ValueAct*: A Lawsuit To Define Activism*, WALL ST. J. (Apr. 4, 2016), http://www.wsj.com/articles/justice
-department-sues-valueact-over-baker-hughes-halliburton-disclosures-1459794637 [http://perma.cc/D29B-RLY2].

Still another fund built stakes in competitors Staples and Office Depot and pushed for them to merge, but largely was out of the stocks by the time the merger collapsed, also on antitrust grounds. David Benoit, *Starboard Avoids the Staples-Office Depot Shredder*, WALL ST. J. (May 12, 2016), http://blogs.wsj.com/moneybeat/2016/05/12/starboard-avoids-the
-staples-office-depot-shredder [http://perma.cc/4KA6-M4G4].

ment at specific high-salience targets to the overall data in the samples they study.

Thus, what remains more common is that a hedge fund will argue that a corporation with healthy profits is not returning enough of those profits to its investors.[104] The hedge fund will argue that the corporation, by dint of excessive costs, is operating inefficiently, and that if it cut its spending or took on more debt, it could pay out more gains to its investors immediately. Thus, arguments to reduce capital and other spending (including headcount) and to increase dividends or do a large stock buyback program are *de rigueur*.[105] Even a giant and massively profitable company like Apple has not been immune from these pressures for short-term increases in returns, as its capitulation to Carl Icahn's demand for an increased stock buyback program demonstrates.[106] Corpo-

104. *See* Brav et al., *supra* note 16, at 1742-43 tbl.I (summarizing stated objectives of activist interventions in sample, finding that 19% of interventions involve arguments in favor of capital return but only 1% involve arguments in favor of pursuing growth strategies); Cheffins & Armour, *supra* note 53, at 60 ("Hedge funds often lobby for finance-oriented changes, such as having a target company squeeze value from the balance sheet by spinning off underperforming non-core assets and by using share buy-backs or a sizeable one-off dividend to distribute 'excess' cash to shareholders."); Klein & Zur, *supra* note 64, at 189, 203-05. *But see* Krishnan et al., *supra* note 64, at 310 (finding that more successful interventions in terms of market reaction involved activists whose interventions were characterized by growth in research and development spending, sales, and return on assets, but that the bulk of interventions in the sample involved activists whose interventions were characterized by meaningful drops in those metrics, resulting in a material percentage of targets delisted for reasons other than merger activity); *Activist Investing*, *supra* note 103, at 11 (describing the high frequency of "balance sheet activism").

105. *See* Brav et al., *supra* note 16, at 1741, 1742 tbl.I (noting that 19% of interventions involve direct calls to address excess cash or change capital structure); *see also* Klein & Zur, *supra* note 64 at 226 ("Hedge funds address the free cash flow problem by frequently demanding the target firm to buy back its own shares, cut the CEO's salary, and initiate dividends."); Vipal Monga et al., *As Activism Rises, U.S. Firms Spend More on Buybacks Than Factories*, WALL ST. J. (May 26, 2015), http://www.wsj.com/articles/companies-send-more-cash-back-to-shareholders-1432693805 [http://perma.cc/6YKK-PJSL] (describing activist investors advocating for increased buybacks and dividends).

106. Icahn took a stake in Apple in 2013, and urged the company to raise capital in the debt markets to buy back its stock. Ian Sherr & David Benoit, *Icahn Pushes Apple on Buyback*, WALL ST. J. (Aug. 13, 2013), http://www.wsj.com/articles/SB10001424127887324085304579010971386703480 [http://perma.cc/GL2G-GXB8]. Apple later did just that. Michael J. De La Merced, *Icahn Ends Call for Apple Stock Buyback*, N.Y. TIMES (Feb. 10, 2014), http://dealbook.nytimes.com/2014/02/10/icahn-backs-off-apple-buyback-proposal [http://perma.cc/ZL4K-CJHA]. Although Icahn claimed that "[t]here is nothing short term about my inten-

rate finance plays of another kind are also common, with the hedge fund arguing that if the company is broken into pieces, its value will increase as pure plays.[107] As suggested, with arguments for all these strategies is an almost always present hint that a sale of the company should also be considered.[108] That sale will not involve a purchase by the hedge fund or its fellow wolves.

Hedge funds, unlike private equity funds, will not buy a company's entire equity and arrange their own financing, as is typically required when a full change of control happens.[109] Rather, hedge funds will not bear that kind of risk and wish for the option of trading out of the company's equity. If a hedge fund can push a target into a merger with a lucrative target-side premium, that will facilitate the hedge fund's exit, but the hedge fund has no desire to be the acquirer in that kind of transaction. And when a hedge fund succeeds in changing the target's business plan in other ways through pressure strategies, the hedge fund typically will make no commitment to remain as a long-term stockholder.[110]

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tions here," he exited his Apple investment within three years of that statement. John Lanchester, *How Should We Read Investor Letters*, NEW YORKER (Sept. 5, 2016), http://www.newyorker.com/magazine/2016/09/05/jeff-gramms-dear-chairman-boardroom-battles-and-the-rise-of-shareholder-activism [http://perma.cc/8PSN-9X4G]. DuPont was another recent activist target that otherwise "had consistently outperformed all relevant benchmarks for corporate performance." Coffee & Palia, *supra* note 6, at 555; *see infra* notes 263–264 and accompanying text.

107. Brav et al., *supra* note 16, at 1741-42 (identifying approximately 9% of activist interventions in the authors' dataset where the goal is enhancing target focus through spinoffs or restructuring). For example, Trian advocated a restructuring of DuPont spinning off aspects of its business. Coffee & Palia, *supra* note 6, at 579 (describing Trian's DuPont intervention as fitting the "paradigm" of the kind of campaigns activists prefer); *see also* Jacob Bunge & David Benoit, *DuPont Defeats Peltz, Trian in Board Fight*, WALL ST. J. (May 13, 2015), http://www.wsj.com/articles/dupont-appears-poised-to-win-over-peltz-1431521564 [http://perma.cc/AJK5-SNVQ] (describing Trian's attempted intervention).

108. *See* Brav et al., *supra* note 16, at 1741-44 (noting that most activism calls for increasing cash flows for near-term payouts, encouraging restructurings such as spinoffs, encouraging a sale of the target, or targeting firm governance).

109. Cheffins & Armour, *supra* note 53, at 60 (noting that hedge funds typically do not wish to own the firms that they seek to fix).

110. *See supra* text accompanying notes 70-74 (discussing relatively short hedge fund holding periods).

How hedge funds succeed in their campaigns vary.[111] For the most part now, they win by coming public, not so subtly suggesting a willingness to scuffle, and by reaching an accommodation with the target's management that involves the hedge fund gaining board seats.[112] Once inside the boardroom, the activists press for their particular variety of corporate change. In the past few years, most activist hedge fund campaigns resulted in the hedge fund gaining at least some degree of representation on the company's board,[113] and in most of these situations, the victory resulted from a settlement.[114] But these settlements would

111. What constitutes "success" is far from clear. For example, a simple uptick in the target's stock price following the announcement that an activist has taken a position in the target's stock can create a profit on paper for the activist. Obtaining minority representation on the target's board through an election or settlement is often argued to constitute "success," although that is no guarantee that the board will adopt the activist's program. Regardless, "success" on either of those definitions does not guarantee that the company is better off in either the short- or long-term. Furthermore, there is at least some evidence that there is no difference in abnormal returns in target company stock regardless of who wins a proxy contest—the theory is that management tends to implement the kinds of changes insurgents want even if they stay in control. *See* Coffee & Palia, *supra* note 6, at 572 (describing the results of a study confirming this conclusion). DuPont's resistance to Trian and later spinoffs and potential merger with Dow is a high-profile example of this phenomenon. *See infra* text accompanying notes 262-264. *But see* Bratton, *supra* note 46, at 1420 (suggesting that when the activist funds stay invested in the target over time, better results ensue); Krishnan et al., *supra* note 64, at 309-10 (same).

112. *See* Elizabeth Judd, *Let's Make a Deal: A Look at Recent Activist Settlements*, CORP. SECRETARY (Jan. 16, 2015), http://www.corporatesecretary.com/articles/proxy-voting-shareholder
-actions/12868/lets-make-deal-look-recent-activist-settlements
[http://perma.cc/6RAE
-XHDQ]; *see also Hedge Fund Activism in Technology and Life Science Companies*, LATHAM & WATKINS LLP 10, 14 (Mar. 2012), http://www.lw.com
/upload/pubContent/_pdf/pub4723_1.pdf [http://perma.cc/TQ8Z-HECD] (discussing the practice of settlements and ways companies may defend against hedge fund activists).

113. Brav et al., *supra* note 16, at 1744 (finding that "hedge funds achieve success, or partial success, in nearly two-thirds of the cases").

114. *See 2016 US Activism Review: Stabilization*, INST. SHAREHOLDER SERVS. 1 (2016) (noting that although activists gained twenty-seven board seats through contested elections in 2016 through September, they gained "substantially" more seats through settlements); Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA L. REV. (forthcoming 2017) (manuscript at 7), http://ssrn.com/abstract=2833399 [http://perma.cc/2YVX-AXSJ] (describing a "dynamic" of "boards and activists . . . edging unmistakably towards collaboration" and noting a trend whereby 40% of announced proxy contests result in settlement); Mi-

not occur at their current high rate without the industry's willingness to engage in high-profile proxy fights, "withhold vote" contests, and other pressure strategies.[115] High-salience wins by the hedge fund industry involving major corporations[116] and the demonstrated willingness of key proxy advisors like ISS, Glass Lewis,[117] and mainstream mutual funds

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chael Flaherty, *Big Funds Push Back Against Activist Investor Settlements*, REUTERS (Jul. 18, 2016, 3:21 PM), http://www.reuters.com/article/us-activist-investors-idUSKCN0ZY2DP [http://perma.cc/2DBT-HFYG] (describing the "historically high number" of settle ments); Judd, *supra* note 112 (noting that 33% of proxy fights in 2014 settled); *see also* Michael Flaherty & Anjali Athavaley, *U.S. Companies Quicker To Give Board Seats to Activists*, REUTERS (Sept. 25, 2015, 7:41 AM EDT), http://www.reuters.com/article/us-hedgefunds-activists-insight-idUSKCN0RP0D020150925 [http://perma.cc/XKY9-WJWH] (describing a decrease in the number of days from initial disclosure of activist position to settlement).

115. *See, e.g.*, Che Odom, *Quick Settlement Times Show Power of Activist Investors*, BLOOMBERG CORP. L. & ACCOUNTABILITY REP. (June 22, 2016), http://www.bna.com/quick-settlement-times-n57982074550 [http://perma.cc/W5V8-C2GC] (quoting Marc Weingarten of Shulte Roth & Zabel, LLP as observing that companies "think it's more prudent to settle than to go through the distraction and expense of a proxy fight they're likely to lose anyway").

116. In one case, ailing internet giant Yahoo agreed to add board members, including the chief executive of the hedge fund agitating for a new board. Douglas Macmillian & David Benoit, *Yahoo Reaches Deal With Starboard To Add Board Members*, WALL ST. J. (Apr. 27, 2016), http://www.wsj.com/articles/yahoo-reaches-deal-with-starboard-1461762387 [http://perma.cc/FC22-FDVB]. Other high-visibility wins include board shakeups at Pentair PLC, Intuit Inc., and Adobe Systems Inc. David Benoit, *Activism's Long Road From Corporate Raiding to Banner Year*, WALL ST. J. (Dec. 26, 2015), http://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910 [http://perma.cc/GCR8-BBBX].

117. Don Duffy, *CEOs Need a 'Healthy Paranoia' of Activist Investors*, CNBC (Aug. 12, 2015, 3:05 PM), http://www.cnbc.com/2015/08/12/ceos-need-a-healthy-paranoia-of-activist-investors-commentary.html [http://perma.cc/5KFH-LNHG] (noting increasing support proxy advisory firms give to activist positions); Anthony Garcia, *Does ISS Pull the Strings in a Proxy Fight?*, FACTSET (Mar. 11, 2015), http://insight.factset.com/does-iss-pull-the-strings-in-a-proxy-fight [http://perma.cc/5KFH-LNHG] (analyzing disclosed ISS recommendations in activist interventions and finding that "in the last three years [ISS support] was more often for the dissident than management"). That support can come indirectly as well, through proxy advisor advocacy for corporate governance rules more conducive to shareholder direct democracy. As a very current example, ISS indicated that starting in the 2017 proxy season, it will recommend no or withhold votes for board members on governance committees where the company restricts shareholder direct democracy in companies' bylaws. *Americas: U.S., Canada, and Latin America Proxy Voting Guidelines Updates*, INST. SHAREHOLDER SERVS. 1 (2016),

to support and vote for activist hedge fund campaigns have made clear to public company boards that activist hedge funds can beat them at the ballot box.

Commonly, these wins arrive well before the ballot box.[118] Settlements typically involve a combination of business policy strategy changes, usually involving some increase in immediate returns to investors through dividends or buybacks, and agreement to put directors proposed by the hedge fund (which can include hedge fund managers themselves) on the board of directors to help oversee the policy changes or a determination to sell the company.[119] The placement of one of a hedge fund's managers on the board does not mean that the fund is likely to commit to remain permanently invested, but it admittedly does subject the hedge fund to regulations like prohibitions on short-swing profit taking and insider trading.[120] For this reason, settlements that in-

http://www.issgovernance.com/policy-gateway/2016-policy-information [http://perma.cc/M358-G5V8].

118. *See Activist Investing*, *supra* note 103, at 12 (observing that board representation is more likely to come through settlement than a contested election).

119. *See id*. at 13 ("Without having board representation, an activist investor may find it difficult to ensure their ideas and strategies are being properly implemented." (quoting Bruce Goldfarb, CEO of proxy solicitation firm, Okapi Partners)). In the case of ValueAct's intervention with Microsoft, the two sides reached a settlement on August 28, 2013, including a provision where Mason Morfit, ValueAct's CEO, would get a seat on Microsoft's board. Within a month, Microsoft announced an increased dividend and stock buyback plan—measures it had previously resisted. *See* OWEN WALKER, BARBARIANS IN THE BOARDROOM: ACTIVIST INVESTORS AND THE BATTLE FOR CONTROL OF THE WORLD'S MOST POWERFUL COMPANIES 150-55 (2016). When art auction house Sotheby's settled with Dan Loeb's Third Point fund, the activist investor received three board seats. David Benoit & Sara Germano, *Sotheby's, Third Point Reach Settlement*, WALL ST. J. (May 5, 2014), http://www.wsj.com/articles/SB10001424052702303647204579543581203051454 [http://perma.cc/6HL6-N3LL]. Less than a year later, Sotheby's tapped an unconventional (for an art company) new CEO—a Harvard Business School MBA with more experience in branding and technology than art, who some regarded as "a safe pair of hands who can deliver on operational efficiencies and help Sotheby's transition" to new owners. Katya Kazakina, *Art Degree Not Needed: New Sotheby's CEO Offers Technology Savvy*, BLOOMBERG (Mar. 30, 2015, 12:00 AM EDT), http://www.bloomberg.com/news/articles/2015-03-30/art-degree-not-needed-new-sotheby-s-ceo-offers-technology-savvy [http://perma.cc/7CS6-TXUY].

120. There are multiple paths for an activist hedge fund to fall within Section 16 short-swing profit liability. *E.g.*, Coffee & Palia, *supra* note 6, at 563 & n.67 (describing how an activist becomes subject to Section 16(b) of the Securities Exchange Act after acquiring 10% of a company's shares, and therefore may be forced to surrender

volve a target implementing the policy changes the hedge fund advocates, but denying the hedge fund board seats, might be attractive to the hedge fund because its liquidity will be considerably enhanced. Nonetheless, it is increasingly common for settlements to involve the hedge fund placing one or more of its key employees directly on the board,[121] and there is some emerging evidence that when hedge funds are willing to invest long-term, the outcomes for all are more positive.[122]

Even when activists obtain seats on the board, their strategies may not be adopted, or the strategies may not succeed. In some high-profile

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"short swing profits"). But, appointing one or more directors to a company board is one way—and a way that is not predicated on the hedge fund remaining a greater-than-10% stockholder. *Cf*. Carol Anne Huff & Elisabeth Martin, *Corporate Governance: Director Equity Awards to PE Fund Representatives on Public Company Boards*, 26 INSIGHTS: THE CORP. & SEC. L. ADVISOR at 18, 19-22 (Sept. 2012), http://www.kirkland.com/siteFiles/Publications/Insights%20(Director%20Equity%20Awards_%20Huff%20byline).pdf [http://perma.cc/WND7-GDXX] (discussing the concept of "director by deputization" in the private equity context where funds placing directors on corporate boards may be brought within Rule 16b—short swing profit liability for insiders—depending on the relationship and interaction between the fund and the director). Depending on the arrangement between the director and investor, the investor also may be restricted from trading if she is receiving information about the company from the director. *See* Francis J. Aquila, *Selecting Directors Designated by an Investor*, PRACTICAL L.J. 20, 24 (Feb. 2015), http://www.sullcrom.com/files/upload/Feb15_InTheBoardroom.pdf [http://perma.cc/H2LE-5HR7].

121. 2015 broke the previous record for campaigns resulting in board seats for investors or their designees. Benoit, *supra* note 116.

122. For example, a new study suggests that activists with a proven capacity to take a very large stake, gain board seats, and influence business strategy over a long period generate more gains. *See* Krishnan et al., *supra* note 64, at 310-12. The study implies this by showing that interventions by certain activists—a minority of the overall interventions and activists in the study—with those characteristics had better results, not simply in terms of stock price, but on growth in metrics like research and development spending, sales, and return on assets. *Id.* at 298. In contrast, those metrics all materially decreased in the majority of interventions. Notably, the more successful minority made materially larger investments, in terms of dollars, and so the difference in performance on a value-weighted basis could be even greater than the authors' data allow them to conclude. *Id*. at 298, 302. The authors of that study have not fully linked together their story, but the case they seem to make is that activists capable of bringing in genuine managerial skill over a longer time period and who act as longer-term owners will generate better results for stockholders and other constituencies. *See* Bratton, *supra* note 46, at 1420 (finding that the best performing subset of portfolios constructed from a sample of 104 hedge fund interventions from 2002-2006 was the one involving companies where the intervening hedge funds continued to hold a substantial ownership block).

situations, this has led to the payment of what traditionally was called "greenmail" as the price of getting a hedge fund to exit.[123] This arguably happened in interventions targeting General Growth Properties, Yahoo, and ADT.[124] These buyouts have been understandably controversial because the corporation's willingness to buy the hedge fund's block arguably confers upon the fund a premium over the block discount it would have suffered if it tried to unload its position in the market while complying with the legal constraints on its selling flexibility attributable to its fiduciary role in the corporation.[125] These situations have not been common, however, and it seems likely that most hedge funds exit through the public markets from which they acquired ownership and do so after a period that is brief in terms of the life cycle of a corporation or an ordinary human investor.[126] Even when hedge funds exit through public markets, it is sometimes with a helping hand from their former target—when the activist agitating for change at J.C. Penney reached a strategic dead end,[127] the board struck a deal with the fund, allowing its

123. *See* Liz Hoffman & David Benoit, *Activist Funds Dust Off 'Greenmail' Playbook*, WALL ST. J. (June 11, 2014), http://www.wsj.com/articles/activist-funds-dust-off-greenmail-playbook -1402527339 [http://perma.cc/UG6H-SJ24]. Unlike the "greenmail" of the 1980s, the share buybacks today are priced slightly below market—avoiding the 50% tax levied on profits from greenmail enacted in 1987. *Id*.

124. *Id*.

125. *See* Kahan & Rock, *supra* note 47, at 1082 (discussing the possibility of such a conflict); *see also* Hoffman & Benoit, *supra* note 123 (quoting a market participant who characterized such buybacks as "inappropriate" and argued that "[m]anagement owes the shareholders an explanation").

126. *See* sources cited *supra* note 72.

127. When Pershing Square intervened in J.C. Penney, it brought in a new CEO with retail, rather than financial, experience; pushed changes in how products were promoted and put on sale; and focused on changes to bring in relatively higher end brands. *See Think Big*, PERSHING SQUARE CAP. MGMT., LP (May 16, 2012), http://ftalphaville.ft.com/files/2012/05/ira-sohn-pershing.pdf [http://perma.cc/M3GC-8KVD] (presenting these changes to investors). The new CEO lasted less than a year, until the board replaced him with his predecessor, and J.C. Penney's sales continued their slide. *See* Emily Glazer et al., *Penney Backfires on Ackman*, WALL ST. J. (Apr. 9, 2013), http://www.wsj.com/articles/SB10001424127887324504704578412440293890624 [http://perma.cc/D9PA-WV4P]. The new team nixed the "JCP" branding, which had been one of the hedge fund team's innovations, and brought back coupons. *Id*.

board designee to resign and providing the fund with help to enable it to sell the fund's stake cost effectively.[128]

Charles Nathan, a distinguished practitioner, has rightly argued that what matters is not that an activist has a short-term holding period but whether the strategy it advocates is sound.[129] But, what he slights in his current thinking, which is somewhat different from his past thinking,[130] is that if the proponent of a strategy with long-term effects has no intention to hold and suffer the risks of that strategy, there is naturally less reason for that proponent to concentrate on the long term.[131] And Nathan is right that activists cannot be held responsible "if shareholders are predisposed to favor shorter-term programs for extraneous reasons (such as concern for quarterly and annual performance rankings on the part of active money managers)."[132] But that makes my primary point. Shareholders predisposed to do that are not shareholders in the original sense of being the risk bearers of the equity they control. Shareholders predisposed to make trades out of a concern for Morningstar ratings are

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128. Emily Glazer et al., *Ackman Moves To Dump Entire Stake in J.C. Penney*, WALL ST. J. (Aug. 26, 2013), http://www.wsj.com/articles/SB10001424127887324591204579037251135114142 [http://perma.cc/C5EV-4P2P].

129. Charles Nathan, *Seven Deadly Fallacies of Activist Investing's Critics*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (June 29, 2016), http://corpgov.law.harvard.edu/2016/06/29/criticism-of-activist-investing [http://perma.cc/26TL-3VJK].

130. Earlier in his career, as a corporate lawyer, Nathan was less generously disposed toward hedge fund activism. In one instance, he described activism as "an alternate universe" separate from value creation and warned of "the large and growing agency costs" that activism imposes on the ultimate owners of public companies. Charles M. Nathan et al., *Corporate Governance Commentary: Corporate Governance Activism: Here To Stay?*, LATHAM & WATKINS LLP: CORPORATE GOVERNANCE COMMENTARY 1 (June 2012), http://www.lw.com/thoughtLeadership/CorporateGovernanceActivism-HereToStay [http://perma.cc/Z47G-XR5Z]. He also referred to wolf packs as "destabilization campaign[s]." Charles M. Nathan, *Recent Poison Pill Developments and Trends*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (May 12, 2009), http://corpgov.law.harvard.edu/2009/05/12/recent-poison-pill-developments-and-trends [http://perma.cc/4Z6H-W4PF].

131. *See, e.g.*, Bratton, *supra* note 46, at 1393 (describing how companies arguably experiencing conglomerate discounts are enticing activist targets because the activist can, if successful, experience the appreciation from a rerating of the stock without being concerned with any long-term implications from the breakup).

132. Nathan, *supra* note 129.

conflicted agents, whose incentives are different and not rationally aligned with the human investors whose capital they possess. If it is the case that these money managers are acting for their own short-term motives and if most hedge funds themselves have no incentive to think long term, that illustrates that we are relying on the law of unintended consequences to drive important elements of decision making in a context critical to human investors' wellbeing.

Studies of the impact of activist hedge fund investing are emerging monthly, and it is hazardous to summarize them. But, there is some emerging evidence suggesting that activist hedge funds prepared to take a long-term position and work as fiduciaries to improve the performance of the companies they target achieve a better market reaction.[133] There is also some evidence that hedge funds with a longer-term outlook are less likely to pursue cuts in long-term growth drivers like research and development, when compared to hedge funds looking for a quick pop.[134] This is also the space where practitioners say there is genuine symbiosis between traditional active mutual fund managers and activist hedge funds. It is these companies where mutual fund managers who feel their input over the years has been ignored suggest to an activist hedge fund with proven clout that company *X* might deserve examination. In this context, the activist can go into the fight with more confidence that the existing investors are frustrated and likely to support an alternative to the present regime. This evidence suggests that hedge fund activism is perhaps most valuable when it involves a

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133. *See supra* note 122 and accompanying text. One example of this might be Pershing Square's intervention at Canadian Pacific. Termed "one of the great corporate turnarounds in recent memory," Pershing Square's strategy involved bringing in a new CEO with extensive railroad industry experience who had already turned around another railroad. Antoine Gara, *By Selling Canadian Pacific, Billionaire Bill Ackman Is Planning To Invest Again*, FORBES (Aug. 3, 2016), http://www.forbes.com/sites/antoinegara/2016/08/03/by-selling-canadian-pacific-bill-ackman-is-planning-to-invest-again [http://perma.cc/6NHL-HF65].

134. *See* Krishnan et al., *supra* note 64, at 298, 309-10 (observing that targets of the high performing hedge funds—funds which also tended to take large stakes in their dataset—not only performed well but experienced growth in research and development spending as compared to targets of other funds); *cf. Activist Funds: An Investor Calls*, *supra* note 47 (analyzing the fifty largest activist positions in public company targets and finding an increase in profits, capital investment, and R&D after the intervention begins).

somewhat rougher form of relationship investing of the kind for which Warren Buffet is known.[135] The activist may need to knock a bit loudly, but once let in, assumes the duties and economic consequences of becoming a genuine fiduciary with duties to other stockholders and of holding its position for a period of five to ten years, during which it is a constructive participant in helping the rest of the board and management improve a lagging company. Nelson Peltz and his Trian Fund Management might be thought of in this manner. Peltz is not a recent business school graduate without management experience. Rather, he has been a successful CEO of several businesses for decades,[136] and has been applauded for his willingness to get into the thicket of important work when serving on target boards.[137] Precisely because in this story the hedge fund is not really short-term, at least in comparison to the rest of the participants in our short-term markets,[138] whatever business ideas it has are likely to be ones that have to consider long-term effects more closely.

In this regard, a caution flag should be noticed by both zealots for and against hedge fund activism. If pro-hedge fund zealots point to evidence that the more successful hedge funds are not in fact short-term, but commit to invest for five to ten years, then they should be far less passionate to defend all hedge fund activism as useful when the results

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135. Warren E. Buffet, *Berkshire Hathaway Inc. 2015 Annual Report*, BERKSHIRE HATHAWAY INC. 33 (Feb. 27, 2016), http://www.berkshirehathaway.com/2015ar/2015ar.pdf [http://perma.cc/7M4Q-G8LB] (describing Berkshire Hathaway's allocation of authority where business managers make operating decisions and capital allocation decisions are made centrally); *id*. at 32 (describing Berkshire Hathaway's acquisition criteria); *id*. at 6 ("At Berkshire, we go only where we are welcome.").

136. Peltz was chairman and CEO for a decade of the company that owns the Wendy's restaurants; he also spent five years as CEO of a conglomerate manufacturer and another eight years as CEO of a specialty chemical company. *Nelson Peltz*, TRIAN PARTNERS, http://www.trianpartners.com/team-members/nelson-peltz [http://perma.cc/8YGB-73RQ].

137. David Benoit, *Trian's Nelson Peltz: What Happens When Activist Comes on Board*, WALL ST. J. (May 7, 2015), http://www.wsj.com/articles/trians-nelson-peltz-what-happens-when -activist-comes-on-board-1430991002 [http://perma.cc/AKN8-MG7H] (describing Peltz's engagement while he was a board member at H.J. Heinz Co., including considerable requests for information, and quoting board members who praised Peltz's analytical strength and preparation). But that is not to say that Trian is without critics. *See supra* note 71.

138. *See* Dolan, *supra* note 71.

from activism overall seem to be more problematic for other stockholders and society as a whole. Meanwhile, anti-hedge fund zealots should not paint with spray cans and suggest that all hedge fund activists are the same. Rather, they should be less worried about activists who 1) bring genuine managerial expertise to bear; 2) are willing to serve as fiduciaries of the target company; and 3) are willing to hold the target's stock for a lengthy period.

This point, of course, raises another important issue, which relates to the question of scale: namely, whether this sort of activism, which represents a minority numerically, can grow to be the predominant form, with the more common and less successful hit-and-run approaches going away. Right now, actual companies face both, and that is problematic, especially if the hit-and-run approaches induce companies to take shortcuts that harm long-term performance, leading to those companies being targeted later by other relationship activists as a result of poor performance resulting from managing the company to the market rather than in a sound long-term way.

To conclude, whether the corporations that activists leave behind are better or worse positioned to generate sustainable profits in the future is still debatable, as shall be discussed. But what is certain is that the fundamental premise of an activist hedge fund campaign is that the target corporation is able to and should make material changes in the way it does business that will make the corporation more valuable. Nothing genuinely valuable is cost-free, and therefore all commentators likely can agree that the corporations successfully targeted by activist hedge funds, as well as those corporations who preemptively tailor their business plans to fit the typical hedge fund demand for corporate management changes, will be differently positioned to seize the opportunities and weather the risks of the future. Those changes have the potential to affect human investors in multiple ways, as will be taken up in Part IV of this Feature.

Although this Feature focuses on hedge fund activism and its effects on human investors, it is first necessary to consider the system within which hedge funds exert influence over public companies, their stockholders, and other constituencies including human investors. Part III, therefore, discusses the features of this strange corporate republic we have today.

III

The corporate governance system to which human investors are now subject and within which activist hedge funds act was in fact built for humans. Although the history is not in a straight line, it can be safely assumed that when for-profit corporations were first chartered under general, not special, legislation, the underlying assumptions of lawmakers were straightforward. Within the corporate polity, the stockholders were the citizens, and they held the managers, the elected officials, accountable through a system of checks and balances, involving republican election principles and elements of direct democracy to deal with certain particularly important subjects. Corporations were originally seen as having identities that were intensely geographic, and their operations, management, and stockholder bases tended to be concentrated.[139] Stockholders were mostly human beings, and they invested for the long term, options for trading were limited, and they made their own voting decisions.[140]

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139. By way of example, in our early history, corporations' ability to do business outside the domicile that created them was dubious. *See* Leo E. Strine, Jr. et al., *Putting Stockholders First, Not the First-Filed Complaint*, 69 BUS. LAW. 1, 30 & n.105 (2013). *See generally* Ralph Gomory & Richard Sylla, *The American Corporation*, 142(2) DAEDALUS 102 (2013) (describing the historical evolution of corporations in America).

140. In a 2009 speech, John Bogle, the famed low-cost fund innovator, observed the change between the "old *ownership* society" where individuals held over 90% of stocks and "today's *agency* society" where institutional ownership dominates. John C. Bogle, *Building a Fiduciary Society*, BOGLE FIN. MKTS. RES. CTR. (Mar. 13, 2009), http://www.vanguard.com/bogle_site/sp20090313.html [http://perma.cc/5AYE-XSDD]; *see also* Marshall E. Blume & Donald B. Keim, The Changing Nature of Institutional
Stock Investing 4 (Nov. 12, 2014) (unpublished manuscript), http://faculty.wharton.upenn.edu/wp-content/uploads/2015/06/ChangingInstitutionPreferences_12Nov2014_CFR.pdf [http://perma.cc/9LXX-RGVE] ("The proportion of equities managed by institutional investors hovered around five percent from 1900 to 1945."). Even in 1965, the "holdings of the three groups of traditional institutional investors amounted to a relatively small fraction of the stock market: 5% for mutual funds, 6% for pension funds, and 3% for insurance companies." Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163, 170 (2015) (footnote omitted). By 2010, some measures put institutional ownership of equities at 67%. Blume & Keim, *supra*, at 4. A few veteran scholars and practitioners—by which I mean seasoned ones who have experienced the markets since the 1960s—made the point that ordinary investors in the past were not particularly active in voting their shares when they had direct ownership. I do not quibble with that point. But, even if true, it does not contradict my central

Perhaps most fundamentally, as the corporation concept expanded and larger corporations with diverse stockholders and large-scale operations emerged, corporations began to take on a national importance and identity.[141] Gain sharing among corporate constituencies was for the most part assumed, and it was thought, particularly after the New Deal, that the stockholders and workers of a corporation were in a symbiotic relationship, where profits for the corporations would translate into gains for both constituencies and for the communities in which the corporation operated.[142] Even though this was the thought, it was also un-

point. Investors in the past largely bought stocks because they liked the company's management and its prospects, and they held their shares for much longer periods. Because they liked the companies, they tended to support the inertial direction of the company's managers, and it was much harder for an intervening investor to galvanize the market forces necessary to disrupt company policy. Perhaps even more importantly for human investors, because the momentary pressures of the stock market on companies were less potent, managers were more free to pursue long-term approaches that involved gain sharing with other constituencies. Not only that, other constituencies, particularly workers in the form of labor unions, had greater power in previous eras, for both market and legal reasons. *See Chattanooga Shoo-Shoo*, ECONOMIST (Feb. 22, 2014), http://www.economist.com/news /business/21596997-union-movement-misses-big-opportunity-halt-its-decline-chattanooga-shoo-shoo [http://perma.cc/SR6C-92SS]; Neil Shah & Ben Casselman, *'Right-To-Work' Economics*, WALL ST. J. (Dec. 14, 2012), http://www.wsj.com/articles/SB10001424127887324296604578179603136860 13 [http://perma.cc/6H6Y-VJ7D].

141. This growth inspired the classic, ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

142. Charles Erwin Wilson, General Motors's CEO, exemplified the period when he observed, when questioned at a Senate confirmation hearing about his GM stock: "I cannot conceive of [a conflict of interest] because for years I thought that what was good for our country was good for General Motors, and vice versa." *Wilson, Charles E.*, GM HERITAGE CTR., http://history.gmheritagecenter .com/wiki/index.php/Wilson,_Charles_E [http://perma.cc/Q69Q-5X7Y]; *see also* William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and* The Modern Corporation, 34 J. CORP. L. 99, 136 (2008) (observing that Adolf Berle, one of the important mid-twentieth century corporate theorists, articulated a framework of "benign equipoise amongst strong organizations, an equipoise constrained by a wider public consensus that empowered the central government in the role of welfare maximizer"). Berle articulated an "American Economic Republic" that was "interdependent," where companies did the producing, "incentivized by the profit motive" and government intervention happened to ensure stability. Bratton & Wachter, *supra*, at 136-37 (footnotes omitted). Private actors "moderat[ed] their conduct" and thus greater government intervention was avoided. *Id*. at 137. "As a wielder of power in the interdependent system, a [corporate] manager would be held to responsibilities to suppliers, customers, employees,

derstood that for the most part, the worker and investor class would not overlap and that workers were unlikely to hold much stock. Rather, stock would tend to be held by wealthy individuals or by corporate pension funds responsible for paying pensions to retired workers.[143]

But from the standpoint of those forced to save for retirement through 401(k) investments, our so-called system of stockholder democracy now works very differently from these original assumptions. Money managers, controlling other people's money, not human investors, now dominate *direct* stock ownership. As a human investor, you turn your capital over every paycheck to funds available among fund families chosen by your employer.[144] Those funds are effectively available to you only when you hit fifty-nine-and-a-half years old. Thus, for decades or even generations, the money is not available to you to meet your expenses. During that time, you do not get to pick the shares of stock bought on your behalf or to express any view about how those shares are voted. Rather, you are a direct stockholder of a mutual or index fund, a status that in essence means you have no real voice at all. Derivative suits, proxy fights, and all the things that self-proclaimed stockholder advocates believe are too scarce, basically do not exist at the mutual fund level.[145] Exit is your only option, and that exit is to an-

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and shareholders, along with other, more peripheral constituents." *Id*. at 141. The public would make demands, much as they would of politicians, and managers would need to respond. *Id*. Berle was an influential member of FDR's "Brains Trust," *id*. at 109, and his articulation of a "new" individualism fit into the ascendant stream of corporatist thinking in the New Deal and post-New Deal time period, *id*. at 111-12; *see also* William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 737 (2001) (describing Berle's landmark book as "the basis of a paradigm that dominated the field" for fifty years).

143. *See supra* note 140.

144. The open-ended funds that are the main choice for human investors putting money into retirement accounts now dominate the U.S. market with over $16 trillion in financial assets. Palmiter, *supra* note 14, at 1. Many are passive; at the end of 2014, "382 index funds managed total net assets of $2.1 trillion." 2015 *Investment Company Fact Book*, INV. COMPANY INST. 45 (2015), http://www.ici.org/pdf/2015_factbook.pdf [http://perma.cc/CGH8-4NM6]. Of that, the majority were equity funds, and the proportion of indexed equity funds to actively managed funds continues to increase. *Id.* By summer 2015, index-tracking ETFs alone constituted close to 30% of U.S. equities trading. Elizabeth MacBride, *Watch Out for This $1 Trillion Stock Bubble*, CNBC (Jan. 14, 2016, 9:48 AM ET), http://www.cnbc.com/2016/01/14/watch-out-for-this-1-trillion-stock-bubble.html [http://perma.cc/9757-JART].

145. For an excellent overview of how limited the tools that mutual fund investors have to hold their fund managers accountable are, see Lyman Johnson, *Protecting Mu-*

other fund in the same mutual fund family or another family selected by your employer, most of which will look the same as the one you exited.[146]

The funds in which you invest will not vote in a way that is fund specific. If you invest in a fund that is supposed to be "socially responsible," it is likely to vote on issues in exactly the same way as the other funds in the fund family, however inconsistent that is with the fund's stated purpose.[147] If you are a rational index fund investor and your fund will not exit until the portfolio stock leaves the index,[148] you will find you get

tual Fund Investors: An Inevitable Eclecticism (Univ. of St. Thomas Minnesota, Legal Studies Research Paper No. 16-17, 2016), http://ssrn.com/abstract=2814214 [http://perma.cc/HS9N-R5LZ]. *See also* Donald C. Langevoort, *Private Litigation To Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1032 (2005) ("Institutional shareholder voice does not exist in the fund area."); Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV BUS. L. REV. 1, 13-17 (2016) (noting that redemption is the key governance tool).

146. Johnson, *supra* note 145, at 7 (citing the statistical reality that, although there are many mutual funds, there are comparatively few fund families, and the choice for ordinary investors involves moving from one fund family to another).

147. Ying Duan & Yawen Jiao, *The Role of Mutual Funds in Corporate Governance: Evidence from Mutual Funds' Proxy Voting and Trading Behavior*, 51 J. FIN. & QUANTITATIVE ANALYSIS 489, 498 n.13 (2016) ("Less than 7% of our sample deviates from unanimous family voting . . . ."); Susanne Craig, *The Giant of Shareholders, Quietly Stirring*, N.Y. TIMES (May 18, 2013), http://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant
-is-quietly-stirring.html [http://perma.cc/ZD7V-A679] (describing BlackRock's centralized decision-making process for voting its shares across all funds, in which the central team prevails "regardless of the views of the firm's portfolio managers or even [CEO] Mr. Fink"); *see also* Johnson, *supra* note 145, at 7 ("[P]roblems with conflicts between one company and its advisor likely plague all funds in the same family.").

148. "[A]n index fund buys all (or a representative sample) of the securities in a specific index, like the S&P 500 Index. The goal of an index fund is to track the performance of a specific market benchmark as closely as possible." *Index Funds Could Help Lower Long-Term Costs*, VANGUARD GRP., INC., http://investor.vanguard.com/mutual-funds/index-funds [http://perma.cc/V4EG-YHPL]. "[T]he ultimate goal in this type of fund is simply to replicate an external and independent phenomenon [the fund's market benchmark], therefore comparatively little human judgment is involved . . . ." BIRDTHISTLE, *supra* note 15, at 26. Even when the actively managed funds in a fund complex are heading for the exits because they smell Enron-level fraud, that complex's index funds will stay in the stock until the stock is taken out of the index. Strine, Jr., *Toward Common Sense and Common Ground*, *supra* note 2, at 17.

no independent thinking at all or any separate voice.[149] Rather, your index fund will vote the same way as the actively traded funds in the fund complex,[150] regardless of the fact that the active funds do not hold long term,[151] and regardless of key factors such as whether the issue on the

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149. *See* Craig, *supra* note 147 (describing how Blackrock's centralized governance team determines how all of Blackrock's funds will vote); *see also* Partnoy & Thomas, *supra* note 48, at 133-34 (observing that ETFs, one of the main instruments that investors use to hold entire indexes, typically have voting policies that indicate their managers believe that "their involvement in corporate governance and voting is not worth the cost").

150. *See* Scott Hirst, *Social Responsibility Resolutions*, J. CORP. L. (forthcoming 2017) (manuscript at 11) (noting how almost all mutual fund families voted all their funds identically on social proposals, regardless of fund purpose); *supra* notes 147-149; *see also, e.g.*, *Statement of Additional Information*, VANGUARD GRP., INC. B-45 (Apr. 27, 2016), http://www.vanguard.com/pub/Pdf/sai040.pdf [http://perma.cc/A4GA-GLX7] ("For most proxy proposals, particularly those involving corporate governance, the evaluation will result in the same position being taken across all of the funds and the funds voting as a block."). The same guidelines do allow that "a fund may vote differently, depending upon the nature and objective of the fund, the composition of its portfolio, and other factors." *Statement of Additional Information*, *supra*. Although Vanguard is best known for its low-cost index funds, it also has twenty-one actively managed funds focused on the U.S. market alone. *Vanguard Mutual Funds*, VANGUARD GRP., INC., http://advisors.vanguard.com/VGApp/iip/site/advisor/home [http://perma.cc/CE7Y-JCKQ] (follow "Investment Products: Mutual funds: U.S. stock" hyperlink; then select "Active" under "Mgmt style/Benchmark" dropdown). BlackRock, another large index fund manager through its iShares unit, has an overarching proxy policy, although it also allows deviation on a case-by-case basis. *Proxy Voting Guidelines for U.S.*
Securities, BLACKROCK (Feb. 2015), http://www.blackrock.com/corporate/en-br/about
-us/investment-stewardship/voting-guidelines-reports-position-papers [http://perma.cc/8G7M-WZZ8]. Other index fund managers such as State Street Global Advisors, Invesco Powershares, Charles Schwab, and Guggenheim Investments rely to varying degrees on the general advice provided by one of the big two proxy advisory firms, ISS and Glass Lewis, and apply the advice consistently. *See* Ari I. Weinberg, *How Activist Is Your Index Fund?*, FORBES (Apr. 25, 2012), http://www.forbes.com/sites/ariweinberg/2012/04/25/how-activist-is-your-index-fund/#327afa6218b0 [http://perma.cc/6DKZ-QN5M]; Rydex ETF Trust, Registration Statement (Form N-1A), at 30 (Aug. 5, 2015).

151. *E.g.*, Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579 (2006) ("The average turnover rate among stock mutual funds was 117[%] in 2004.").

table is a stock-for-stock merger in which the index fund holds both the acquirer and the target.[152]

Interestingly, a study that focused intensively on mutual funds exiting companies that are the subject of controversy never focused on what the index funds at the same fund families did after their actively traded fund cousins exited.[153] If those funds exited because of dangers of insolvency or other serious risks, what did the fund family do for those of its index investors who still faced the risk? Did they voice concerns on behalf of their stuck-in investors? Or just do nothing? The latter seems more likely given the data on mutual fund family behavior.

Regardless of fund, those who manage active funds are likely to have compensation arrangements more based on the fund family's profits or short-term returns than the long-term returns of the funds they manage.[154] Fund managers will not be the ones who make most voting decisions. Because fund managers find most voting a waste of time,[155] the fund family will, at best, establish a centralized voting unit comprised of comparatively less expensive employees, who will develop voting policies and make sure government mandates for voting are sat-

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152. The reason for this is that mutual fund complexes tend to come to a position based on how the stock of a particular public company should be voted. All funds in the family, including index funds, vote the same way, regardless of whether a fund owns the other stock affected by the transaction. *Cf*. Coffee & Palia, *supra* note 6, at 558 (observing that many mutual fund families compete on cost and thus find it more efficient to outsource vote decisions to proxy advisors like ISS).

153. Duan & Jiao, *supra* note 147.

154. A study looking at over 3,400 U.S. open-end mutual funds found that manager pay is often tied to the performance of the fund advisor and that "[t]he performance evaluation window ranges from one quarter to ten years, and the average evaluation window is three years." Linlin Ma et al., *Portfolio Manager Compensation and Mutual Fund Performance* 2 (Finance Down Under 2014 Building on the Best from the Cellars of Finance, 2016), http://ssrn.com/abstract=2024027 [http//perma.cc/9SYW-JTSX]; *see also* Cheffins & Armour, *supra* note 53, at 74 (identifying prohibitions on tying manager compensation to fund performance in the Investment Advisers Act of 1940); Kahan & Rock, *supra* note 47, at 1050 (highlighting regulatory obstacles to basing management fees on performance). Although mutual fund manager pay may not be as closely aligned with human investors' needs as would be ideal, hedge fund manager pay structures, especially incentive fees, look worse in comparison. *See, e.g.*, Pozen, *supra* note 55, at 7.

155. This is especially true for managers of index funds whose incentives are to achieve a return matching the index at low cost, not outperformance over time. Kahan & Rock, *supra* note 47, at 1051.

isfied.[156] In a materially important way, many fund families tend to defer to proxy advisory firms[157] on votes, because this gives them a way to say they have made an informed vote—and thus satisfy federal regulatory requirements[158]—on the thousands and thousands of votes they have to cast each year.[159] Even though fund managers may believe the number of votes is wasteful and not good for them or their investors, they remain silent and go along with those, to be discussed, who press for corporations to be governed on a direct democracy, corporate Cali-

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156. *See e.g.*, *Proxy Voting and Shareholder Engagement FAQ*, BLACKROCK (2014), http://www.blackrock.com/corporate/en-is/literature/fact-sheet/blk-responsible-investment-faq-global.pdf [http://perma.cc/3BS6-FD4E] ("BlackRock's proxy voting process is led by our Corporate Governance and Responsible Investment team . . . ."); *Statement of Additional Information*, *supra* note 150, at B-45 ("For most proxy proposals, particularly those involving corporate governance, the evaluation will result in the same position being taken across all of the funds and the funds voting as a block."). In 2012, BlackRock's Corporate Governance and Responsible Investment team globally had twenty individuals, determining votes for 15,000 shareholder meetings. Letter from Robert E. Zivnuska, Head of Corp. Governance & Responsible Inv., Americas, BlackRock, to B.C. Sec. Comm. et al. 1 (Sept. 20, 2012). This is the best case and is more true at larger funds than smaller ones. The general trend is that smaller firms with more limited resources tend to rely more on proxy advisory services. *See, e.g.*, Letter from Karrie McMillan, Gen. Counsel, Inv. Co. Inst., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Oct. 20, 2010), http://www.sec.gov/comments/s7-14-10/s71410-167.pdf [http://perma.cc/JDD5-RSBV] ("[Certain] funds—such as those that are part of smaller fund families with more limited resources—may rely more heavily on proxy advisory firms to guide their votes."); *see also* David F. Larcker et al., *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173, 177 n.4 (2015) ("[Based on 2011 data on say-on-pay votes,] SEI Investment Management; Grantham, Mayo, Van Otterloo; Evergreen Investment Management; Dimensional Fund Advisors; Wells Fargo Funds Management; and Nuveen Asset Management voted more than 99 percent of the time with the Institutional Shareholder Services (ISS) recommendation when this recommendation differed from that of management. Similarly, Charles Schwab, Neuberger Berman, Loomis Sayles, and Invesco explicitly disclose that they follow Glass, Lewis & Co. (GL) SOP recommendations.").

157. Really, just two firms—Glass Lewis and ISS—have 97% market share in the United States. Bryce C. Tingle, *The Agency Cost Case for Regulating Proxy Advisory Firms*, 49 U.B.C. L. REV. 725, 743 (2016).

158. *See* 17 C.F.R. § 275.206(4)-6 (2016) (requiring investment advisers to "[a]dopt and implement written policies and procedures that are reasonably designed to ensure that [the investment advisers] vote client securities in the best interest of clients").

159. Duan & Jiao, *supra* note 147, at 501 (summarizing research that found that 29.6% of mutual funds in the sample always voted consistently with ISS and all funds in the sample were more likely to vote against the recommendation of corporate management or sell the stock when ISS was recommending action different from management).

fornia model—where there is always an opportunity for immediate market sentiments to be heard and where there is no attempt to establish a rational system of periodic votes on issues like executive compensation or to ensure that certain stockholders with trifling amounts of equity do not burden corporate performance with constant precatory proposals, which involve no cost to them and great cost to corporations. The chain separating actual human beings from voting shares in corporations can be long indeed.

None of the participants in this lengthy chain can be meaningfully thought of as anything other than agents, and the ties of their agency tend to be thicker as to the interests of the money manager fund family seeking profit than to the human investors the power of whose capital is being wielded.[160] In 2016, the concept of "superdelegates" playing a material role in the presidential nomination process faced renewed criticism,[161] and the voice of superdelegates is being turned down substantially.[162] In the corporate governance system, however, we have moved

160. Johnson, *supra* note 145, at 4-6 (observing that advisors hold the most power in the mutual fund context and describing conflicts of interest between investors and advisors); Memorandum from Chester Spratt, Chief Economist, Office of Econ. Analysis, SEC, to Inv. Co., File S7-03-04, at 4-10 (Dec. 29, 2006), http://www.sec.gov/rules/proposed/s70304/oeamemo122906-litreview.pdf [http://perma.cc/RP9D-HLJD] (describing agency conflicts between fund managers and investors); *see also* Ma et al., *supra* note 154, at 2 (reviewing mutual fund manager compensation and finding that, in half of their sample, a manager's bonus was linked to the fund complex's performance, rather than the manager's own fund); Tingle, *supra* note 157, at 12 (observing that the size of assets under management plays a materially greater role in fund manager compensation than the fund's performance for its investors). If one turns one's gaze to the hedge fund industry, rather than more conventional money managers, the incentives are arguably even harder to rationalize. Simon Lack, *The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good To Be True*, C.F.A. INST. 14, 18-19 (2012) (noting that since 1998, 98% of net real profits derived from hedge funds have gone to hedge fund and fund-of-fund managers rather than to the investors). *But see* Ma et al., *supra* note 154, at 2 ("[T]he bonus component of compensation is explicitly tied to the fund's investment performance for 79.2% of sample funds.").

161. *E.g.*, Laura Meckler, *Bernie Sanders Makes a Last Push: To Change Party Rules*, WALL ST. J. (June 17, 2016), http://www.wsj.com/articles/bernie-sanders-makes-a-last-push-to-change-party-rules-1466202267 [http://perma.cc/PQ56-39K7]; Diane Russell, Opinion, *Abolish Superdelegates. It's Only Democratic*, N.Y. TIMES (July 22, 2016), http://www.nytimes.com/2016/07/23/opinion/campaign-stops/abolish-superdelegates-its-only-democratic.html [http://perma.cc/ZAG3-446D].

162. *See* Evelyn Rupert, *Democrats Vote To Overhaul Superdelegate System*, HILL (July 23, 2016), http://thehill.com/blogs/blog-briefing-room/news/288989-democrats-vote-

to a system almost exclusively comprised of layers of superdelegates, who have the chance to use the delegated power of ordinary human investors to influence public corporations.

Even worse than 401(k) investors who have (limited) ability to vote with their feet, workers who look to pension funds for their retirement have no investment choice at all, much less any voice over how the power conferred by their capital is exercised. The pension fund decides where the funds taken from the workers' checks are invested. Although most human investors are locked out of investing in private equity funds or hedge funds or other unregistered investments, pension funds get to do so on their behalf, because of their supposed sophistication. Thus, when unregistered investment advisers fail, it is human investors who have no choice in the matter, who bear the costs. Likewise, pension funds have been active[163] in proliferating litigation over mergers and acquisitions that involve no conflict of interest, that were overwhelmingly supported by most institutional investors (often including the pension fund's own investment managers), and where the litigation delivered no benefits to investors as a class,[164] but only to the law firms with whom the pension funds' board had developed an unusually close and not

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to
-reform-super-delegate-system [http://perma.cc/8B32-KAUP].

163. David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions*, 38 DEL. J. CORP. L. 907, 960-61 (2014) (noting the prevalence of pension funds as lead plaintiffs in mergers and acquisition litigation in Delaware).

164. *See* Matthew D. Cain & Steven Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 100 IOWA L. REV. 465, 475 tbl.1, 476 tbl.2 (2015) (highlighting the precipitous rise in the incidence of merger litigation and number of suits generated by a single transaction); *id*. at 478-79 (noting that well over half of merger litigation settlements only result in enhanced disclosure); *id*. at 485-86 (noting that shareholders are unlikely to change their votes in light of settlement-driven disclosure); Charles R. Korsmo & Minor Myers, *The Structure of Stockholder Litigation: When Do the Merits Matter?*, 75 OHIO ST. L.J. 829, 835-36 (2014). Certain pension funds act as lead plaintiff so frequently it attracts opprobrium. Inst. for Legal Reform, *Bayou State Fund Is a Voracious Frequent Filer*, U.S. CHAMBER COM. (Oct. 21, 2013), http://www.instituteforlegalreform.com/resource/bayou-state-fund-is-voracious-frequent-filer [http://perma.cc/3BGC-WCJW] (identifying the Louisiana Municipal Police Employees' Retirement System pension fund as the "most prolific filer of shareholder litigation in U.S. history"); Inst. for Legal Reform, *Frequent Filers: The Problems of Shareholder Lawsuits and the Path to Reform*, U.S. CHAMBER COM. 11-14 (Feb. 2014), http://www.instituteforlegalreform.com/uploads/sites/1/Frequent_Filers_Final_Version.pdf [http://perma.cc/UX8M-JR4A] (discussing the Mississippi Public Employees' Retirement System's frequent filing of securities class actions).

easily explicable relationship.[165] As one learned practitioner said to me, the role of pension funds affiliated with labor unions has been disheartening in this story.[166] I agree with that point. Labor unions felt burned by their experience when they believed their support of management in fights over constituency statutes and anti-takeover statutes were not rewarded with a commitment by management to address global competition in a way that involved investment in and nurturing of American workers. Instead, unions saw managers using the statutes to give them leverage for higher pay and severance packages. So, pension funds affiliated with labor then joined forces with others to push for an elimination to structural defenses, to push for options-based executive pay, and in general to push for corporate governance changes that make companies immediately susceptible to influence by the stock market.[167]

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165. Cain & Solomon, *supra* note 164, at 478 tbl.3 (reporting mean attorneys' fees for disclosure-only settlements at $749,000); Korsmo & Myers, *supra* note 164, at 841 (describing acute conflicts of interest between securities plaintiff litigators and the plaintiffs (quoting Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN L. REV. 497, 535 (1991))); *id*. at 857 ("[T]he plaintiffs' attorney has the strongest financial stake in the claim, virtually always far outweighing that of any individual stockholder."); *see also* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 535-36 (1991) ("Class actions . . . are characterized by high agency costs: that is, a significant possibility that litigation decisions will be made in accordance with the lawyer's economic interests rather than those of the class."); Partnoy & Thomas, *supra* note 48, at 111 (observing instances of plaintiffs' law firms being accused of making campaign contributions to elected officials who make pension fund decisions).

166. E-mail to author (Sept. 4, 2016, 10:25 AM) (on file with author).

167. *See* Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55 (2007) (describing the rising prevalence of union-fund sponsored shareholder proposals in the mid-1990s); *id*. at 63 fig.3 (showing the increase in proposals by union funds in the 2004-05 period compared to 1987-94 period and decreases in proposals by other groups over same comparison periods); Andrew K. Prevost et al., *Labor Unions as Shareholder Activists: Champions or Detractors?*, 47 FIN. REV. 327, 329-31 (2012) (summarizing studies showing labor unions' high level of activity in submitting shareholder proposals related to corporate governance—and relatively high levels of success); *id*. at 333-36, 334 tbl.1 (reviewing a sample of union-sponsored shareholder proposals and finding them concentrated in efforts to remove antitakeover devices, repeal classified boards, and increase board independence); Paula Tkac, *Federal Reserve Bank of Atlanta, One Proxy at a Time: Pursuing Social Change through Shareholder Proposals*, 91 ECON. REV. 1, 6 (2006) ("In the years since 2002 the unions have withdrawn from social advocacy and focused entirely on corporate governance proposals."); *see also* John W. Cioffi, *Fiduciaries, Federalization, and Finance Capitalism: Berle's Ambiguous Legacy and the Collapse of Countervailing Power*,

At the same time, labor funds did little to encourage companies to improve risk management practices, to embrace sustainable approaches to value creation, or to manage their businesses in ways that involved good treatment of their human capital.[168] Rather, they added their voices to the choir of voices that most fervently pushed for stock market direct democracy.[169] This is a complicated story, and it is evolving, but this simple rendering regrettably has the ring of truth.

Relatedly, certain pension funds have been consistent advocates for turning the American corporate governance system into a direct democracy, with constant agitation for referenda and frequent stockholder votes on a variety of topics. The symbiotic relationship activist hedge funds have with pension funds that engage in corporate governance ac-

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34 SEATTLE U. L. REV. 1081, 1112 (2011) ("Paradoxically, the legal recognition of nonshareholder interests served only to entrench and empower management . . . . Managerial interests and organized labor spearheaded the political support for constituency statutes . . . . Labor, however, occupied a subordinate position in the antitakeover alliance . . . . Labor . . . served as a legitimating fig leaf for managerial power.").

168. Prevost et al., *supra* note 167, at 334 tbl.1 (showing relatively few union proposals remotely related to firm operations); Tkac, *supra* note 167 at 10, 11 n.13 (summarizing a sample of proposals and finding that, historically, unions sponsored at least some proposals seeking higher wages or enhanced working conditions overseas—arguably in at least partial service of maintaining labor unions' relevance—but also finding that since 2002, "unions have switched their shareholder activism strategy to sponsor corporate governance proposals *rather than call for socially responsible firm behavior*" (emphasis added)); *cf*. STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 247 (2012) (describing the vulnerability of public pension funds to "being used as a vehicle for advancing political/social goals unrelated to shareholder interests generally").

169. *E.g.*, *AFL-CIO Proxy Voting Guidelines: Exercising Authority, Restoring Accountability*, AM. FED'N LAB. & CONG. INDUS. ORGS. 7 (2012), http://www.aflcio.org/Corporate-Watch/Capital-Stewardship/Proxy-Voting [http://perma.cc/8KV5-YSUK] (discouraging classified boards and encouraging a majority, rather than plurality standard for director elections); *id.* at 7-8 (encouraging proposals easing shareholder ability to elect their own directors); *id*. at 18 (opposing reincorporation in states with stronger antitakeover protections and poison pills that do not require a routine shareholder vote); *see also* Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term*, 66 BUS. L. 1, 13 n.44 (2010) (examining corporate governance activism after the Enron and WorldCom scandals and concluding the evidence "does not suggest that institutional investors changed their focus to concentrate more on issues of fundamental risk, fraud avoidance, and effective risk and leverage management practices," but instead focused on takeover defenses and making corporations more subject to direct stockholder action).

tivism is well understood.[170] At times, scholars have called the changes wrought by corporate governance activism "small,"[171] but the large company-specific changes activist hedge funds have made have been facilitated by those governance changes. By making target corporations susceptible to immediate market pressures through the elimination of staggered boards, proliferating stockholder votes on proposals, the move to turn a decision not to vote into a "no vote," and similar changes in governance, corporate governance activists have made it much easier for activist hedge funds to prevail in a contest with management. Thus, although putatively arguing that corporate executives should be paid in a way that aligns their interests with those of pensioners,[172] pen-

170. Coffee & Palia, *supra* note 6, at 572 (observing the increased power that activists can gain through partnership with pension funds and other traditional money managers); 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, 897-99 (2013) (describing the "complementary" specializations of institutional investors and activist investors, where activist investors specialize in monitoring company strategy and institutional investors specialize in assessing activist ideas).

171. Kahan & Rock, *supra* note 47, at 1044; *see also id*. at 1042-45 (describing the types of governance changes historically sought by pension funds).

172. *E.g.*, Press Release, Cal. Pub. Emps.' Ret. Sys., CalPERS Approves Plan To Crack Down on Executive Compensation System; Believes that Fat Cat Pay Is out of Control (June 17, 2003), http://www.businesswire.com/news/home/20030617005632/en/CalPERS-Approves-Plan-Crack-Executive-Compensation-System [http://perma.cc/7CCM-FG7U] ("Poorly designed compensation packages are having a disastrous impact on companies and shareowners by emphasizing short-term or self interested behavior . . . . This plan will help curb the abusive practices by aligning corporate management with its owners and enhancing long-term superior performance."); Press Release, Controller of the State of Cal., CalPERS Adopts Westly Executive Pay Proposals (Feb. 14, 2006), http://www.sco.ca.gov/Press-Releases/2006/pr017execPay0214.pdf [http://perma.cc/74XN-X8QM] (heralding CalPERS's adoption of executive compensation clawbacks as a criterion in its proxy voting guidelines and arguing that "[o]ur retirees pay the price when companies misrepresent their performance. Clawbacks make executives accountable"); *see also* Marilyn F. Johnson et al., *Stakeholder Pressure and the Structure of Executive Compensation* 37 (Working Paper, 1997), http://ssrn.com/abstract=41780 [http://perma.cc/WA2P-JARV] (finding that stakeholder pressure, including that by institutional investors, resulted in short-term compensation becoming more sensitive to firm performance); *id*. at 12-13 (discussing calls by institutional investors for moderation of CEO pay). For a more recent example, see Athanasia Karananou & Olivia Mooney, *Integrating ESG Issues into Executive Pay, Principles for Responsible Investment*, PRINCIPLES FOR RESPONSIBLE INV. 6 (2016), http://www.unpri.org/download_report/8534 [http://perma.cc/M2DD-LP5W], which analyzes ways to tie executive pay to environmen-

sion funds have pushed for annual say-on-pay votes that overwhelm the capacity of voting institutions to vote thoughtfully,[173] that are clearly inconsistent with any prudent and rational way of contracting with executives, and that result in the views of proxy advisors being the key determinant of outcomes.[174] Pension funds vote yes on the same pay plan

tal, social, and governance issues in the name of "sustainable value creation" and long-term business strategy. Principles for Responsible Investment is an organization advocating for various ESG-related concerns on behalf of a group of signatories including ninety-some pension funds (including CalPERS). *Signatory Directory*, PRINCIPLES FOR RESPONSIBLE INV., http://www.unpri.org/signatory-directory [http://perma.cc/W5DX-KVZT].

173. Tkac, *supra* note 167 at 11 fig.2 (showing that pensions and unions constituted the bulk of the proponents of pay-related ballot measures in the 1992-2002 sample period); *see also* James F. Cotter et al., *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 979 (2013) (noting that the 2011 proxy season, the first year of required say-on-pay voting, entailed votes at over 2,200 companies); Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1036-37 (1999) (describing the historical focus of labor pension-related shareholders on executive compensation issues); Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1218 (2012) (observing that the American Federation of State, County, and Municipal Employees submitted the first shareholder proposal seeking a say-on-pay vote).

174. Evidence exists that ISS's views are the most important determinants of the outcomes in say-on-pay votes. Cotter et al., *supra* note 173, at 981 (summarizing findings that ISS recommendations had a "significant" effect on say-on-pay votes); *id*. at 989 (observing that an "against" recommendation from ISS "overshadow[s]" other performance factors such as the growth of CEO pay); *id*. at 1001 (describing trends suggesting ISS's influence on say-on-pay votes is increasing); Holly J. Gregory, *Lessons for the 2015 Proxy Season*, PRAC. L. (Sept. 1, 2014), http://us.practicallaw.com/4-578-4485 [http://perma.cc/8XRK-A4YL] ("It appears that ISS negative vote recommendations based on the perceived lack of board responsiveness to shareholder concerns (as evidenced by the failure to implement a successful shareholder proposal) was the leading factor associated with directors who failed to receive a majority of votes cast in an uncontested election in 2014."); U.S. GOV'T ACCOUNTABILITY OFF., GAO-17-47, CORPORATE SHAREHOLDER MEETINGS: PROXY ADVISORY FIRMS' ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES 16 (2016), http://www.gao.gov/assets/690/681050.pdf [http://perma.cc/DT2J-P7P3] (describing studies suggesting that "proxy advisory firm recommendations are the key determinant of voting outcomes in the context of mandatory 'say-on-pay' votes"). Even a study that purports to show that proxy advisor recommendations are not as influential as some contend finds that the advisors drive 6 to 10% of the vote. *See* Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 906 (2010). Tellingly, negative recommendations by ISS often do not reflect changes in the pay plan—which ISS would have supported in prior years—but rather the company's current performance, making the vote less about the pay plan

for four years, and then vote no in the fifth year, because that year was a poor year economically for the company, signaling either that the prior four votes were uninformed or that say-on-pay is being used as a way to express general unhappiness when that spirit moves the market.

Little apparent effort has flowed from pension funds to rationalize the corporate governance republic, or to consider how pushing for corporate California and therefore for corporations to be subject to the immediate influences of stock market sentiment at all times would affect pensioners, most of whose funds should be rationally invested through index funds, who should have parts of their portfolio in debt, and who need continuing access to quality jobs and wage growth to live a dignified and secure life. For them, pension fund activism would have been far better spent on issues like ensuring that corporations have appropriate risk management structures, fundamentally sound accounting and business practices, and proper capitalization to handle the risks of their business plans. For that reason, the obsession of pension funds over recent decades with causes like reducing takeover defenses, shifting executive compensation from cash to stock options, and other issues more directed to the extraction of short-term gains, rather than ones involving more fundamental questions of sustained long-term performance, seems to reflect the fact that those involved in corporate governance policymaking at pension funds have interests quite different from those who are depending on a pension to fund their retirements.[175]

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and more about expressing general unhappiness with the company's stock price. *See* Ryan Kraus et al., *When Do Shareholders Care About CEO Pay?*, CONF. BOARD 4 (2013), http://www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V5N16-131.pdf&type=subsite [http://perma.cc/LK6V-SGDV] ("Our results provide clear evidence that shareholders, even those acting in the role of institutional shareholders, only weigh their own losses when deciding whether to approve a SOP ballot."). There is evidence that the influence proxy advisors have over say-on-pay votes extends more broadly. *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra*, at 15 ("Recent studies, market participants, and other stakeholders agree that proxy advisory firms have influence on shareholder voting and corporate governance practices, but had mixed views about the extent of their influence.").

175. *See* INSTITUTIONAL INVESTOR ACTIVISM: HEDGE FUNDS AND PRIVATE EQUITY, ECONOMICS AND REGULATION 2 (William W. Bratton & Joseph A. McCahery eds., 2015) ("Public sector pension funds and labour unions take the lead roles, acting through agents incentivised by prospects of reputational advancement. These actors target companies and challenge their managers with shareholder proposals and 'just vote no' campaigns. They thereby register their voice and affect outcomes, but from a secondary position and on an occasional basis. The cumulated governance activity is impressive, but none of it assures or very often results in constructive engagement

In this corporate republic, human investors are basically witnesses to a clash of agents. At best, the human investors can hope that their direct agents (the institutional investors) and their indirect agents (the managers of the public companies) will reach some constructive accommodation when push comes to shove. Focusing on just these layers of agency actually simplifies the typical situation. If a corporation makes a bid for another, the human investor will find the layers of agency compounded, because the institutional investors they directly invest in will often own both stocks. Likewise, when a hedge fund launches a proxy contest in support of its expressed desire for a corporation to change policies, a pension fund may well be invested in the hedge fund, at the same time as it is more heavily invested in an index fund committed to holding the target's stock until it leaves the benchmark index. The pension fund may also own corporate debt securities of the target. And mutual fund families are not immune from these realities. The 2020 target retirement fund may well own the stock of the target and debt securities of the target. In this mix, of course, will be the proxy advisory firms that can tip the balance in even high-salience cases.

If those who get to suit up on behalf of human investors tended to act like human investors would seem to want, the bystander status of human investors might be less a source of concern. But, in the corporate governance game, the most vocal and powerful of the electorate will be those with investment horizons the least aligned with human investors. This is true not just of hedge funds themselves, but even more importantly true of the pension funds and mutual funds. The pension funds making the most noise are often not the most prudently financed or invested.[176] And the actively managed mutual funds—that is to say, the ones most likely to underperform as they depend on outguessing

by shareholders in the formulation of business policy at individual firms. As to that, collective action problems and the problems of separation of ownership and control persist."); Roberta Romano, *Less Is More: Making Shareholder Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174, 231-32 (2001) (describing the private benefits that accrue to pension fund investors from sponsoring shareholder proposals, including enhanced political reputations and advancements in personal employment); sources cited *supra* note 169 (showing the paucity of stockholder proposals related to issues of fundamental risk and the plethora of proposals to tear down defenses, making it easier to remove directors and tie executive pay to market prices).

176. David H. Webber, *Is "Pay-To-Play" Driving Public Pension Fund Activism in Securities Class Actions?*, 90 B.U. L. Rev. 2031, 2035, 2072-74 (2010) (finding that "the degree of the funds' underfunding correlates positively with lead plaintiff appointments").

the market—and proxy advisors like ISS drive the voting outcomes, not the index funds.

Within this system, the voice of traditional lenders and other creditors has also gone down.[177] With the increasing securitization of corporate debt, many companies do not have a traditional lender.[178] And outside of distressed situations, the voice of creditors in monitoring corporate financial practices and leverage is comparatively minor.[179] A variety of factors, from low interest rates to competition among banks for lucrative underwriting opportunities, has contributed to an easing of terms for companies seeking new loans. With the advent of terms like "covenant lite" to describe diminution in credit protection, reason exists to suspect that the risk-taking voice of equity has been amplified in part because the voice of creditors has reduced its volume.[180]

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177. *See* Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 706-08 (2008) ("An investor can purchase the debt of a financially troubled company and then try to influence corporate matters by exercising or threatening to exercise its contractual and statutory rights as a debtholder . . . . Institutional investors increasingly are looking to the distressed debt market not only to make a quick profit, but also to create value by proactively influencing corporate governance.").

178. Franklin R. Edwards & Frederic S. Mishkin, *The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy*, 1 FED. RESERVE BANK N.Y. ECON. POL'Y REV. 27, 27-28 (July 1995), http://www.newyorkfed.org/research/epr/95v01n2/9507edwa.html [http://perma.cc/LCA9-KUEF] (describing decrease in importance of commercial banks as source of funds for commercial borrowers); *id*. at 31 (attributing that decrease in part to increased securitization); Taylor D. Nadauld & Michael S. Weisbach, *Did Securitization Affect the Cost of Corporate Debt?*, 105 J. FIN. ECON. 332, 332 (2012) (explaining that the market for collateralized loan obligations underpinned by corporate loans reached $540 billion in 2007).

179. Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U.L. REV. 281, 314 (2009) (noting that traditional investors in corporate debt such as mutual funds and insurance companies do not act aggressively even when their contractual rights are violated and only act if bond values plummet suddenly); *id*. at 294 (observing that traditional investors hold the vast majority of corporate bonds and engage in very little activism); *see also* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1076 (1995) (summarizing the general corporate governance approach as viewing "managerial agency problems through the lens of equity interests").

180. Covenant-light (or "cov-lite") loans—loans where the covenants are tested much less frequently than traditional loans—have been issued in increasing volume, passing their pre-2008 peak in 2012. Bo Becker & Victoria Ivashina, *Covenant-Light*

I am not revealing some undiscovered, obvious reality about our corporate governance system. This fundamental fact—that human investors are now largely spectators to the game—is known and occasionally kept in mind. Most prominently, it has been reflected in trying to address the reality that who we think of normatively as "owners" in the real sense do not exist. The most high-profile of those efforts was to get CEOs to think like owners rather than as highly, but reasonably, paid salaried workers. Instead of steady captains of safe, stable ships, money managers wanted American CEOs to be risk takers, going hell-bent for equity gains, even if that meant hurting or compromising constituencies like workers through downsizings or communities through plant closings and offshoring.[181] Money managers, activists of many kinds,

Contracts and Creditor Coordination 1-2 (Swedish House of Fin. Research Paper No. 16-09, 2016) http://ssrn.com/abstract=2756926 [http://perma.cc/NHV3-UZSR]. The authors point out that this phenomenon is a creature of the leveraged loan market, where loans are sliced up—syndicated—and held by a broad set of investors. *Id*. at 2. The dynamics of this market are in flux in part due to relatively new leverage regulation from the Federal Reserve leading new nonbank actors to enter the market, competing with traditional banks. Christine Idzelis & Craig Torres, *Risky Loans Shunned by Banks Are Booming in Wall Street's Shadow*, BLOOMBERG (May 22, 2015), http://www.bloomberg.com/news/articles/2015-05-22/wall-street-flouts -fed-standards-to-fund-high-risk-loans [http://perma.cc/399V-RKHF]; *see also* Tracy Alloway, *Growth of 'Cov-lite' Loans Sparks Debate*, FIN. TIMES (Mar. 23, 2014), http://www.ft.com/content/723dfb5c-b0f8-11e3-9f6f-00144feab7de [http://perma.cc/4QFF-9Z76] (describing issuer pressure for less-restrictive covenants and incentives for banks to comply to avoid another bank acting as underwriter and because banks rarely hold the loans they originate for long); Michelle Davis, *Borrowers Take Charge of Leveraged-Loan Market*, BLOOMBERG (June 7, 2016), http://www.bloomberg.com/news/articles/2016-06-07/borrowers-take -charge-of-leveraged-loan-market-as-returns-shrink [http://perma.cc/9EL9-N5SB] (describing strong investor demand for loans).

181. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV. 138, 138 (May-June 1990), http://hbr.org/1990/05/ceo-incentives-its-not-how-much-you-pay-but-how [http://perma.cc/FG6G-6W57] (observing in 1990 that CEOs were paid like bureaucrats and calling for CEO compensation to be more sensitive to corporate stock price because "[i]s it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?"); Mark Maremont & Charles Forelle, *Bosses' Pay: How Stock Options Became Part of the Problem*, WALL ST. J. (Dec. 27, 2006), http://www.wsj.com/articles/SB116718927302760228 [http://perma.cc/GJ2L-BD7T] (describing the effort by "[a]cademics, politicians and investors" to get CEOs' pay shifted to stock-based compensation from cash).

and other interests called for management to get paid in equity, with the growth of stock options being among the first results of that advocacy—to align them with the so-called "owners," those who hold corporate stock.[182] These owners in turn called for more and more independent directors—fiduciaries with no prior ties to the company or its indirect competitors, suppliers, or customers—to check management even more.[183] To make them think like owners, independent directors were supposed to be paid in equity.[184] The compensation of these independent directors has grown enormously.[185] And it creates strong incentives for directors to support transactions that involve a sale of the company

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182. *See* LUCIAN BEBCHUCK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 72 (2004) (describing the push by investors, economists, and regulators for increased use of performance-based compensation). *See generally* Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 211 (2013) (surveying shifts in executive compensation and the theories for what drives those changes).

183. TESSA HEBB, NO SMALL CHANGE: PENSION FUNDS AND CORPORATE ENGAGEMENT 47 (2008) (noting that demands for independent directors were at the forefront of CalPERS' Focus List corporate governance campaigns from 1990 to 2000, during which 42% of the shareholder resolutions put forward by CalPERS called for more independent boards and committees).

184. David A. Katz, *Dealing with Director Compensation*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (May 22, 2015), http://corpgov.law.harvard.edu/2015/05/22/dealing-with-director-compensation [http://perma.cc/8TSB-DWXN] ("As with executive pay, the theory is that full-value awards create closer alignment of leadership and shareholder interests."); *U.S. Executive Compensation 2015 Recap, Key Developments & Notable Trends,* SIMPSON THACHER & BARTLETT LLP & FREDERIC W. COOK & CO., INC. 4, 21-22 (Mar. 31, 2016) [hereinafter *2015 Executive Compensation Recap*], http://www.stblaw.com/docs/default-source/memos/firmmemo_fwcook_03_31_16.pdf [http://perma.cc/CS5D-N95W] (describing the institutional investor's expectation that directors hold a substantial block of equity until they depart and be compensated primarily in equity during their service).

185. Alice Lee & Herman Yang, *2014 Board & Committee Fees Report*, 16 CSUITE INSIGHT 11 (2015) ("Among S&P 1500 boards, 38% are paying retainers of $200,000 or more, compared to just 18.4% five years ago."). Other studies have yielded slightly different numbers but the same upward direction. *2015 Spencer Stuart Board Index*, SPENCERSTUART 7 (Nov. 2015), http://www.spencerstuart.com/~/media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf [http://perma.cc/63Y7-9D55] (reporting a 98% increase in average annual retainer from 2005 to 2015).

and will therefore unlock the capital that they would otherwise be required to keep invested.[186] Not only that, because of the influence of proxy advisors and certain vocal institutional investors, independent directors who wish to remain on the independent director circuit—which likely comprises almost all of them—are highly sensitive to resisting institutional campaigns at any company on whose board they serve, for fear that they will be targeted for withhold campaigns at all companies with which they are affiliated. That fear is rational because the leading proxy advisory firms look at director performance at other companies when voting at particular companies, and so do the largest investment fund.[187]

Less focus, oddly, was on those who claimed to be owners, i.e., the money managers who controlled the funds that held human investors' wealth, than on the managers and directors of public companies. And the alignment between the interest of fund managers and human investors is, at best, imperfect, and at worst, out of sync.[188] Funds under management, short-term performance benchmarks not aligned with fund investors' horizons, and other factors drive their compensation. Nothing close to a serious attempt to subject fund managers to the risks of truly stuck-in 401(k) investors has been made. Pervading all efforts at

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186. *See 2015 Executive Compensation Recap*, *supra* note 184, at 4, 21 (describing how director compensation tends to be at least half stock, if not closer to 60%, and the increasing use of stock ownership guidelines requiring directors to maintain company stock ownership at a minimum of five times their annual cash retainer).

187. *E.g.*, *Proxy Paper Guidelines 2016 Proxy Season: An Overview of the Glass Lewis Approach to Proxy Advice*, GLASS, LEWIS & CO., LLC 7 (2016) [hereinafter *Glass Lewis 2016 Proxy Guidelines*], http://www.glasslewis.com/wp-content/uploads/2016/01/2016_Guidelines_United_States.pdf [http://perma.cc/5ARP-QWLX] (listing director "bad acts" prefaced by the observation that "[w]e believe shareholders should avoid electing directors who have a record of not fulfilling their responsibilities to shareholders at any company where they have held a board or executive position"); *see also, e.g.*, *Proxy Voting Guidelines for U.S. Securities*, BLACKROCK 2-3 (Feb. 2015), http://www.blackrock.com/corporate/en-no/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf [http://perma.cc/L2G5-XTG2] (reporting that the firm "generally supports board nominees in most uncontested elections" but also "may withhold votes from certain directors" if, for example, "it appears the director has acted (at the company *or at other companies*) in a manner that compromises his or her reliability in representing the best long-term economic interests of shareholders" (emphasis added)). Glass Lewis also uses a database to track directors' performance across companies as a basis for their voting recommendations. *Glass Lewis 2016 Proxy Guidelines*, *supra*, at 6-7.

188. *See supra* notes 75-78, 154-156, and accompanying text.

alignment is the fundamental question: ultimately, are we good enough at creating efficient and reliable incentives that hold the full chain of agents accountable for representing the interests of the long-term investor to whom they ultimately owe the duties of loyalty? Ordinary people's wages and wealth have stagnated, while the take of the financial classes—who control ordinary people's capital—have soared.[189] So far, acting as if alignment can be created by giving agents some form of instant, Tang-like ownership—which turns them after-the-fact into what an owner in the traditional sense would already be—has generated big picture results that have been less than outstanding for human investors.[190]

In this complicated design process, have we lost something? We have spent all kinds of time trying to make managers—a form of worker—have the incentives the stock market wants. But have we forgotten that *most Americans* would rather the system generate the most wealth for workers? Have we aligned on the wrong dimension? And is this misalignment because of a prior shared sense that "what was good for GM" was good for America,[191] when it was thought that with jobs came growth, and as profits grew so did wages?

Into this republic sliding toward full direct democracy, we must connect the role of the hedge fund activists. Now, this corporate republic has a concept of citizenship that is truly remarkable in its liberality. There is no waiting period or application process to be a citizen, or even to be elected to the highest office of this republic; buying stock is all that is required, and you can come and go largely as you please. In the case of activist hedge funds, the evidence of their behavior as corpo-

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189. *See* sources cited *infra* notes 243-244 .

190. A prominent practitioner, who has represented many of the leading corporate boards in the U.S., commented on the independent director class we now have in an incisive, not-for-attribution way:

> [Directors] don't care enough. Boards are now overloaded with directors with zero ties to the company, financial or personal. They are not just disinterested. They are uninterested. They have no skin in the game at all. They didn't participate in building the enterprise. They don't know the key employees. They have no relationship with the history or story of the company. They are robotic in fearing personal embarrassment. They are there as part of a sea change responding to the problems of the past and only invite the problems of the future. They are the result of best practice visionaries who seem to always be looking backwards.

E-mail to author (Sept. 14, 2016, 9:08 PM) (on file with author).

191. *See supra* note 142.

rate citizens is clear. As explained in Part II, activist hedge funds are not dissatisfied stockholders who decide to become active in changing policies of the corporation. Rather, they become stockholders for the first time to act on the corporation, change its business plans, and reap a profit over a period that can be as short as a handful of months, but is typically no longer than two to three years.[192] Although the hedge fund will argue to other investors that its plans are durably valuable and maximize long-term returns, the hedge fund will itself not stay and reap the long-term gains for its beneficence. Rather, it will exit, take whatever gains have been baked into the stock price, and leave the actual upside and downside of the change it wrought to others. In fairness to the activist investors, they may actually hold the stock longer than the horizon of the traditional money manager whose votes will determine the outcome of any showdown vote on the proposal. Yes, index funds will also vote, but not using their own "brains" or independent investment perspective. Instead, the actively traded funds' proxy advisor unit will drive the votes, and if the funds vote on long-term metrics, they will be voting in a way that does not match their investment horizon. Turnover rates reflecting their actual behavior—buying and selling—would suggest they are looking to outguess market movements short-term and to reap gains off price movements in the immediate year or so, not off long-term growth as buy and hold investors—i.e., human investors.

The actual holding strategies of both hedge funds and actively traded mutual funds also act as a real world check on the issue of a key academic model—the shareholder primacy model espoused by advocates of corporate California, which justifies a focus on stockholders' best interests within corporate governance on the normative ground that it is best for everyone because the stockholders can only win as residual claimants if everyone else, including workers and creditors, have their legitimate claims paid.[193] This conception, of course, acts as

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192. *See* sources cited *supra* note 70.

193. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38 (1991) ("[M]aximizing profits for equity investors assists the other 'constituencies' automatically. . . . A successful firm provides jobs for workers and goods and services for consumers. The more appealing the goods to consumers, the more profit (and jobs). . . . Wealthy firms provide better working conditions and clean up their outfalls . . . ."); *see also* LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 36 (2012) (describing assumptions for the "standard" model of the economic structure of a corporation, including that "[s]hareholders are the residual claimants in corporations, meaning they receive all profits left over after the company's con-

if there is an ultimate reckoning of accounts, and that stockholders can only gain if that final accounting is one where everyone else is treated as they are entitled.[194] But that is not how the world works. Certain stockholders can come in and reap trading profits, even if the underlying corporation's ability to create value is compromised to the detriment of continuing stockholders, company workers, and creditors.[195] In fact, those speculative profits do not come out of residue in any but a momentary sense, and because they do not come out of anything like a long-term summing up, those active traders who seek to reap them have no rational incentive to seek to maximize the ultimate residual value of the target firm, just its ability and willingness to generate gains for those who hold its equity over the active trader's short-term horizon. And the rationalization that they can only exit favorably if the rest of an actively speculating market believes the target's discounted cash flow value is attractive is less assuring when the range of company trading prices over short-term periods is far more expansive and shifting than can plausibly be explained by fundamental changes in the company's earnings prospects.[196]

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tractual obligations to its creditors, employees, customers, and suppliers have been satisfied").

194. STOUT, *supra* note 193, at 38-39.

195. Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 828-35 (2006) (describing the use of equity derivatives, complex ownership structures, and other techniques that have the effect of giving certain shareholders interests at odds both with other shareholders and their theoretical role as residual claimants); Kahan & Rock, *supra* note 47, at 1071 (noting that hedge funds' use of sophisticated strategies, including hedging and arbitrage, means that hedge funds are able to make money "without regard to whether the strategies they follow benefit shareholders generally").

196. Market studies have found a long-term increase in overall market volatility when measured on a daily basis. *See generally* Kenneth M. Washer et al., *The Increasing Volatility of the Stock Market?*, 19 J. WEALTH MGMT. 71 (2016). Some have found that financial innovations like high frequency trading and ETFs are associated with increased stock price volatility. *See* Itzhak Ben-David et al., *Do ETFs Increase Volatility?* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 20071, 2014); X. Frank Zhang, *High-Frequency Trading, Stock Volatility, and Price Discovery* 1-3 (Yale Sch. of Mgmt., 2010), http://ssrn.com/abstract=1691679 [http://perma.cc/EHT3-UHXR]. Others have attributed increased volatility to regulatory factors. Emily Glazer, *J.P. Morgan's James Dimon Says Increased Volatility Here To Stay*, WALL ST. J. (Apr. 6, 2016), http://www.wsj.com/articles/jpmorgans-james-dimon-says-increased-volatility-here-to-stay-1459983813 [http://perma.cc/RG6C-EH2L]. Although by some measures market volatility is no higher today than before the financial crisis, after a heightened period from late 2007 through 2011, the likelihood of quick swings from low volatility to high volatility has increased markedly.

If most of the intermediaries influencing corporate policies are in fact acting with a short-term perspective, why is it likely that the things that they advocate for will be wise for human investors? Active trading strategies are unlikely to beat the market.[197] In fact, those who purport to advocate for stockholder direct democracy tend to tout the semi-strong form of the efficient market hypothesis in favor of their argument. But they ignore that the claim of the efficient market hypothesis is not that a corporation's stock price at any time is a reliable estimate of fundamental value, but rather that it is not possible to design a trading strategy that will outguess the guesses of the market as a whole.[198] Stockholder direct democracy advocates then compound that by arguing to place more and more immediate power behind the views of marginal traders—i.e., those traders who are most likely to be engaged in active, speculative trading strategies dependent on their ability to outguess the market.

Hedge funds, at least of the kind we are focused upon here, argue that their deviation from passivity can result in higher than market returns because they assume non-diversifiable risks and acquire attributes of control from which they can influence corporate policies and extract alpha.[199] They also argue passionately for the right to secure a big

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Tracy Alloway, *Market Volatility Has Changed Immensely*, BLOOMBERG (Sept. 8, 2015), http://www.bloomberg.com/news/articles/2015-09-08/market-volatility-has-changed-immensely [http://perma.cc/7H39-CU4X]. Market participants attribute this, in part, to an increase in direct speculation on volatility indices. *Id*.

197. *See generally* Malkiel, *supra* note 43 (collecting studies suggesting financial markets are efficient enough that investors can't earn above-average risk adjusted returns).

198. Bratton & Wachter, *supra* note 41, at 692; *cf*. Coffee & Palia, *supra* note 6, at 573 ("[O]utperforming the market as a passive [i.e., non-activist] stock picker is hard to do consistently (and impossible if we assume the market to be efficient).").

199. *See, e.g.*, *About Us*, TRIAN PARTNERS (2016), http://www.trianpartners.com/about-us [http://perma.cc/5JLP-DZGA] ("Trian's strategy involves investing in public companies with attractive business models that Trian believes trade significantly below intrinsic value due to operating underperformance. Trian believes that its core competency is its ability to optimize the profitability of the companies in which it invests by working constructively with management and the board of directors to execute Trian's operational and strategic initiatives designed to increase the company's overall value."); *Our Company*, THIRD POINT (2013), http://www.thirdpoint.com/our-company [http://perma.cc/RZY4-8RYF] ("Third Point employs an event-driven, value-oriented investment style. The Firm seeks to identify situations where we anticipate a catalyst will unlock value."); *Overview*, STARBOARD VALUE (2016), http://www.starboardvalue.com/overview [http://perma.cc/MD4D-E9L6] ("[Starboard employs] a focused and fundamental approach to investing in

stake before coming public because it is precisely the nonpublic information they possess—their plans to influence the target's business strategy—that is not baked into their pre-13D disclosure purchase price. The reason, therefore, that activists can supposedly beat a market return is that they can keep post-purchase gains based on their ability to change the company's earnings potential in a way that will increase its share price. The industry's ability to claim success in that regard is compromised, however, by a few realities. Even at the most optimistic of estimates, the returns generated by hedge funds as a whole do not seem to exceed those of the market on a risk adjusted basis.[200] And the most optimistic is not the most reliable. Public CEOs that manage corporations into insolvency do not tend to get second acts. But hedge funds fail regularly,[201] and the industry-wide data about their returns is likely overstated in a material way by the failure to consider this reality.[202] Of course, it is not surprising that hedge funds would fail more; af-

publicly traded U.S. companies. Starboard invests in deeply undervalued companies and actively engages with management teams and boards of directors to identify and execute on opportunities to unlock value for the benefit of all shareholders.").

200. When comparing against benchmarks and adjusting for hedge-fund-specific data biases, studies have found that hedge funds materially underperform their relevant benchmarks. Mila Getmansky et al., *Hedge Funds: A Dynamic Industry in Transition* 21 (Nat'l Bureau of Econ. Research, Working Paper No. 21449, 2015), http://ssrn.com/abstract=2645525 [http://perma.cc/2ZV9-AHWD]. At least one analysis found that, in the aggregate, investors would have been better off putting money into Treasuries than hedge funds. Lack, *supra* note 160, at 14. The measurement time frame is very important. Studies examining returns before the late 1990s and early 2000s tend to find positive risk-adjusted returns, albeit not necessarily performances that materially exceed a benchmark index. Getmansky et al., *supra*, at 21. But even some of those studies find that their positive returns result from a limited number of months within a multi-year sample period. *Id*. Additionally, even when studies have found only short-term persistence in strong performance, evidence of long-term persistence in strong performance is elusive. *Id*. at 24 (observing that overall evidence is "mixed" although most studies focused on hedge fund industry returns found persistence in the short term, if at all); *see also* Nir Kaissar, *Hedge Funds Have a Performance Problem*, BLOOMBERG GADFLY (Mar. 24, 2016, 10:23 AM EDT), http://www.bloomberg.com/gadfly/articles/2016-03-24/hedge-funds-have-a-performance-problem [http://perma.cc/W349-7VJ2] (showing that ten-year returns peaked for equity hedge funds in February 2000 and have declined by an order of magnitude since then). The same general decrease in returns exists for hedge funds focused on strategies other than equity trading, e.g., macro funds. Kaissar, *supra*.

201. *See supra* note 55 and accompanying text.

202. *See supra* notes 55-56 and accompanying text.

ter all, the argument is that they are taking more risk to get more gain. The question, though, is why anyone who believes in the efficient market hypothesis would embrace the idea that hedge fund managers as a class were likely to beat the market. Sure, there may be the fund manager who types Shakespeare for a decade or so, but that anomaly is likely to be just that. Investors who thought high-flying hedge fund activists were writing *A Midsummer Night's Dream* earlier this decade likely found their 2015 reports announcing record-breaking poor performance to read more like a disgraced politician's "mistakes were made" speech.[203] And the hedge fund industry's overall performance has decreased steadily since the late 1990s,[204] raising questions about whether hedge fund activists can continue to grow and find high-quality targets.[205] More fundamentally, if it is now the case that hedge funds predominantly focus on consistently profitable firms that they believe should pay out more to their investors now,[206] there is less reason to think they are making the economy much more efficient and more reason to be concerned that they are perhaps pushing steady producers of societal wealth on a riskier course that has no substantial long-term upside.

Another worrying trend in this republic is the unmooring of corporate citizenship. Corporate citizenship is not tied to any natural conception of citizenship, and so-called American corporations have a large international investor base and derive large portions of their revenues from offshore operations. The adage that "what's good for GM is good for America"[207] is likely to induce justifiable eye rolling if it is applied to many American corporations now. In fact, many household names have abandoned the U.S. as their domicile altogether, putting the chance to secure a tax haven and calmer governance controls over any concern

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203. *See* Jen Wieczner, *Why Big Investors Are Finally Pulling Their Money out of Hedge Funds*, FORTUNE (Mar. 2, 2016, 2:35 PM EDT), http://fortune.com/2016/03/02/hedge-fund-investors-withdraw-returns/ [http://perma.cc/QCJ5-A367].

204. *See supra* note 200 and accompanying text.

205. *See supra* note 64 (discussing changes in activist targets from underperforming companies to profitable firms and an associated decrease in returns).

206. *See supra* note 104 and accompanying text.

207. *See* Wilson, *supra* note 142.

for national identity.[208] American institutional investors have been happy to support these abandonments of our nation.

No doubt, it would markedly overstate things to attribute stagnation in median wages, simultaneous explosive growth in executive compensation and pay for financial industry participants, and overall income and wealth inequality to the increasing ability of momentary stockholder majorities to influence corporate behavior through the adoption of corporate governance policies moving corporations toward a form of direct democracy. But it would also be wrong to ignore the influence that enhancing the power of a stock market focused on immediate gratification has on the way public corporations approach doing business. Investing in their workers' productivity to increase profits over the long term takes more time than offshoring jobs to nations where workers receive pay that none of the advocates of stockholder power would accept for themselves or their children. Keeping the market happy with stock buybacks, special dividends, or a tax-slashing inversion may involve less headache than sticking by a thoughtful, substantial program of long-term capital investment. Shortcuts become comparatively more tempting when those who wield the power seem more focused on near-term returns than cultivating sustainable wealth.

Admittedly, these big picture facts cannot be solely or primarily attributed to policy moves within corporate law itself or to the increasing power of institutional investors and immediate stock market sentiment over public companies. Trends like vigorous international competition that accelerated rapidly since the 1970s, the reduction in legal protections for constituencies like organized labor, and evolving technologies have influenced how American public corporations have done business and had an effect on key issues like employment and wage growth, income inequality, and the extent to which corporations can engage in gain-sharing between their equity investors and other corporate constituencies, such as workers and the communities in which the corporation operates. Likewise, with the globalization of not only product and service markets, but stock ownership itself, corporations have increasingly lost any genuine national identity.

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208. Zachary Mider & Jesse Drucker, *Tax Inversion*, BLOOMBERG QUICKTAKE (Apr. 6, 2016, 5:15 PM UTC), http://www.bloomberg.com/quicktake/tax-inversion [http://perma.cc/DE9R
-RGU9] (reporting that more than fifty U.S. companies have reincorporated in low-tax jurisdictions and twenty have done so in the last four years).

The intra-agent skirmishes of this corporate republic do not fit nicely with the needs of those agents' supposed masters—human investors. As Part I explained, real humans are stuck in for materially longer periods of time, and they obtain most of their wealth through wages, rather than the markets. What wealth does come from the markets is derived from a mixture of equity and debt. These special attributes of human investors, distinct from the other members of the corporate republic, give them disproportionate exposure to whatever risks hedge funds generate for our country. As I discuss in the next Part, human investors face two main areas of exposure: as indirect investors in hedge funds themselves and as participants in the real economy businesses in which activist hedge funds intervene.

IV

Hedge funds, as one peculiar class of agents in this corporate republic, have the potential to cause harm to human investors in two different capacities. One that is too often overlooked is that human investors bear risk as indirect investors in hedge funds themselves. The hedge fund industry's growth has been increasingly fueled by investments made by pension funds to which human investors are looking for support in their retirement. The other source of potential harm comes from the influence that activist hedge funds have on the policies of public companies. That influence involves, most obviously, the changes hedge funds generate when they target specific companies and those companies accede in whole or in part to the hedge funds' demands. But both proponents and skeptics of hedge funds agree that the influence of activist hedge funds goes beyond the companies they specifically target because the potency of hedge fund activism has an effect on the policies of companies not yet facing the wolf pack's direct attack.[209] Those who fear the wolf rationally have an incentive to do what it takes to

209. *See* Bebchuk et al., *supra* note 5, at 1147-54; Coffee & Palia, *supra* note 6, at 594 (noting that the threat of an activist engagement has been found to pressure non-targeted firms "to cut back on long-term investments and increase shareholder payout"); Martin Lipton, *The Bebchuk Syllogism*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Aug. 26, 2013), http://corpgov.law.harvard.edu/2013/08/26/the-bebchuk-syllogism/ [http://perma.cc/57F9-HKZB] ("There is no way to study the parallel universe that would exist, and the value that could be created for shareholders and other constituents, if these pressures and constraints were lifted and companies and their boards and managements were free to invest for the long term.").

avoid an encounter, by deciding to adopt strategies that make it less attractive to the wolves to mount an attack.

A.

Although typically unable to invest in hedge funds on their own, human investors are still frequently directly exposed to hedge fund gains and losses. Human investors are locked out of direct investments in hedge funds themselves by a variety of paternalistic, if well-meaning, rules, which include requirements that investors must be able to change their allocation of investments in 401(k)s at least once every three months,[210] and by the reality that almost all hedge funds offer only unregistered securities and are thus prohibited from securing investments from anyone who is not a so-called "accredited investor" under Regulation D.[211] But those prohibitions do not mean that human investors, or important societal institutions, such as our hugely subsidized university sector and many charities, do not bear investment risk if hedge funds fail or deliver returns lower than the market, on a risk-adjusted basis. It just means that human investors are dependent on the sophistication and fidelity of pension boards and other fiduciaries. Count me skeptical that there has been an exponential growth in the base of sophisticated pension board fiduciaries, which renders them able to assess the quality and prudence of hedge fund investments well, at least in the absence of better data than are currently available.[212]

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210. 29 C.F.R. § 2550.404c-1(b)(2)(ii)(C)(1) (2015). Hedge funds typically impose a variety of requirements that make it difficult for investors to achieve instant liquidity. *See, e.g.*, *All Locked-Up*, ECONOMIST (Aug. 2, 2007), http://www.economist.com/node/9596328 [http://perma.cc/9X4F-XQ9C]; Ross Ford et al., *Liquidity: Overview of Hedge Fund Liquidity Structures*, PREQIN (Dec. 2012), http://www.preqin.com/docs/newsletters/hf/Preqin_HFSL_Dec_2012 _Liquidity_Structures.pdf [http://perma.cc/RP9R-6UQ6] (describing hedge fund restrictions on redemptions).

211. *See* 17 C.F.R. § 230.501(a) (2016).

212. *See e.g.*, Elizabeth Parisian & Saqib Bhatti, *All That Glitters Is Not Gold*, ROOSEVELT INST. (2015), http://rooseveltinstitute.org/wp-content/uploads/2015/12/All-That-Glitters-Is-Not -Gold-Nov-2015.pdf [http://perma.cc/3JC6-SHWJ] (noting that hedge funds were responsible for significant investment losses for pension funds).

The accredited investor exception has its origins in allowing rich investors to engage in caveat emptor transactions if they wished.[213] I think of it as the Thurston Howell exception because that iconic figure from Gilligan's Island comes to mind as the sort of person policymakers believed could proceed at his own risk because we did not particularly care if he got hurt.[214] But that exception has ballooned into one that exposes far more than super-wealthy individuals to substantial risk from making investments about which they know too little. Because pension funds, charities, and universities can qualify and claim to be sophisticated,[215] they regularly now expose human investors and society as a whole to the risks that come with hedge fund investing. Many pension funds are not in fact well positioned to prudently select hedge funds or other non-registered investments and may be attracted to those types of investments because they have not prudently funded and invested the pension fund in the past.[216] Thus, they chase the impossible dream

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213. *See Report on the Review of the Definition of "Accredited Investor*," SEC. & EXCHANGE COMMISSION 2 (Dec. 18, 2015), http://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf [http://perma.cc/6PVD-D42A] (remarking that the concept of an accredited investor was "intended to encompass those persons and entities whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary" (quoting Regulation D Revisions; Exemption for Certain Employee Benefit Plans, 52 Fed. Reg. 3015 (Jan. 16, 1987))).

214. *Id*. Thurston Howell III has appeared at number nine on Forbes Magazine's "Fictional 15" list of the wealthiest figures in popular fiction. Michael Noer, *#9 Howell III, Thurston*, FORBES (Dec. 11, 2007), http://www.forbes.com/2007/12/11/thurston-howell-money-oped -books-cx_mn_fict1507_1211howell.html [http://perma.cc/2FJ7-9HJP].

215. 17 C.F.R. § 230.501(a) (2016) (including in the definition of accredited investor "any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000" and "[a]ny organization described in section 501(c)(3) of the Internal Revenue Code . . . with total assets in excess of $5,000,000"); *see also* Cheffins & Armour, *supra* note 53, at 89-90 (describing how rule changes in the mid-1990s allowed greater institutional investor participation in hedge funds).

216. *See* Parisian & Bhatti, *supra* note 212, at 4 ("[H]edge funds failed to deliver significant benefits to any of the pension funds we reviewed."); *id*. at 3 (arguing that pension fund motivation for selecting hedge funds was the "promise [of] outsized returns"). Some pension funds have gotten burned after they rushed to alternative asset managers, like hedge funds, to fill funding gaps. For example, after the dot-com crash caused steep losses, the Austin Police Retirement System moved almost half of its assets to alternative managers, only to experience another steep

of using above-market returns to fill a hole left by previous underinvestment and poor investing, creating a probability that when the impossible dream does not come true, the hole is even larger. And although the direct investor who makes these investments is accredited, it is the human investor (who is supposedly unable to invest in these vehicles) who in fact bears the risk of investment losses. Making this system even less rational is the reality that the lack of disclosure puts consumers like pension funds and college investment funds in a poor position to shop knowledgeably because track record information is unclear and unreliable, and fund managers seem to be able to tout publicly return records that put to the side their past failures.

The other major question is whether hedge fund activism can actually scale in an effective and rational way, if the hedge funds who engage in the activism are to be a prudent investment for socially important institutions upon which human investors depend, such as pension funds, universities, and charities.[217] As has been discussed, as hedge fund ac-

decline in the financial crisis. Julie Creswell, *Pensions Find Riskier Funds Fail To Pay Off*, N.Y. TIMES (Apr. 1, 2012), http://www.nytimes.com/2012/04/02/business/pension-funds-making-alternative-bets-struggle-to-keep-up.html [http://perma.cc/RU6R-DT78]. The Teacher Retirement System of Texas has similarly moved into alternatives, committing slightly under a third of its assets to various private equity and hedge fund managers to try to make up losses from the financial crisis. Michael Corkery, *Pensions Bet Big with Private Equity*, WALL ST. J. (Jan. 24, 2013), http://www.wsj.com/articles/SB10001424127887323485704578258242293295894 [http://perma.cc/5TW7-5845] (describing, among other investments, a material stake in the hedge fund Bridgewater Associates).

217. LO, *supra* note 56, at 16 ("As assets under management increase, it becomes progressively more difficult for fund managers to implement strategies that are truly uncorrelated with broad-based market indexes like the S&P 500."). Concrete examples exist too. In a study conducted on the University of California's twelve-year experiment with hedge fund investments, AFSCME Local 3299 found that that the University of California could have saved $950 million in fees and generated the superior returns it sought by investing in low-cost, traditional asset classes. There was a strong, positive correlation between the University of California's hedge fund-based returns and general market returns, showing that the University paid upward of $1 billion in fees for returns that largely mirrored the trends in the stock market. The University's hedge fund program yielded a cumulative 112% in net returns whereas, excluding hedge fund investments, the returns were 168%. *See Missing the Mark: How Hedge Fund Investments at the University of California Shortchange Students, Staff and California Taxpayers*, AFSCME LOC. 3299 (Jan. 2016) http://www.afscme3299.org/documents/media/WhitePaper_MissingTheMark.pdf [http://perma.cc/522R-7JS3]. Pension funds have also suffered because of unsuccessful investments in hedge funds. The New York Times reported in April 2012 that the $26.3 billion Pennsylvania State Employees' Retirement System had paid $1.35 billion in management fees during the prior five years and reported a five-year an-

tivism has grown, its targets have shifted to profitable companies that they think can be even more so,[218] but there is also evidence that returns from this shift are less substantial.[219] At the same time, more money managers and more money are chasing what seem to be a finite set of high-growth opportunities,[220] and that competition is vigorous, so it is not clear that hedge funds will be able to find value gaps that will produce the above-market returns required to justify their greater costs and risks as a larger industry,[221] and the evidence to date is that industry-wide hedge fund returns generate either a small amount of return over a safer buy-and-hold market-based strategy, or in fact, are lagging the market.[222] Because the activist hedge funds are pursuing strategies in strong tension with what the efficient market hypothesis and market

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nualized return of 3.6%, well below the 4.9% median return among public pension systems. Creswell, *supra* note 216. In the wake of these developments, some pension funds have increased their allocation to passive management and reduced the money given to private equity funds and hedge funds. *See, e.g.*, Timothy W. Martin, *What Does Nevada's $35 Billion Fund Manager Do All Day? Nothing*, WALL ST. J. (Oct. 19, 2016), http://www.wsj.com/articles/what-does-nevadas-35-billion-fund-manager-do-all -day-nothing-1476887420 [http://perma.cc/7R68-ZEBC] (profiling the head of the Nevada Public Employees' Retirement System, which has moved all of its holdings to passive funds but has returns over one-, three-, five-, and ten-year periods besting pension funds such as CalPERS).

218. *See supra* note 64 and accompanying text.

219. Brav et al., *supra* note 5, at 2726 ("[W]e find that the improvement in production efficiency associated with hedge fund activism is more pronounced when the activist targets operational issues, such as business strategies or asset sales, relative to when the activist targets general undervaluation or capital structure issues."); *see also id*. at 2739 tbl.5 (providing statistics behind Brav et al.'s findings).

220. John Authers & Robin Wigglesworth, *Pensions: Low Yields, High Stress*, FIN. TIMES (Aug. 22, 2016), http://www.ft.com/content/8a54a0c6-648b-11e6-a08a-c7ac04ef00aa [http://perma.cc/F84K-B5WB] (describing pension deficits and pension funds' focus on finding better-yielding—usually riskier—investment opportunities driven by the increasing number of retirees and low interest rates).

221. Lack, *supra* note 160, at 15 (finding decreasing overall returns as the hedge fund industry has increased in size); *cf*. Eileen Appelbaum & Rosemary Batt, *Are Lower Private Equity Returns the New Normal?*, CTR. FOR ECON. & POL'Y RES. 3 (June 2016), http://cepr.net/images/stories/reports/private-equity-performance-2016-06.pdf [http://perma.cc/N34C-TEFL] (attributing the decrease in private equity returns in part to increased competition among private equity firms for deals and increased capital available to deploy).

222. *See supra* note 200 and accompanying text.

data suggest about prudent long-term approaches to investment, these factors suggest reason for concern that it is socially useful to have important institutions that ordinary investors depend upon investing in hedge funds, especially given the dearth of reliable and consistent information available about them.[223]

B.

The other way that human investors are exposed to the risk of hedge fund activism is the one that is more often discussed. That involves the question of whether hedge fund activism has a positive or negative effect on the long-term performance of the public companies it targets. Because human investors bear risk as indirect investors in public companies and, more importantly, as workers dependent on the economy's ability to create and sustain good jobs, this issue is very important. This exposure is not limited to firms directly targeted by activists. As Professors Coffee and Palia observe, summarizing studies on the topic, "[f]or every firm targeted [by activists], several more are likely to reduce R&D expenditures in order to avoid becoming a target."[224] A detailed survey of top managers and directors found that corporate boards were not only feeling increasing pressure to think and act short-term, but that boards and managers were themselves more and more likely to propose the types of corporate finance moves, such as increasing stock buybacks, that they perceived activist hedge funds would likely advocate.[225] Other companies, perhaps including those in this country's dynamic sectors, try to find ways to avoid the wolf. An incisive market participant argued to me that stockholder activism is having an influence on even the faster-growing segments of the economy.[226] He noted that because even the most successful companies have been

223. *See supra* notes 51-57 and accompanying text.

224. Coffee & Palia, *supra* note 6, at 576 (summarizing studies on the topic).

225. Dominic Barton et al., *Rising to the Challenge of Short-Termism*, FCLT GLOBAL 8-10 (2016), http://www.fcltglobal.org/docs/default-source/default-document-library/fclt -global-rising-to-the-challenge.pdf [http://perma.cc/7Z8P-QPJJ]. Also, the propensity of managers and directors to say "more-vocal activist investors," which was the most important driver of pressure for short-term performance, doubled in the three years since the last survey took place. *Id*. at 10.

226. E-mail to author (Oct. 17, 2016, 12:44 PM) (on file with author).

targeted by activists,[227] entrepreneurs in the technology space are insisting on securing a dual-class structure or other strong defenses if they go public, or they consider avoiding activism another advantage to remaining private.[228]

For human investors, the overall trends as to the factors relevant to the question of if activism harms or helps them are, at the least, worrying. American public corporations seem to be spending much more of their free cash flow on stock buybacks, increasing dividends, and other tactics to guarantee immediate payoffs than on research and development and other forms of long-term investment.[229] For the stuck-in human investor, increased dividends have to be invested back into the very companies paying them out, and the same is basically true as to buybacks. And if the sources of those dividends or buybacks are funds that would have otherwise been invested in developing new products or services, which involve the prospect for greater employment opportunities and growth in the future, this choice of current consumption over

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227. *Id*. Apple has been one recent activist target. *See* sources cited *supra* note 106. Other well-performing technology companies that have been recent activist targets include Microsoft, data-storage company NetApp, and design software maker Adobe Systems. David Benoit et al., *Activist Investor Report Card*, WALL ST. J. (Oct. 5, 2015), http://graphics.wsj.com/activist-investor/#FBHS [http://perma.cc/9CF4-KX68]; David Benoit & Vipal Monga, *Are Activist Investors Helping or Undermining American Companies?*, WALL ST. J. (Oct. 5, 2015), http://www.wsj.com/articles/activist-investors-helping-or-hindering-1444067712 [http://perma.cc/U4KC-CHVW]; *supra* note 119 and accompanying text.

228. A prominent venture capitalist made this point as well. In an interview with the Wall Street Journal, Ben Horowitz argued that activist investors increase the likelihood that young, growing companies will refrain from going public. Joann S. Lublin, *Venture Capitalist: Beware of Activist Holders*, WALL ST. J. (July 10, 2012), http://www.wsj.com/articles/SB10001424052702303292204577518733086203236 [http://perma.cc/Q7E5-VB2P].

229. In the second quarter of 2016, forty-four companies in the S&P 500 paid annual dividends exceeding their prior twelve month's net income, reaching a new decade-high. Mike Bird et al., *Dividends Eat up Bigger Slice of Company Profits*, WALL ST. J. (Aug. 18, 2016), http://www.wsj.com/articles/dividends-eat-up-bigger-slice-of-company-profits-1471565154 [http://perma.cc/56XE-JDBF]. The time horizons of a company's shareholders have been shown to affect managers' decisions about investment—specifically, that "transient" ownership "significantly increases" the likelihood that managers will cut research and development investment for the sake of earnings. Coffee & Palia, *supra* note 6, at 573-74 (quoting Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCT. REV. 305, 307 (1998) (summarizing studies)).

future growth is problematic.[230] Even Professor Brav, who is generally optimistic regarding the effect of hedge fund activism, admits that hedge funds' tool boxes are limited and tend to be concentrated in corporate finance moves,[231] as discussed in Part II. The reason for this, Brav candidly admits, is that most hedge fund managers are financial, not operational or management, experts and "are not experts in the specific business of the target firms."[232]

Another important attribute of human investors is that they are also likely to be invested not just in equity securities, but in debt securities.[233] Without disparaging them, it is not clear that mutual fund families spend a great deal of time worrying about the implications of corporate governance arrangements on their investors in funds that focus on debt securities. As discussed, the voice of debt capital in corporate governance has decreased and tends to become loud only when firms are in actual distress.[234] And under corporate law itself, the corporation's lenders

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230. Taking a broader look at the effect of changes that shift power from management to shareholders (including hedge fund activism) on target companies, one study found that companies experienced a "pop" in performance in the first year after the change, followed by a reverse in gains in terms of sales, profitability, and payouts. Jillian Popadak, *A Corporate Culture Channel: How Increased Shareholder Governance Reduces Firm Value* 3-4 (Oct. 25, 2013) (unpublished manuscript), http://ssrn.com/abstract=2345384 [http://perma.cc/56U6-SSST]. The author concludes that shareholder-centric governance reforms are a "dual-edged sword," by which she means that whatever short-term boost stockholders get is then followed by the risk of a longer-term decline that erases the gain and cuts long-run performance. *Id*. at 4; *see also* Coffee & Palia, *supra* note 6, at 574-76 (describing studies by researchers who nominally fall on both sides of the activist debate but who all tend to find that activist targets reduce spending on research and development after an intervention; and summarizing the studies' findings by stating that "it seems safe to conclude only that research and development expenditures decline significantly in the wake of hedge fund pressure," but conceding that it is possible that targets "increase the profitability of their R&D investments" in the wake of an activist intervention).

231. Brav et al., *supra* note 16, at 1741-44.

232. *Id*. at 1755; *see also* Coffee & Palia, *supra* note 6, at 591 (summarizing studies tending to show "[l]ittle evidence" that activist interventions promote sales growth or increases in assets).

233. *See, e.g.*, *Frequently Asked Questions About 401(k) Plans*, INV. COMPANY INST. (Sept. 2014) http://www.ici.org/policy/retirement/plan/401k/faqs_401k [http://perma.cc/VE68-RXYD] (showing that 401(k) balances included at least 20% fixed income assets, measured as a percentage of assets).

234. *See supra* text accompanying notes 178-180.

have no vote and are left to rely on triggering events of default and other extreme measures.[235] Perhaps for this reason, some scholars have found that rather than creating additional firm value, hedge fund activism engaged in by equity investors has the effect of shifting wealth from debt capital to equity capital.[236] For human investors, especially those in the years when they actually are relying on their investment portfolio to pay for tuition or their expenses during retirement,[237] value shifts of this kind are of dubious, and even perhaps negative, value, especially when solvency risks are considered.[238]

Perhaps more troubling, there is evidence that equity gains from activism come from the workers of the target firm. Because human investors owe most of their wealth to their ability to find and hold a job, and

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235. See Triantis & Daniels, *supra* note 179, at 1075-77.

236. *See* Klein & Zur, *supra* note 64, at 194 & n.11, 224-25 (finding that hedge funds' targets experienced a "significant" post-intervention increase in leverage, often sold off assets, and were less profitable, but paid out more returns to equity); Hadiye Aslan & Hilda Maraachlian, *Wealth Effects of Hedge Fund Activism* 30 (Feb. 2009) (unpublished manuscript), http://www.efa2009.org/papers/SSRN-id1428047.pdf [http://perma.cc/CD3M-79FS] ("[P]art of the overall gain to stockholders is the result of a wealth transfer from bondholders."); *see also* Coffee & Palia, *supra* note 6, at 588-89 (summarizing studies showing, for example, "that there is a wealth transferred from bondholders to shareholders"); Chris Plath, *Shareholder Activism: Impact on North American Corporate Sectors*, MOODY'S INV. SERV. 1 (Mar. 11, 2014), http://www.law.harvard.edu/programs/corp_gov/activist-interventions-round table-2014-materials/2014_03_shareholder-activism-impact-on-na-corporates.pdf [http://perma.cc/5WLE-BBQT] (noting that activist interventions are "[i]n most cases . . . a credit-negative for bondholders"). *But see* Bebchuk et al., *supra* note 5, at 1147 ("[S]ummary statistics for the full universe of activist interventions do not reveal higher odds of financial distress than for non-targeted public companies."); Brav et al., *supra* note 16, at 1732, 1767 (finding no shifts from equity to debt because even though leverage goes up, many targets have no substantial long-term debt, even after increasing near-term payouts).

237. *See* discussion *supra* Part I.

238. *See* Jin Xu & Yinghua Li, *Hedge Fund Activism and Bank Loan Contracting* 25 (AFA 2011 Denver Meetings Paper 2010), http://ssrn.com/abstract=1573217 [http://perma.cc/J8F9-57XD] ("[W]e find that hedge fund activism significantly increases the credit risk of target firms."); *see also* Plath, *supra* note 236, at 1. Human investors also depend on life insurance, and life insurance companies often buy debt securities in order to fund their obligations to pay off policies. Insurance companies buy their bonds looking for the correct durational structure and risk profile, rather than an investment with which they can take an aggressive posture. Kahan & Rock, *supra* note 179, at 296.

from the wages that they receive from their labor,[239] transfers from labor to equity are likely to hurt human investors. In one paper by respected scholars, the authors referred to the activists reducing "labor rents."[240] That is an interesting usage, which suggests that the workers at the target firm were exploiting the equity holders. There are other words than "interesting" for this usage, given the overall trends during the last thirty years of American economic history. During this period, the traditional share that workers have received from increases in their productivity has been eroded substantially to their detriment and to the benefit of equity investors.[241] Given this undisputed reality, as well as stagnation in median income and wage growth,[242] post-activist intervention gains that result from reducing labor rents might well be considered yet another deepening of income inequality that reduces the wealth of the many to benefit the few.[243] Human investors care not just about whether corporations make money, but also about how. Gains that come from squeezing out workers and squeezing those who remain do not promise wealth gains for most human investors, but wealth losses.

Another related issue is the potential costs to human investors in the future, in terms of slower job, wage, and overall economic growth, if hedge fund activism tends to result, both for direct targets of activism and, as a systemic matter, for the overall market, in reduced capital investments. Respected scholars have concluded that after hedge fund activists succeed, targeted firms' research and development spending materially decreases.[244] Now, there are of course contradictory argu-

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239. *See* discussion *supra* Part I.

240. Brav et al., *supra* note 5, at 2753; *see also* Coffee & Palia, *supra* note 6, at 589 (noting that wages and hours worked at target firms stagnate and that the total number of employees may decrease).

241. Lawrence Mishel et al., *Wage Stagnation in Nine Charts*, ECON. POL'Y INST. 4 fig.2 (Jan. 6, 2015), http://www.epi.org/files/2013/wage-stagnation-in-nine-charts.pdf [http://perma.cc/4MFT-HXKS].

242. Josh Bivens et al., *Raising America's Pay: Why It's Our Central Economic Policy Challenge*, ECON. POL'Y INST. 4-5 (June 4, 2014), http://www.epi.org/files/pdf/65287.pdf [http://perma.cc/TYG9-VF2M] (showing that wages for the vast majority of workers have either stagnated or declined since 1979, extending even to college degree holders).

243. Mishel et al., *supra* note 241, at 3 fig.1.

244. One recent study concludes:

> We provide evidence that the presence of short-term investors is associated with cuts in long-term investment to generate earnings surprises, leading to temporary boosts in the stock price. Short-term investors benefit

ments and evidence that hedge fund activists increase the short-term harvest on prior investments and make research and development more efficient.[245] What is worrying, of course, is that most of us realize that it is possible, over some period, to milk an asset (human or machine) to squeeze out more. When a new coach or boss comes in, when the workforce is terrified by the prospects of job cuts, when output is pushed to the max in a blitz, results can go up.[246] But if the changes are not durable and do not involve policies that are sustainable and nurture future growth, the immediate years of robust harvest can portend future famine. Surveys of corporate managers done by scholars have found that: 1) managers feel the pressure to deliver short-term profits and to develop business plans using a horizon that they believe is

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from temporarily inflated stock prices as they subsequently leave the firm so that only long-term shareholders suffer from the reduction in long-term investment and equity value.

Martijn Cremers et al., *Short-Term Investors, Long-Term Investments, and Firm Value* 27 (July 2016), http://ssrn.com/abstract=2720248 [http://perma.cc/7E7E-NG7C]; *see also* Coffee & Palia, *supra* note 6, at 574-77, 590 (noting that activist interventions are associated "with a decline in R&D and long-term investment"); Krishnan et al., *supra* note 64, at 309 tbl.9 (noting that research and development spending decreased post-intervention in the aggregate for a collection of 396 of 447 interventions studied); *supra* notes 229-232 and accompanying text. *But see* Klein & Zur, *supra* note 64, at 220-21 tbl.VIII (finding negative effects to creditors but no drop in spending on research and development in the first year after a hedge fund activist intervention, and suggesting that other activist interventions reduce research and development more than hedge fund interventions). There is also more generalized evidence suggesting short-term shareholders decrease companies' research and development spending. Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCT. REV. 305, 307 (1998) (finding that firms with more short-term shareholders are more likely to cut research and development expenses to meet short-term targets). As discussed elsewhere, interventions by certain subsets of activist investors are associated with an increase in research and development. Krishnan et al., *supra* note 64, at 309 tbl.9.

245. Alon Brav et al., *How Does Hedge Fund Activism Reshape Corporate Innovation?* 6-7 (2016), http://ssrn.com/abstract=2409404 [http://perma.cc/2W5S-CSZA] (noting that target firms decrease research and development spending, but do not see a decrease in the quality and quantity of patents); *see also* Coffee & Palia, *supra* note 6, at 576 (noting that activist targets may increase profitability from research and development after an activist engages with the company).

246. *Cf*. Jon Bois, *Should You Fire Your Coach Midseason? A Statistical Breakdown*, SB NATION (Apr. 10, 2012, 12:12 PM), http://www.sbnation.com/2012/4/10/2936696/head-coach-fired-stats [http://perma.cc/UT2D-5X3E] (reviewing changes in professional sports teams' intra-season records when a head coach is fired midseason and showing a slight boost from such firings in the aggregate—with a great deal of underlying variation).

counterproductively short-term;[247] and 2) managers admit to refusing to do projects with very positive long-term prospects because they would involve reductions in GAAP earnings in the near term and therefore a feared negative immediate stock market reaction.[248] Other scholars have looked at the effect of short-term pressure on research and development output and found similar trends.[249] Admittedly, there is also some evidence that the intervention of activist hedge funds who are willing to place experienced business executives on target boards and remain as investors for a period more like a typical private equity investor is not associated with declines in research and development. In contrast, the results in interventions by hedge funds who are more short-term and less focused on a strategy of improving their targets' long-term performance is associated with declines.[250]

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247. Dominic Barton & Mark Wiseman, *Investing for the Long Term*, MCKINSEY & CO. (Dec. 2014), http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/investing-for-the-long-term [http://perma.cc/5N9M-PRYY] (surveying directors and C-suite executives and finding that 79% felt "especially pressured" to demonstrate strong financial performance over a period of two years or less and that 86% of respondents believed that using a longer time horizon would positively affect corporate performance). Managers are possibly pressured to the point of engaging in financial misreporting. Natasha Burns et al., *Institutional Ownership and Monitoring: Evidence from Financial Misreporting*, 16 J. CORP. FIN. 443, 454 (2010).

248. *See* John R. Graham et al., *Value Destruction and Financial Reporting Decisions*, 62 FIN. ANALYSTS J. 27 (2006) (surveying a material group of executives willing to trade long-term growth for smoother earnings).

249. For example, one study, using research-analyst coverage as a proxy for pressure to focus on the short term, found that the number of granted patent applications and citations of those applications by other parties was inversely related to the intensity of analyst coverage. Jie (Jack) He & Xuan Tian, *The Dark Side of Analyst Coverage: The Case of Innovation*, 109 J. FIN. ECON. 856 (2013).

250. One interesting example of this work is a study of the Hermes UK Focus Fund, which has a blended private equity and hedge fund model, where researchers were afforded unusual access to the fund's private records. Marco Becht et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund*, 22 REV. FIN. STUD. 3093 (2009). Hermes is generally regarded as a strong performer and the researchers determined that over 90% of the fund's excess return was related to activism. *Id*. at 3096. The vast majority of interventions were never public and involved "numerous meetings and telephone calls" both with senior executives as well as other executives, such as divisional managers. *Id*. at 3109 tbl.5. The fund's median holding period was around two-and-a-half years, although that masks material variation, with Hermes holding many of its targets closer to three to four years. *Id*. at 3107 tbl.3. This is materially longer than results recorded studying hedge funds more broadly. *See* Coffee & Palia, *supra* note 6, at 567 (summarizing studies). Intervention by Hermes was connected with an increase on

Setting aside the effect activism has on the internal workings of its targets, how stock prices increase matters to human investors. For example, a good deal of the stock price gains that scholars claim result from hedge fund activism come in the form of returns from targets pushed or nudged into sale mode.[251] It is, of course, the case that hedge funds sometimes come in on the buy side to argue that the buyer is making an improvident acquisition, sometimes an acquisition urged by another activist.[252] What seems less clear is that there is anything like symmetry in this context, as it seems unlikely and not borne out by experience that hedge funds have often come into ownership of acquiring firms to block an improvident acquisition.[253] By contrast it has often been the case that hedge funds have bought into corporations and pushed them to sell themselves.[254] There is evidence, in fact, that activ-

return on assets that was sustained after the fund exited the investment. Becht et al., *supra*, at 3097, 3118 tbl.10. Although Hermes often called for asset sales and other typical activist goals, its goals were as often operational in nature, involving calls for changes in company strategy, as often as they were financial, involving changes in the firm's payout policy. *Id*. at 3112 tbl.6 (comparing the "Financial policies" category of goals with the "Other policies" category). Even when viewed in this comparatively positive light, though, Hermes's interventions may not have been universally positive for human investors: in twenty-eight out of thirty interventions, at least one of the fund's goals included asset sales or restrictions on new investments, *id*. at 3097, and companies targeted for restructuring by the fund substantially decreased the number of their employees after the fund's intervention, *id*.

251. Brav et al., *supra* note 16, at 1759; Coffee & Palia, *supra* note 6, at 588 ("[C]hanges in the expected takeover premium, more than operating improvements, account for most of the stock price gain, both in short-term and long-term studies."); William W. Bratton, *Hedge Fund Activism, Poison Pills, and the Jurisprudence of Threat* 13 (Univ. of Pa. Law Sch. Inst. for Law and Econ. Research Paper No. 16-20; Eur. Corp. Governance Inst. Working Paper Series in Law Paper No. 330/2016) (Sept. 1, 2016), http://ssrn.com/abstract=2835610 [http://perma.cc/MU7Q-JS7S] (summarizing studies and observing that "[t]here is no question that activism prompts mergers"); *see also* Yvan Allaire & François Dauphin, *The Game of 'Activist' Hedge Funds:* Cui Bono*?*, INT'L J. DISCLOSURE & GOVERNANCE 18 ("[T]he large gains *realized by hedge funds* [came] from getting targeted companies sold off.").

252. Bratton, *supra* note 46, at 1426.

253. Brav et al., *supra* note 16, at 1742 tbl.I (noting that 2.4% of studied hedge fund activism involved buying the shares of an acquirer in a pending acquisition to block the deal or push for better terms).

254. *See id*. (noting that 14% of studied hedge fund activism involved urging the sale of a target to a third party). *See generally* Nicole M. Boyson et al., *Activism Mergers*, J. FIN. ECON. (forthcoming 2017) (noting that the probability of a company receiving a takeover bid is three times larger for companies in which a hedge fund switches

ism aimed at encouraging the target company to sell itself provides the best returns for the activists.[255] And to the extent that some hedge funds enter the target side to goose up an already large premium, the potential for negative effects to employees and communities grows, as the only way for the buyer to maintain the profitability of the surviving entity is to jack up the "synergy gains" from the merger, gains that often involve cutting jobs, slashing wages, and closing operations in some communities. In other words, activism of this kind can actually increase the dangers of mergers to human investors.

Human investors experience the benefits and risks of this sort of merger or sale differently from their agents. For one thing, target-side gains must be weighed against buy-side losses. A good deal of evidence exists that mergers are often injurious to the buying firm and its stockholders.[256] If human investors tend to be diversified and a merger involves two public companies, it will often, if not usually, be the case that the human investor has a stake in both sides of the merger.[257] The question for the human investor is whether the costs of the merger outweigh the benefits, a question that cannot be answered without evaluating the costs to the buying firm and whether the wealth that will be gen-

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from being a passive investor to an activist investor in the company, compared to companies that did not experience such a switch).

255. Brav et al., *supra* note 16, at 1759; Coffee & Palia, *supra* note 6, at 588. *See generally* Allaire & Dauphin, *supra* note 251 (noting that the most lucrative opportunities for activists involve a sale of the target company or a spinoff of some of its assets). One troubling case study on this point involves Timken Steel, by all accounts a well-run midwestern steel manufacturer that had delivered steady profits and was beginning to reap the rewards of a multi-decade investment program, but became a target for an activist urging the company to sell or break itself up to achieve a higher market value. Nelson D. Schwartz, *How Wall Street Bent Steel*, N.Y. TIMES (Dec. 6, 2014), http://www.nytimes.com/2014/12/07/business/timken-bows-to-investors-and-splits-in-two.html [http://perma.cc/RVJ5-XG4N]. The company ultimately acceded to the activist's demands and split apart, delivering a strong stock price return but creating great uncertainty about the two new companies' respective futures. *Id*.

256. *See, e.g.*, Sara B. Moeller et al., *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757, 757 (2005) (noting that acquiring-firm shareholders lost twelve cents per dollar spent on acquisitions).

257. Maria Goranova et al., *Owners on Both Sides of the Deal: Mergers and Acquisitions and Overlapping Institutional Ownership*, 31 STRATEGIC MGMT. J. 1114, 1115 (2010) ("A cursory analysis of the 2,688 M&A deals involving publicly traded companies during 1998-2004 from the Bloomberg database reveals that in 41.7 percent of the deals, the acquiring and target firms shared some of the same owners.").

erated by the single entity after the merger exceeds that which would have been expected had the firms continued to operate independently. What is likely, as scholars have long detailed, is that the acquirer in a merger will not do well, and for many mergers, it is not clear that the net gains to diversified investors from the premiums paid to them as owners of targets are outweighed by the collective losses.[258]

Those stock price losses may not constitute the only way human investors lose out in a hedge fund-induced merger. For human investors, of course, the other costs involved in mergers—which can often involve job losses for workers, demands on state and local governments to provide subsidies as a cost of keeping operations, and the diverse harms that can occur when an acquisition is done at such a high premium that the resulting firm cannot pay its creditors from operations after the merger and must enter bankruptcy[259]—are very real and little focused on by corporate law scholars.

In certain activism campaigns, activists have set off a chain of events that have caused a transfer in wealth from society as a whole to equity investors. For example, to the extent that activists have pushed for inversion transactions that reduce the duty of previously American corporations to pay taxes,[260] the burden to fund important American pri-

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258. Bratton, *supra* note 46, at 1424-25 (observing that the "merger premium appears in most cases to be so substantial as to arrogate the entire merger gain to the selling shareholders," and that a study looking at combined gains and losses from mergers from 1991 to 2001 found mergers caused a combined loss of $90 billion in stock price terms).

259. *See* Neil Fligstein & Taek-Jin Shin, *Shareholder Value and the Transformation of the U.S. Economy, 1984-2000*, 22 SOC. F. 399, 401 (2007) ("[M]ergers subsequently led to more layoffs, consistent with the shareholder value perspective that emphasizes that firms needed to deploy their resources more efficiently as they reorganized."); Paul M. Healy et al., *Does Corporate Performance Improve After Mergers?* 15 (NBER Working Paper No. 3348, 1990) (finding that the median number of employees and employee growth rate at merged firms decline post-merger); William D. Schneper & Mauro F. Guillén, *Stakeholder Rights and Corporate Governance: A Cross-National Study of Hostile Takeovers*, 49 ADMIN. SCI. Q. 263, 275 (2004) (summarizing studies showing that hostile takeovers tend to result in job cuts). *See generally* Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33 (Alan J. Auerbach ed., 1988) (arguing that hostile takeovers enable private benefits even when they are socially undesirable).

260. Many activists have indeed pushed for inversion transactions in the recent inversion wave. *See, e.g.*, David Benoit, *Activist Firms Join Tax-Deal Push*, WALL ST. J. (Aug. 3, 2014), http://www.wsj.com/articles/activist-firms-join-tax-deal-push-1407124167 [http://perma.cc/CAW8-SMWG] (describing the hedge fund Mercato shopping an

orities like national defense, health research, transportation, technologies to address climate change, higher education, and other priorities that matter to Americans—and that provide a support structure within which businesses operate—is shifted to others. Not only that, hedge fund activism has spurred mergers and other activities, such as plant closings and consolidations, that involve wealth transfers to the corporations from society.[261] That does not just involve the obvious costs,

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inversion involving InterContinental Hotels Group PLC); Liz Hoffman & Rob Copeland, *Hedge Funds Bet Big on Overseas Tax Deals*, WALL ST. J. (July 25, 2014), http://www.wsj.com/articles/hedge-funds-bet-big-on-overseas-tax-deals-1406330775 [http://perma.cc/82EQ-WY8B] (describing Sachem Head calling for Helen of Troy Ltd. to find a U.S. buyer for inversion purposes).

261. *See, e.g.*, Liz Moyer, *2 Senate Democrats Introduce Bill To Curb Activist Hedge Funds*, N.Y. TIMES (Mar. 17, 2016), http://www.nytimes.com/2016/03/18/business/dealbook/2-senate-democrats-introduce-bill-to-curb-activist-hedge-funds.html [http://perma.cc/4N3U-BBEC] (explaining that a bill designed to limit hedge fund activism was inspired by a small town in Wisconsin whose economy was devastated after activist fund Starboard Value targeted the Wausau Paper Company, which led to the closing of a paper mill and the elimination of more than a hundred jobs). In the case of Wausau, the hundred jobs were only the beginning—a total of 450 jobs were predicted to be eliminated shortly after Starboard announced its program. John Schmid, *Changes at Wausau Paper To Have a Ripple Effect*, MILWAUKEE J. SENTINEL (Dec. 24, 2011), http://archive.jsonline.com/business/changes-at-wausau-paper-to-have-a-ripple-effect-ko3hkhm-136163678.html [http://perma.cc/ZV7D-7GGE]. The layoffs were predicted to remove at least $72 million a year from central Wisconsin's economy. *Id*. *But see generally* Alon Brav et al., Anti-Activist Legislation: The Curious Case of the Brokaw Act (Oct. 27, 2016) (unpublished manuscript), http://ssrn.com/abstract=2860167 [http://perma.cc/3HED-VWJK] (examining the events driving the Brokaw Act and arguing that activists were not the cause of the mill closures). Other recent examples abound across many sectors of the economy. Design software company Autodesk cut 10% of its workforce within two months of an activist disclosing its stake. Kshitiz Goliya, *Autodesk To Cut Jobs by 10 Percent as It Transitions to Cloud*, REUTERS (Feb. 3, 2016), http://www.reuters.com/article/us-autodesk-restructuring-idUSKCN0VC1OR [http://perma.cc/W6EZ-5HLS]. Rolls-Royce said it would cut three thousand jobs in its aerospace and marine businesses after an activist began agitating for change. Robert Wall, *Rolls-Royce To Cut More Senior Management Jobs*, WALL ST. J. (Jan. 28, 2016), http://www.wsj.com/articles/rolls-royce-to-cut-more-senior-management-jobs-1454013670 [http://perma.cc/S8YU-8T48]. Packaged foods company ConAgra cut one thousand jobs and moved its headquarters from Omaha to Chicago at an activist's behest. Barbara Soderlin, *Jana's Still Hungry: ConAgra's Activist Investor Is Sticking Around, Which Means More Changes May Be on the Way*, OMAHA WORLD-HERALD (June 7, 2016), http://www.omaha.com/money/jana-s-still-hungry-conagra-s-activist-investor-is-sticking/article_612c8b4f-6bcf-5a5f-93df-8299d279fd4f.html [http://

such as increases in government expenditures for unemployment and other dislocation costs when workers are displaced, but also involves the arbitrage corporations engage in with affected communities when they are squeezed by stockholders. In a case that hits close to home for me, inthe activism campaigns at DuPont and Dow that resulted in their decision to merge, any resulting gains to equity holders will involve direct shifts from taxpayers in Delaware, Iowa, and Indiana.[262] In Dela-

perma.cc/MB38-BM2T]. Qualcomm provides another example, having announced plans to cut around 15% of its workforce after an activist took a stake in the company. Liana B. Baker, *Qualcomm President Says Splitting Company May Not Create Value*, REUTERS (Sept. 3, 2015), http://www.reuters.com/article/us-qualcomm-president-idUSKCN0R32HL20150903 [http://perma.cc/7S9D-XD8P]. Still another example is Macy's, the department store chain. After activist Starboard took a stake in Macy's, it began agitating for Macy's to split its property portfolio into separate joint ventures, arguing that the stock market was not giving Macy's adequate "credit" for those holdings. *Unlocking Value at Macy's*, STARBOARD VALUE 4-5 (Jan. 11, 2016), http://www.starboardvalue.com/publications/Starboard_Value_LP_Present ation_M_01.11.16.pdf [http://perma.cc/3UMY-TX73]. Macy's ended up cutting costs by laying off thousands of workers and closing department store locations. Suzanne Kapner, *Macy's To Cut Costs, Thousands of Jobs*, WALL ST. J. (Jan. 6, 2016), http://www.wsj.com/articles/macys-to-cut-costs-thousands-of-jobs-1452115239 [http://perma.cc/WXK4-GY22]. DuPont and its spin-off, Chemours, cut thousands of jobs and closed plants as part of their efforts to address an activist intervention. *See* sources cited *supra* notes 246-247. Over a decade earlier, a distant descendant of the DuPont Company, Hercules Inc., was approached by corporate raider *cum* activist Samuel Heyman. Reid Champagne, *Recalling Hercules*, DEL. TODAY (Dec. 2008), http://www.delawaretoday.com/Delaware-Today/December-2008 /Recalling-Hercules [http://perma.cc/TV47-6PTY]; Andrew Ross Sorkin, *Corporate Raider Tries a Moneyless Coup*, N.Y. TIMES (July 11, 2003), http://www.nytimes.com /2003/07/11/business/corporate-raider-tries-a-moneyless-coup.html [http://perma.cc /DNE2
-TNLZ]. Against that backdrop, Hercules went from 10,000 employees in 2000 to 4,700 in post-activist 2008 when it was purchased by a competitor. Joseph N. DiStefano, *Hercules Inc. Sold; Another Headquarters To Leave Area*, PHILA. INQUIRER (July 12, 2008), http://articles.philly.com/2008-07-12/business/25245304_1_hercules-shareholders-hercules-chief-executive-officer-dow-chemical [http://perma.cc/2BE2-54V6]. In a twist, Hercules's acquirer was later acquired by Ashland Inc., which has more recently shed businesses and jobs at the behest of a different activist. Jack Kaskey & Brooke Sutherland, *Ashland Pushed by Jana Seen Higher with Split*, BLOOMBERG (May 28, 2013), http://www.bloomberg .com/news/articles/2013-05-28/ashland-pushed-by-jana-seen-higher-with-split-real-m-a [http://perma.cc/H8AW-ZM47].

262. Joseph N. DiStefano, *In Delaware, New Incentives for Wealthy DuPont and Dow*, PHILA. INQUIRER (Mar. 28, 2016), http://www.philly.com/philly/business /20160328_In_Delaware__new_incentives_for_wealthy_DuPont_and_Dow.html [http://perma.cc/GZ9V-DD8S]; Christopher Doering & Kevin Hardy, *$17M Deal: No*

ware alone, DuPont and its to-be-named agricultural spin-off asked for and received subsidies from the state and county governments, costing other taxpayers over $57 million over four years for keeping downsized operations in Delaware.[263] These operations are downsized in the important sense of involving operations that employ at least 1,700 fewer workers, many of whom were skilled scientific researchers and technical workers.[264] The hedge fund-inspired merger itself was leveraged by DuPont and Dow to extract value from society itself to give to its hungry equity owners. Whether the merger—which involves two huge science corporations becoming one in order to then become three—will generate more jobs and wealth for Americans in the long term remains to be proven. What is certain is that lots of corporate advisors and others will have generated huge fees when the tumult settles, lots of human investors will have lost jobs, and the affected communities will either have to look to their human citizens to make up for the revenues lost or cut the public services they would otherwise have delivered.

Admittedly, no one wants executive rent seeking or empire building for its own sake. Perhaps hedge funds are operating on companies that face slack competitive pressures to otherwise be efficient in deploying capital? Perhaps they squeeze oligopolies? I suppose this story would be more plausible had we not just gone through nearly fifty years of robust and ever-growing international competition. Yesterday's Japan became today's China, without lessening the vigor of Japanese competition, or Korean, or German, or Swedish for that matter. Even without

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DuPont Ag HQ, but No Jobs Lost Either, DES MOINES REG. (Feb. 19, 2016), http://www.desmoinesregister.com/story/money/agriculture/2016/02/19/iowa-loses-ag-headquarters-new-dow-dupont/80561874 [http://perma.cc/BMJ4-A9XW]; Scott Goss et al., *How Delaware Outhustled Other States To Win DuPont Ag Unit*, NEWS J. (Feb. 21, 2016), http://www.delawareonline.com/story/news/2016/02/20/how-delaware-outhustled-other-states-win-ag-unit/80633980 [http://perma.cc/SS9P-NTHU]; Jeff Mordock et al., *Spinoffs To Stay in Delaware After Dow-DuPont Merger*, NEWS J. (Feb. 20, 2016), http://www.delawareonline.com/story/news/2016/02/19/dupont-dow-name-delaware-headquarters-ag-unit/80599772 [http://perma.cc/HN74-LGU9]; Press Release, Office of Governor Markell, Governor Signs Commitment to Innovation Act (Mar. 17, 2016), http://news.delaware.gov/2016/03/17/governor-signs-commitment-to-innovation-act [http://perma.cc/PZW3-JYEX].

263. Mordock et al., *supra* note 262.

264. Beryl Lieff Benderly, *DuPont Cutbacks Send a Chill Through Delaware's Science Community*, SCI. AM. (June 23, 2016), http://www.scientificamerican.com/article/dupont-cutbacks-send-a-chill-through-delaware-s-science-community [http://perma.cc/H7UR-QP8X].

hedge funds, private equity firms, strategic acquirers, and institutional money managers have had sharp eyes on American public companies. Without doubting that inefficiency will always tend to creep into some organizations, the overall vigor of competition seems to belie the idea that large pockets of "fat" exist that can be cut, cost-free. Thus, fear that what may be occurring are cuts in investments in "muscle" are not irrational, but instead arise from considering the larger facts about the markets and incentive systems within which American corporations and their managers work. And this is the crucial point often lost in corporate governance debates: Just because a fact is large and systemic does not render it unimportant. That a "law and ampersand" scholar can't fit it into his model without creating too much noise does not make the uncomfortable sound of reality go away.

Looking at the big and systemic facts from the perspective of an average American human investor, the world is not an optimistic place. Median income has stagnated since the early 1970s.[265] Productivity increases have slowed and wages never did fully experience the benefit of the rapid productivity increases of the last two decades.[266] Economic growth is stagnant.[267] The government has been compelled to provide giant subsidies to corporations engaged in risky commercial conduct.[268]

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265. Real median household income has hovered around $50,000 since the mid-1970s. *See* Carmen DeNavas-Walt & Bernadette D. Proctor, *Income and Poverty in the United States 2013: Current Population Reports,* U.S. CENSUS BUREAU 5 fig.1 (2014), http://www.census.gov/content/dam/Census/library/publications/2014/demo/p60-249.pdf [http://perma.cc/L3KV-7JYR].

266. Bivens et al., *supra* note 242, at 5 ("Between 1979 and 2013, productivity grew 64.9 percent, while hourly compensation of production and nonsupervisory workers, who comprise 80 percent of the private-sector workforce, grew just 8.2 percent. Productivity thus grew eight times faster than typical worker compensation.").

267. *See* PAVLOS E. MASOUROS, CORPORATE LAW AND ECONOMIC STAGNATION: HOW SHAREHOLDER VALUE AND SHORT-TERMISM CONTRIBUTE TO THE DECLINE OF THE WESTERN ECONOMIES 3 (2013) (arguing that increased short-term focused shareholder influence has contributed to "persistent stagnation" and lower GDP growth).

268. *See* STOUT, *supra* note 193, at 4-5 (arguing that recent events such as the 2008 bailouts illustrate how "[c]orporate America's mass embrace of shareholder value thinking has not translated into better corporate or economic performance"); Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1231 (2012) ("[T]he long-term implications of a short-run income-maximization strategy were apparent, but preserving long-term reputation did little to address immediate earnings pressures."); Tyler Cowen, *Bailout of Long-Term Capital: A Bad Precedent?*, N.Y. TIMES (Dec. 26, 2008), http://www.nytimes.com/2008/12/28/business/economy/28view.html [http://perma.cc/2F8N-P4FB].

At the same time, the number of American public corporations has declined sharply.[269] Finally, there is a growing disparity between the pay of CEOs and that of average workers, symptomatic of a general increase in inequality.[270] These larger considerations raise an issue about hedge fund activism's effect on human investors that is serious. If proponents of hedge fund activism disclaim that activists have contributed to these negative trends—things like growing income inequality, inflated executive pay, job losses, wage stagnation, increases in externalities—and instead attribute them to vigorous international and domestic competition in products and services markets, they must consider the consequences of that answer. If that type of competition is already acting on American public companies, does it add socially useful value for activist investors with short-term perspectives to put additional pressure on them, pressures that tend to involve increases in near-term payouts rather than innovative, long-term investment strategies that position the U.S. and its worker base to thrive in the future? In other words, if competition in products and services markets has already squeezed out most of the slack, the likelihood that pressures that predominantly involve demands for corporate finance moves, like leveraging up, spin

269. David Weild & Edward Kim, *Capital Markets Series: A Wake-Up Call for America*, GRANT THORNTON 1 (2009), http://www.rcgt.com/wp-content/blogs.dir/2/files/2011/04/A_wake_up_call_for_America.pdf [http://perma.cc/PG6J-BWQ9] (noting that between 1997—the peak for U.S. listings—and 2008, the number of exchange-listed companies declined from 6,943 to 5,401); *see also* STOUT, *supra* note 193, at 5 (describing the "go-private" trend).

270. *See* STOUT, *supra* note 193, at 20-21 (noting that the disparity between CEO and worker pay increased after Congress enacted tax policies encouraging linking CEO compensation to stock price increases); Roger Altman et al., *Reforming Our Tax System, Reducing Our Deficit*, CTR. FOR AM. PROGRESS 6-7 (Dec. 2012) http://cdn.americanprogress.org/wp-content/uploads/2012/12/CAPTaxPlanReportFINAL-b.pdf [http://perma.cc/MF3P-TH47] (noting "skyrocket[ing]" income inequality over a period from 1979 to 2007 and the shrinkage of the federal tax rate applied to the wealthiest Americans); Harold Meyerson, *The Forty-Year Slump*, AM. PROSPECT 20-27 (Sept.-Oct. 2013), http://prospect.org/article/40-year-slump [http://perma.cc/2YD8-AN5A] (noting that income stagnation was driven in important part by the embrace of the principle that shareholder wealth maximization is the sole objective for corporate governance and noting that if median household income kept pace with productivity gains from 1974-2013, the income level would be over $86,000, rather than the 2013 level of approximately $50,000); *cf.* COLIN MAYER, FIRM COMMITMENT: WHY THE CORPORATION IS FAILING US AND HOW TO RESTORE TRUST IN IT 185-86, 200, 240 (2013) (arguing that corporate owners with the shortest time horizon are able to concentrate wealth with themselves "at the expense of other stakeholders").

offs, or mergers, will create incentives for corporations to focus their energies on ways of making money that are also good for their workers and society seems less probable.

C.

In the clash between small, less important facts that the law and ampersand movement can measure and evaluate, and bigger, more important ones the movement seems to slight because it cannot, modesty would suggest grappling with the larger facts in as candid a way as possible and not instead exaggerating the significance of less important facts, such as short-term stock market prices, that law and ampersand scholars can turn into mathematical equations and when the smaller facts you measure are themselves less than assuringly reliable, there is even less basis for failing to challenge your ideological world view against the systemic facts.

In that vein, the most hotly debated topic regarding activist hedge funds does not, however, involve whether it is good for human investors for pension funds and charitable institutions invest in them or whether human investors benefit from the changes activist hedge funds work on human investors' employers. Rather, the central topic has been whether hedge fund activism has a positive or negative effect on the stock price performance of public corporations. Specifically, much ink has been spilled on the question of whether companies targeted by hedge funds enjoy durable increases in their stock prices after the activist intervention has occurred, and whether any resulting gains reflect an increase in overall societal wealth or a transfer in wealth from other corporate constituencies to equity holders. These debates are ongoing and vigorous.[271]

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271. The papers in this back and forth have proliferated in recent years. A database started by Professors Randall Thomas, Alon Brav, Wei Jiang, and Frank Partnoy has been the source of numerous articles examining the impact of hedge fund activism on stock prices, corporate creditors, employees, and other workers. Brav et al., *supra* note 16. Later authors whose work uses the database include Yvan Allaire, *The Case for and Against Activist Hedge Funds*, INST. FOR GOVERNANCE OF PRIV. & PUB. ORGS. (2015), http://ssrn.com/abstract=2613154 [http://perma.cc/6WKZ-L8D8]; Allaire & Dauphin, *supra* note 251; Bebchuk et al., *supra* note 5; and Alon Brav et al., *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS FIN. 185 (2010). Other respected law and economics scholars have also contributed to the debate. *See, e.g.*, Bratton, *supra* note 46; Coffee & Palia, *supra* note 6; Cremers et al., *supra* note 244; K.J. Martijn Cremers & Simone M. Sepe, *The*

Distinguished corporate practitioners have also jumped into the fray, complicating the lives of those obsessed with regressions by introducing perspectives from those in the trenches.[272] Firing back, scholars with their own firm ideological views have in turn vexed the practitioners by taking them up on duels regarding what data is necessary to prove their contending perspectives.[273] Although some of the intellectual fisticuffs have a "handbags at six paces" quality, the intensity of the interaction is suggestive of the shared agreement of the participants that the subject they are discussing is societally important.

Empirical data is a very useful thing, and it should not be ignored. But empirical data also involves factual renditions of what is behind a statistic that has been aggregated. For humans interested in knowing about their human world, that means that the story behind statistics matters. And the stories behind the empirical data cited by hedge fund activists seem to mostly involve financial engineering. And what they do not commonly involve is most important. They do not involve tangible stories of technological breakthrough accomplished because hedge funds have identified an innovative new way to make something. They do not typically involve thinking up new services that humans need or even want. They do not typically involve transformational approaches in managing businesses, or in marshalling the productivity of American workers. Even as to interventions by hedge funds led by experienced, proven operators, the scholars have not yet put names of companies to the data, to show how the hedge fund has improved corporate opera-

Shareholder Value of Empowered Boards, 68 STAN. L. REV. 67 (2016); Gilson & Gordon, *supra* note 170; Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362 (2002); Martijn Cremers et al., *Hedge Fund Activism and Long-Term Firm Value* (2015), http://ssrn.com/abstract=2693231 [http://perma.cc/N6WP-7Q9Z].

272. *See, e.g.*, Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681 (2007); Martin Lipton, *Important Questions About Activist Hedge Funds*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Mar. 9, 2013), http://corpgov.law.harvard.edu/2013/03/09/important-questions-about-activist -hedge-funds [http://perma.cc/MP6N-R3NL].

273. The origin of *The Long-Term Effects of Hedge Fund Activism*, Bebchuk et al., *supra* note 5, was a debate between its author, Lucian Bebchuk, and corporate lawyer Martin Lipton. *See* Michael D. Goldhaber, *Marty Lipton's War*, AM. LAW. 44 (Apr. 2015), http://www.siia.net/archive/neals/2016/filez/442068/688_1732_442068_e3453e11-8f7e-4e03-bbee-a396f76c806a_82357_3_1.pdf [http://perma.cc/U3N5-AVQ6].

tions in a durably valuable way.[274] By contrast, examples of operational failures, such as the interventions at J.C. Penney[275] and Sears,[276] are widely known.

Of course, if one could peer behind the regressions and consider the human facts, these overall tendencies are not surprising. Hedge fund managers have typically never managed an actual business that makes a product or delivers a service. For the most part, they are the sidewalk superintendents of management, those who by dint of having gotten a prestigious M.B.A. and being good in finance classes, were recruited into the stock-picking business. Finance is what they were taught and what they focus on. This is not a criticism; it is simply an observation, but one that cannot be logically ignored by anyone concerned about facts. Because if the reality is that the ability of corporations that make products and deliver services to generate sustainable profits turns more importantly on talents that do not involve financial engineering, then why would one rationally expect that business strategies shaped by pressures from hedge funds lacking any substantial managerial, technological, scientific, or entrepreneurial expertise would be engines for long-term wealth creation?

Participants in the debate about our corporate governance system often joust about the comparative relevance of examinations of empirical evidence from relatively short-term periods and of arguments based on more descriptive evidence about how corporations and the institutional investors who influence them behave. I have no desire to disparage either source of information, as it seems to me that someone who is open-minded ought to be willing to consider a variety of relevant fac-

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274. *E.g.*, Krishnan et al., *supra* note 64 (finding meaningful differences in post-intervention return on assets among targets of different groups of activist hedge funds without connecting differences to operation change).

275. *See supra* notes 84, 125-126 and accompanying text.

276. *See* Kevin Allison, *Edward Lampert and His White Whale, Sears*, N.Y. TIMES (Aug. 29, 2016), http://www.nytimes.com/2016/08/30/business/dealbook/edward-lampert-and
-his-white-whale-sears.html [http://perma.cc/9724-V7TH] (comparing the activist head fund manager and CEO of Sears to Captain Ahab); Mina Kimes, *At Sears, Eddie*
Lampert's Warring Divisions Model Adds to the Troubles, BLOOMBERG (July 11, 2013), http://www.bloomberg.com/news/articles/2013-07-11/at-sears-eddie-lamperts
-warring-divisions-model-adds-to-the-troubles [http://perma.cc/M6D9-GJVA] (attributing many of Sears's problems to its hedge fund manager-CEO).

tors in coming to conclusions about important issues of public policy. But being open-minded does not require paying homage to arguable results from arguable data measuring results inarguably inconsistent with the horizon relevant to human investors and relevant to those who actually manage real businesses. As to the debate about wolf packs, there are several factors that make these studies a dubious guide to good policy.

For starters, the gains to target stock prices from hedge fund activism do not seem that impressive, even when taken at face value. Professor Bebchuk's five-year analysis of target company stock price performance finds value-weighted abnormal returns of 5.81% over that five-year period (by another measure, investors would have experienced a slightly negative abnormal return).[277] But these gains are not measured in a way that makes for easy acceptance on that basis. For example, that study starts with 1,584 companies targeted by activism and ends with 694 companies in year five.[278] This is a large drop, and each company's fate is not tracked and documented.[279] Undoubtedly, targets were pushed into sale. Others may have gone insolvent, though. And the overall gains seem largely driven by those targets that did get sold for a premium, rather than by increased productivity or the execution of a new business plan.[280] Scholars who bring a non-ideological perspective to the debate have questioned how sufficiently that study's data supports its findings.[281]

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277. Bebchuk et al., *supra* note 5, at 1126-27.

278. Allaire & Dauphin, *supra* note 70, at 9 (critiquing the study's methodology). The study's authors acknowledged this defect. Bebchuk et al., *supra* note 5, at 1118.

279. Allaire & Dauphin, *supra* note 70, at 9.

280. *See supra* note 251 and accompanying text.

281. Coffee & Palia, *supra* note 6, at 587 n.173. Professors Coffee and Palia observe:

> [Professor Bebchuk's] Table 4, which reports ROA and Tobin's Q over the six years that begin with the event year, shows only five out of twenty regression coefficients in the post-event year (or 25%) to be positive at the standard 95% confidence level. Thus, the majority of coefficients are not positive, which is hardly supportive of their conclusion. They also find that the third, fourth and fifth years after the activist intervention earn higher ROA and Tobin's Q than the year of, or prior to, intervention. But this test is inconclusive because we know that it is significantly affected by the firm's underperformance in the year of, or prior to, intervention. Additionally, in their Table 5, they repeat their analysis, using high dimensional fixed-effects of industry codes and year dummies as controls. This method does not adequately control for firm-level effects.

Duration is another issue. The longest of the studies measure the impact of hedge funds over a period—typically two years, with one important study tracking performance for five years following activist intervention[282]—that is decidedly not long-term. Human investors save for two primary purposes, paying for college for their kids and paying for retirement for themselves. Determining that hedge fund activism is not associated with any negative impact on stock price during a one- to five-year period is not the same thing as determining that the changes in business policy generated by that activism produce more wealth for human investors than a policy not influenced by their behavior.

The argument, of course, is that if the stock price increase driven by activism endures for one to five years, that means that the activism has not reduced the corporation's ability to generate sustainable returns over the long term. But proving that is not only difficult, it also seems to me to require a long-term analysis, which scholars have not done. If market prices are dominated by speculation (i.e., traders with short-term perspectives) and thus those involved in marginal trading tend to be focusing on short-term movements in prices, it seems possible that the changes activists cause could, in fact, reduce the firm's long-term earnings without necessarily causing it to suffer a stock price reduction in the near term.[283] That is especially so if activists are targeting so-called value firms that are profitable but pre-intervention are reinvesting more cash in the business or retaining more of it than other firms. It is, of course, possible that changing their financing to reduce capital expenditures and increase current payouts will have no negative impact on the firm's earnings future, but it is also possible that it will have a

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Id. (citations omitted); *see also* Allaire & Dauphin, *supra* note 70, at 8, 11 (observing that some of the study's results are not statistically significant and that its use of dummy variables "is particularly questionable").

282. *See* Bebchuk et al., *supra* note 5, at 1089, 1099 ("[W]e study how operational performance and stock performance relative to the benchmark evolve during the five-year period following activist interventions," and "we use this dataset of activist interventions to provide the *first systematic evidence* on the *long-term effects* of hedge fund activism." (emphasis added)); Matthew Denes, et al., *Thirty Years of Shareholder Activism: A Survey of Empirical Research* 10-11 (June 8, 2016), http://ssrn.com/abstract=2608085 [http://perma.cc/9WYN-8V6N] (summarizing studies focusing on hedge fund activism with measurement windows largely measured in terms of months, not years).

283. That said, a survey of studies finds that firms targeted by activists do not seem to produce better operating results. *See* Coffee & Palia, *supra* note 6, at 587.

negative impact but that the effects are not felt enough in the near term to have a negative effect on the stock price.

As to this point, this is where ignoring long-term trends and the absence of plausible real-world stories comes in. The big picture for human investors entails declining wages, growing inequality, and greater international competition. At the same time, pension money has flooded into the market and demand has met supply with more funds looking for investments and more analysts searching for value gaps. Between these two trends, it is unclear what story hedge funds have to explain how they create long-term value.

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As the preceding discussion suggests, any policy initiative sensibly designed at better balancing the benefits and risks of hedge fund activism must focus as much, if not more, on the incentives and duties of other institutional investors and other agents who participate in the corporate governance debate, as much as on the activist hedge funds themselves. In this final Section, I offer a measured set of proposals, beginning with regulatory changes that would increase hedge fund disclosure of factors, such as performance, managers' compensation, and prior manager fund failures, that are relevant to human investors and their agents. Then, in a similar vein, I propose changes to current position-reporting rules so human investors, mainstream institutional investors, proxy advisory firms, target corporations, and other participants in our corporate republic can understand an activist's overall economic positions in a target—and take them into account accordingly. Expanding my focus from the wolves to their prey, I next turn to what the rise of activism means for public companies and how those concerned about activism's effect on their investments should think about certain corporate takeover defenses. The balance of this Section considers what other participants in this corporate republic—including the agents who hold human investors' equity capital—can do to better align their actions with the best interests of human investors. I offer reforms that will best promote a long-term perspective on the part of human investors in how they hold their mutual and index funds and on the part of funds themselves in terms of how they vote and compensate their managers. Finally, I propose that we treat human investors more like adults and give them direct access to invest in private equity funds that have investment philosophies more aligned with long-term investors than those of actively traded mutual funds.

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The primary issues regarding the regulation of activist hedge funds are similar to those faced by many industries when they reach a level of success where they wield power that affects society in a materially important way. When that happens, it is often the case that the emerging industry must be prepared to disclose more about how it works and to be open about its interests.[284] To my mind, there is nothing intrinsically worrisome about the philosophy of activist hedge funds. Whether or not I or others believe their approach to investment is sustainable on the scale to which it has now grown is not a sufficient basis to ban the industry. If it were, then actively traded mutual funds would be on regulatory death row. And, as to those hedge funds willing to, as my British friends say, get stuck in, contribute meaningful management expertise for the long term, and eat their own cooking, I harbor little skepticism at all, so long as the fund matches its actions in long-term commitment to its upfront promises.

But what does distinguish all activist hedge funds is not only that they do not have to make anywhere near the level of disclosure required of investment funds registered under the Investment Company Act, but also that the activist funds are not passive investors, and instead have as their goal influencing the business plans of their targets in a manner that therefore affects other investors and other corporate constituencies. Furthermore, because it is not the case that hedge funds take only investments from wealthy individuals who are well positioned to bargain for themselves, but take money from pension funds, universities, charities and other institutions on which ordinary Americans depend, the rationale for allowing them to continue to disclose so little in terms of reliable track records, taking into account past failures, is hard to discern.

To better protect human investors from direct investment risk, it would therefore seem useful to enhance the disclosure hedge funds must provide to those considering investing in them. The additional registration and disclosure mandated by Dodd-Frank[285] was a step in the

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284. *See* Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 331-36 (1988) (describing the development of federal securities law partially in response to growth in industry and capital markets activity in the first quarter of the twentieth century).

285. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. IV, 124 Stat. 1376, 1570 (2010). Title IV of Dodd-Frank eliminates the private

right direction, but it was not sufficient. Recognizing the reality that hedge funds' main investors are increasingly socially important pension funds and university and charitable endowments on which ordinary Americans depend, rather than wealthy and financially sophisticated individuals, suggests more and standardized disclosure about hedge fund performance should be required. Under this model, institutional investors who are fiduciaries of pensioners, universities, or charities could not purchase hedge fund investments that were not subject to a more extensive disclosure regime. This disclosure regime should require complete disclosure regarding the fund manager's past track record so that over time better public information about specific fund managers and overall industry performance is known. Especially important is a requirement to identify closed funds and account for their records, including the records of the funds that failed. Likewise, it is vital that regulators develop a standard disclosure regime allowing for reliable comparisons of what the sponsoring fund manager made, considering its profit participation, total fees, and returns, and that of its actual investors, and taking into account their costs, including the manager's compensation. These should involve clear charts comparing how dollars invested resulted in investment gains, net of fees, over time in comparison to the overall market and to the fund manager itself. As for all investment funds—not just hedge funds, but traditional mutual funds, too—disclosure about average and median holding periods for particular investments would be illuminating, by giving investors and regulators reliable information about portfolio turnover and how much a fund deviates from a buy and hold strategy. These disclosures, in all respects, should not allow for material variations among funds, but rather create reliable information about industry performance and its effect on investors.

Now it may be that some will argue this disclosure regime would lock these institutions out of this sector. There are two answers to that

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adviser exemption from the Investment Advisors Act of 1940 and requires advisers with more than $150 million in assets under management to register with the SEC as investment advisers. *Id*. §§ 403, 408. Title IV also includes exceptions for venture capital fund advisers and advisers with less than $25 million in assets under management, as well as foreign private advisers. *Id*. §§ 402-403, 408. Title IV also requires registered investment advisers to maintain records and other information that the SEC requires to evaluate the private fund industry. *Id*. § 404. *See also* Wulf A. Kaal, *The Post Dodd-Frank Act Evolution of the Private Fund Industry: Comparative Evidence from 2012 and 2015*, 71 BUS. LAW. 1151, 1158-65 (2016) (explaining the new requirements for private fund advisers under Dodd-Frank).

concern. The first is that if those are the consequences of increased disclosure, a departure from the sector might be preferable to a status quo where human investors and society as a whole face risk from fiduciaries poorly positioned to be good consumers of funds whose investment philosophy is unlikely to beat the market over time, especially when risk is considered. The second is that this is a false choice. The hedge fund industry cannot function at its current scale without finding investments from pension funds and the like, and would, as a practical matter, be required to comply with a sensible registration and disclosure regime that takes into account the industry's unique investment style—no need to disclose the "secret sauce"—but that recognizes that style is no justification for lack of other forms of reliable disclosure. This would help pension fund fiduciaries make more informed decisions about with whom they entrust their real human beneficiaries' capital.[286]

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Consistent with the focus on disclosure, more should be known about hedge fund interests by the rest of the market. Scholars have argued that hedge funds are useful in framing debates between themselves and corporate managers, which mainstream investors like mutual funds can then resolve using their voting power.[287] This contention, however, is problematic if the electorate does not have full and complete information about the activists' own economic interests. Just like institutional investors have called for corporate managers and directors to disclose their economic interests, so too is it vital that the electorate know just how long an activist is in the company and any arrangements relevant to its likely holding period. The current reach of Section 13 is

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286. On a related front, state efforts to mandate better disclosure of information of this sort by private equity funds were met with fierce resistance by the industry. Gretchen Morgenson, *Private Equity Funds Balk at Disclosure, and Public Risk Grows*, N.Y. TIMES (July 1, 2016), http://www.nytimes.com/2016/07/03/business/private-equity-funds-balk-at-disclosure-and-public-risk-grows.html [http://perma.cc/6436-QNYH] (describing efforts to require private equity funds investing public pension money to publicly disclose information, such as fees and related-party transactions). Like hedge funds, private equity fund returns have been declining in the past decade relative to funds that track market returns, and like hedge funds, there is a question of whether the private equity industry can generate solid returns at its greatly expanded size. *See generally* Appelbaum & Batt, *supra* note 221, at 5 (reviewing recent studies and suggesting that the median private equity fund no longer beats the S&P 500).

287. *See, e.g.*, Gilson & Gordon, *supra* note 170, at 901 ("Activist shareholders specialize in framing alternatives to existing company strategies and thereby increasing the value of governance rights to institutional investors.").

incomplete, outdated, and has not kept pace with financial evolutions. It seems a modest and inarguable improvement to require all-in disclosure of financial instruments of any kind—long or short, natural or synthetic—tied to the value of the company's stock so market participants can understand a fund's ability to gain from increases or decreases in a target's stock price. All in, pure and simple, no exceptions. Likewise, disclosure relating to any contractual or other arrangements that relate to the hedge fund's incentives, commitment, and ability to hold the target stock should be reported so that its likely investment horizon can be evaluated by the electorate. Given the emerging evidence that funds that act as long-term relational investors are associated with better outcomes, disclosure requirements that bear on the hedge fund's investment horizon and willingness to remain as a long-term investor as well as bear the risks of its proposed strategy as long-term investors would be valuable. This important information would help mainstream investment funds and their proxy advisors evaluate whether activist incentives are really aligned with the best interests of the target's long-term investors.

In addition, after an activist has come public under Section 13(d), real-time disclosures of changes in position, as are now required in the United Kingdom and the European Union generally, should be expected. Even Professor Bebchuk, an ardent opponent of amending the rule to require more timely disclosure, is troubled by the evidence he has found of substantial rates of noncompliance with the existing disclosure rules.[288] An effort by the Securities and Exchange Commission (SEC), similar to its 2014 sweep of routinely late-filing insiders,[289] could help increase the baseline level of compliance with the current rule in a way few involved in the corporate governance debates could criticize.

And, of course, evidence that other hedge funds follow the scent of the alpha wolf supports updating Section 13 to require more prompt disclosure when an investor crosses the reporting threshold. It seems

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288. *See* Bebchuk et al., *supra* note 85, at 13-14 (identifying more than 10% of a sample of Section 13(d) filings where investors failed to disclose stakes within ten days of crossing the 5% threshold).

289. Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Charges Against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings (Sept. 10, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542904678 [http://perma.cc/CXP7-VH2E]. This enforcement initiative involved "quantitative analytics" of ownership reports completed by corporate insiders, including Schedule 13D. *Id*.

entirely clear to me that the idea of Section 13 was that an investor should come public as soon as reasonably possible after hitting the 5% threshold and that the reporting deadline was due to what it took to type up, proof, and deliver to Washington the required filing in 1968, when word processors and electronic filing with a button push did not exist.[290] But, the hedge fund industry wants to grab more stock than 5%. Fair enough, I suppose. But how about then coming up with a sensible higher threshold—say 8%[291]—and requiring immediate reporting upon hitting that threshold or a requirement to cease further acquisitions until disclosure is made. Opponents of reform vehemently argue that situations when a hedge fund or its fellows in the pack have come public with control of over 10% are anomalous[292] and that most hedge fund

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290. *See* Adam O. Emmerich et al., *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. 135, 143 (2013) (citing *Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking and Currency*, 90th Cong. 136 (1967) (statement of Stanley Kaplan, Professor, University of Chicago)) (noting that Congress's decision to impose a ten-day reporting window was due to the administrative burden of preparing and filing the Schedule 13D).

291. The U.S.'s 5% level is higher than that of major European nations, such as the U.K., Germany, Netherlands, and Italy. *See, e.g.*, Marco Becht et al., *Hedge Fund Activism in Europe* 8 n.8 (Eur. Corp. Governance Inst. Fin. Working Paper No. 283, 2010) (noting that public disclosure thresholds were set at 2% in Italy and at 3% in the U.K.); *European Regulatory Snapshot: The Amended Transparency Directive*, DAVIS POLK & WARDWELL 3 (2013), http://www.davispolk.com/sites/default/files/10.24.13.European.Regulatory.Snapshot.pdf [http://perma.cc/Z734-4NUV] (describing the current U.K. disclosure thresholds, where disclosure is required when an investor's voting rights reach, exceed, or fall below 3% and each 1% threshold thereafter); *Rulefinder Shareholding Disclosure: Germany*, AOSPHERE 1 (2016), http://www.aosphere.com/downloads/Germany_Shareholding_Disclosure_Rules_Summary.pdf [http://perma.cc/4TFE-DASJ] (reflecting Germany's 3% disclosure threshold); Han Terrink, *Summary of Changes in Ongoing Reporting and Disclosure Requirements Following Implementation of Amendments to Transparency Directive in the Netherlands*, CLIFFORD CHANCE 2 (2016), http://www.cliffordchance.com/briefings/2016/02/summary_of_changesinongoingreportingan.html [http://perma.cc/74PL-KHUW] (noting the Netherlands's 3% threshold). This Feature does not deal with the ideal. Rather, it advances a practical threshold that allows sizable but not unreasonable stake building. But it then demands that stake building cease until immediate disclosure.

292. *See* Bebchuk et al., *supra* note 85, at 4 (arguing that anecdotes supposedly illustrating gaps in the current rules are not representative of typical practice). The an-

activists come public with a median stake of 6.3%.[293] If that is so, how about using a sensible threshold as the basis for a new rule? Additionally, sophisticated commentators have noted that using a single percentage threshold for all companies, regardless of market capitalization, is a rather blunt instrument, given the variation in market capitalization of U.S. companies. Perhaps, then, it would make sense to have a threshold that is lower—e.g., the current 5% threshold—for purchases of shares in large cap companies and one that is higher for small- and mid-cap companies, where a larger percentage stake is necessary to obtain an economic interest sufficient to reward the activist for its costs.

Furthermore, given the strong evidence that activist accumulations seem to be discovered by other wolves and that these other wolves engage in trading before the alpha wolf discloses to the larger public, there seems to be a strong basis for requirements that address what information an activist can share with others before the activist goes public. A presumption that a tip made between investors creates a 13(d) group might be one way to do it.[294] The argument that hedge funds should not have to disclose until they can stake out a position that is sufficiently large to justify the costs of their activism is understandable. What is not understandable is carving out an exception that allows funds to selectively share knowledge of their purchases and other plans with industry colleagues while keeping the larger community of investors in the dark.

Some commentators believe that activist investors should be considered fiduciaries, owing duties of loyalty to their targets on the grounds that they act on their targets, influence their business strategies, and thus wield elements of corporate control that affect all other investors.[295] Adolph Berle, no less, presaged the potential power of in-

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ecdotes include two funds' acquisition of 25% beneficial ownership of J.C. Penney before disclosure. *See* Letter from Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 5-6 (Mar. 7, 2011), http://www.sec.gov/rules/petitions/2011/petn4-624.pdf [http://perma.cc/6WF7-WCR5].

293. *See* Bebchuk et al., *supra* note 85, at 4-5. *But see* Coffee & Palia, *supra* note 6, at 597 (arguing that reported stability in hedge fund accumulations does not take into account the growth in "wolf pack" behavior).

294. Professors Coffee and Palia have proposed something similar. *See* Coffee & Palia, *supra* note 6, at 600-01.

295. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

stitutional investors and the need to regulate their power.[296] This is a complicated topic, but I do agree that there is more comfort for other investors and corporate constituencies when an activist hedge fund places a representative on the board, and, as a result, is subject to a host of equitable and legal restrictions. These include the state law and fiduciary trading restrictions that result if the fund representative on the board has access to non-public confidential information, both by their status as an insider[297] and by typical provisions operating to restrict the fund's ability to trade apart from regulation.[298]

Eliminating the unfair tax advantages hedge funds get over other human laborers—e.g., the ability to treat some of their managerial income as capital gains rather than wages from labor under the "2 and 20" model—would also diminish the ability of hedge fund managers to reap profits not shared with their investors and their targets' other stockholders in the long-run.[299] This would therefore shift the activist hedge fund market directionally toward those fund managers able to generate value by contributing managerial expertise that creates durable value for the public companies in its portfolio.

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Under the current Section 13(d) stake disclosure regime, concerns about creeping control from wolf pack behavior are not irrational. In much of the world, the definitions of when an investor or group of investors are considered to have control are triggered at lower levels than is the case in U.S. corporate law. In the European Union, it is common for any group of concerted investors who acquire 30% of shares to be required to make a mandatory offer to all other stockholders to buy their shares.[300] The emergence of a bloc of stockholders who can deter other

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296. *See* Bratton & Wachter, *supra* note 142, at 143.

297. There are obvious and important fiduciary implications of that representative sharing company information back at the hedge fund ranch. In that situation, the hedge fund itself is a fiduciary and can only use that information while complying with its legal and equitable duties to the portfolio company and to its other stockholders.

298. *See supra* note 120 and accompanying text.

299. *See* Fleischer, *supra* note 78 and accompanying text.

300. *See* Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2002 O.J. (L 142) 12 (stating that the "mandatory bid rule" requires stockholders crossing certain ownership thresholds set by individual European countries to make a bid for all of the company's shares); *Report on the Implementation of the Directive on Takeover Bids*, COMM'N OF THE EUR. COMTYS. 13-14 (2007), http://ec.europa.eu/internal_market/company/docs/takeoverbids/2007-02-report_en.pdf [http://perma.cc/FH36-L4NL] (summarizing ownership thresholds

bidders and influence corporate management poses risks for other stockholders. Institutional investors have long salivated for sell-side premiums. Thus, they should understand why it is useful to ensure that control is not bought on the cheap, leaving ordinary investors without a takeover premium and potentially subject to a riskier business plan. Especially in a world where classified boards are increasingly rare,[301] institutional investors should rethink their traditional hostility to poison pills. A standard poison pill used by a declassified board can do human investors more help than harm by preventing a creeping takeover where an activist or wolf pack acquires effective negative control over a corporation without paying a control premium. An innovative refinement to the standard pill comes from Professors Coffee and Palia, who have proposed a "window closing" pill structured to force activists to disclose their stakes before the end of the Schedule 13D ten-day period.[302]

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But the most important changes suggested in this Feature are not within the hedge fund industry itself. Rather, human investors would see great benefit from reforms encouraging the agents responsible for their money to adopt the long-term horizon held by their principals, i.e., human investors.

First, recognizing that mutual funds and other institutional investors face irrational incentives to compete on short-term metrics rather than areas aligned with the interests of human investors is vital. Demonizing fund managers is unfair when they face cost-free fund hopping from their investors and equity investors get credit for holding an asset long-term if they can eke out a year. Adoption of a sensible fractional trading tax on all securities transactions, including transactions by 401(k) investors, and capital gains reform to make eligibility for a long-term rate dependent on long-term investment would help fund managers focus more on long-term returns.[303] Not only that, Pigouvian taxes like these

adopted in different jurisdictions with 30% being the most common threshold in major economies, such as Belgium, Germany, France, Ireland, Luxembourg, Spain, and the U.K.).

301. *2015 Spencer Stuart Board Index*, *supra* note 185, at 12 (noting that 92% of directors are currently elected on an annual basis, compared to 51% in 2005).

302. Coffee & Palia, *supra* note 6, at 602. The pill would be triggered if an activist crossed the 5% threshold and did not file a Schedule 13D immediately. *Id*.

303. Others have proposed tax law reforms that might have the effect of inducing activist funds to increase their holding periods and "deter the 'hit-and-run' activist." Coffee & Palia, *supra* note 6, at 594-95.

discourage speculation, including in derivatives, thus reducing systemic risks and the need for more complex forms of regulation. And they would also raise world government revenues to invest in infrastructure; basic research to address critical issues, such as climate change; and human capital to give workers the skills needed to compete in more technologically advanced societies, thereby fueling long-term economic growth.

At the same time, corporate managers are often hostage—or at least feel hostage—to the metrics they are required to report in securities disclosures, and to which fund managers and stock analysts look when considering if they will invest in or recommend the stock. An interesting proposal has been made to give corporations greater market credit for a type of investment that human investors should care deeply about—investment in human capital, such as job training.[304] Unlike research and development spending, which is typically disclosed as a separate line-item on a company's income statement, expenditures on human capital are lumped in the Sales, General, and Administration ("SG&A") expense line.[305] SG&A is also home to the kinds of general overhead expenses that investors, activist or otherwise, like to see kept to a minimum, and so this disclosure regime creates an incentive for corporate managers to cut back on the all-important investment in human capital.[306] Commentators concerned that activist campaigns will put even more pressure on human capital investments have thus urged that the SEC require disclosure of several variables related to human capital investment, including, most importantly, disclosing the total amount spent on worker skills training.[307] There are perhaps other changes to public company disclosure that would similarly help align the metrics corporate managers are measured against to the interests of human investors.

The index and mutual funds that are primarily responsible for human investors' money should vote with their investors' needs in mind. This is

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304. *See* Angela Hanks et al., *Workers or Waste? How Companies Disclose—Or Do Not Disclose—Human Capital Investments and What to Do About It*, CTR. FOR AM. PROGRESS (June 2016), http://cdn.americanprogress.org/wp-content/uploads/2016/06/03042031/HumanCapital.pdf [http://perma.cc/S85Q-KZD4].

305. *Id*. at 9.

306. *Id*. at 10-11.

307. *Id*. at 14.

a relatively simple proposition to state but, as discussed elsewhere in this Feature, it gets lost in practice. Index funds should be required to use voting policies and recommendations tailored to the reality that they have only voice, not exit options. Human index investors do not benefit from bubbles or corporate-governance fads. Thus, index funds should be required to think independently and vote in a way that reflects an informed judgment about what is best for their investors over the long haul—not just what the fund family proxy unit or, even worse, a proxy advisor has generically instructed it to do. To that end, index funds should be precluded from relying on proxy advisory firms that do not provide guidance tailored to index funds' unique buy-and-hold perspective. Admittedly, there are promising developments in this field. A prominent investment manager, Blackrock, has voiced the need for and utility of index funds more assertively voting their stuck-in, long-term perspective.[308] And, some important money managers have signed on to a paper arguing for a "new paradigm," which contains a call for money managers to adopt a set of shared principles predicated on the goal of "economic growth that benefits shareholders, *employees and the economy as a whole*."[309]

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308. *See, e.g.*, John Authers, *Passive Investors Are Good Corporate Stewards*, FIN. TIMES (Jan. 19, 2016), http://www.ft.com/content/c4e7a4f6-be8a-11e5-846f-79b0e3d20eaf [http://perma.cc/6BCG-7U6Y] (reporting on Blackrock CEO Larry Fink's comment that "[index funds] can't sell those stocks even if they are terrible companies. As an indexer, our only action is our voice and so we are taking a more active dialogue with our companies and are imposing more of what we think is correct").

309. Tim Armour et al., *Commonsense Corporate Governance Principles*, COMMONSENSE CORP. GOVERNANCE PRINCIPLES, http://www.governanceprinciples.org [http://perma.cc/YWN6-48PR] (emphasis added); *see also* Tim Armour et al., *Commonsense Principles of Corporate Governance*, COMMONSENSE CORP. GOVERNANCE PRINCIPLES (July 2016) http://www.governanceprinciples.org/wp-content/uploads/2016/07/GovernancePrinciples_Principles.pdf [http://perma.cc/D6VJ-7W97] (further elaborating on the governance principles). The open letter adopting this goal has been signed by money managers including Blackrock, Capital Group, J.P. Morgan Asset Management, State Street Global Advisors, T.Rowe Price, and Vanguard. Tim Armour et al., *Open Letter: Commonsense Principles of Corporate Governance*, COMMONSENSE CORP. GOVERNANCE PRINCIPLES (July 2016), http://www.governanceprinciples.org/wp-content/uploads/2016/07/Governance_Principles_Open_Letter.pdf [http://perma.cc/949R-DYNT]. Notably, the Canadian Pension Plan Investment Board and activist investor ValueAct Capital have also signed on. *Id*. The open letter calls for corporate governance principles, including encouraging a long-term focus similar to that of owners of a private company. *Commonsense Principles*, *supra*, at 4. It also calls for money managers to devote sufficient efforts to voting with

Both index funds and mutual funds should also take a fresh look at their policies and how the policies fit with the long-term growth conducive to human investors' needs. Any fund that accepts 401(k) or college savings money should be required to have voting policies specifically tailored to the long-term purposes of those investments.[310] At a minimum, increased disclosure demonstrating, as a practical matter, how much a given fund deviated from off-the-shelf voting procedures would help investors gauge if a fund advertising itself as socially responsible or for the long-term actually behaved that way.

Implicit in these proposals that essentially urge more thoughtful voting behavior is a need for votes only on those matters requiring thought. Rolling back the federal mandate that essentially requires institutional investors to vote on every measure before them would be one way to begin to achieve this end.[311] As former SEC Commissioner Gallagher has argued, money managers have approached voting with too much of a "compliance mindset" rather than a "fiduciary mindset," and he at least partially attributes that shift to the SEC.[312] Rule changes allowing institutional investors to make rational decisions about what votes actually mattered to the investment objectives of their human principals, and

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an eye toward "long-term value creation," *id*. at 8, as well as toward "senior-level oversight" for proxy vote decisions, *id*. at 9. But it is worth noting that even this document does not call for differentiated index fund voting.

310. This idea has been given a high-level gloss by the Group of Twenty and by the Organisation for Economic Co-operation and Development. *See generally G20/OECD High-Level Principles of Long-Term Investment Financing by Institutional Investors*, ORG. ECON. CO-OPERATION & DEV. (Sept. 2013), http://www.oecd.org/daf/fin/private-pensions/G20-OECD-Principles
-LTI-Financing.pdf [http://perma.cc/49VT-YLZH].

311. *See* Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, Dep't of Labor, to Helmuth Fandl, Chairman of the Ret. Bd, Avon Prods., Inc. at *2 (Feb. 23, 1988), 1988 WL 897696 ("In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock."); *see also* 29 C.F.R. § 2509.08-2 (2015) ("The fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock.").

312. Daniel M. Gallagher, Comm'r, Sec. & Exch. Comm'n, Remarks at Society of Corporate Secretaries and Governance Professionals (July 11, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539700301
[http://perma.cc/4FER-Q7MV]. Gallagher also identifies rulemaking by the SEC as inadvertently increasing money manager reliance on proxy advisory services. *Id*.; *see also* Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (2011) (codified at 17 C.F.R. § 275).

focusing their limited resources on analyzing the optimal way to vote would be useful.

As important, if proxy advisory firms are going to continue to be an important influence on the behavior of societally important institutions like money managers and public companies, they should be regulated in the public interest. Sensible requirements preventing investment funds from relying upon proxy advisory firm recommendations unless those are tailored to the fund's investment style and horizon would create incentives for proxy advisory firms to do better; and in particular, force them to develop voting recommendations and policies tailored to index investors, who are uniquely long-term and committed to sustainable wealth creation. A bill in Congress was introduced[313] and action at the SEC has been suggested[314] to address the responsibility of this industry, which only exists because of changes to federal laws, such as ERISA[315] and the Investment Company Act,[316] in recent decades mandating that institutional investors have voting policies.

As important, stockholder votes should only occur if the electorate can actually take them seriously and vote on an informed basis faithful to the investors' interests. It comes with little grace to simultaneously argue that corporations should be inundated with thousands of votes on say-on-pay, 14a-8 proposals, and the like, and then argue that institutional investors cannot possibly be expected to vote on a fund-specific basis because that costs too much. That is inconsistent hypocrisy. Stockholder voting is only valuable if it is thoughtful and helpful to holding corporations accountable for the creation of sustainable wealth. Burdening corporations with constant referenda at the insistence of in-

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313. Corporate Governance Reform and Transparency Act of 2016, H.R. 5311, 114th Cong. (2016) (proposing requirements for proxy firms to register with the SEC).

314. *Id*. (requiring the SEC to conduct assessments of proxy advisory firms). *But see* Div. of Inv. Mgmt. & Div. of Corp. Fin., *Staff Legal Bulletin No. 20 (IM/CF), Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, U.S. SEC. & EXCHANGE COMM'N (June 30, 2014), http://www.sec.gov/interps/legal/cfslb20.htm [http://perma.cc/LJG3-549F] (describing the SEC staff's position that investment advisors should assess proxy advisory firms' "capacity and competency to adequately analyze proxy issues").

315. *See* 29 C.F.R. § 2509.08-2 (2015) ("The fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock."); *see also* Letter from Alan D. Lebowitz to Helmuth Fandl, *supra* note 311.

316. *See supra* note 158.

stitutions that do not wish to invest in thinking about voting is a wasteful drag on social welfare. If something is important to do, it should be done only when it can be done well.

The current frantic cycle of say-on-pay votes in particular is not conducive to thoughtful voting and could be made more rational on a systemic basis. The initial legislative mandate for say-on-pay votes did not require that they be held annually.[317] Holding say-on-pay votes every third or fourth year would allow investors to cast their votes more thoughtfully, both because they would have fewer votes to focus on in a given year and because they would have an actual management track record to assess. The incidence of costly 14a-8 proposals could be reduced by sensible reform involving a required filing fee, a higher ownership threshold, and a stronger bar on resubmitting proposals that have failed.[318] Scholars have noted that as a practical reality, there is "no alternative to stockholder democracy."[319] Taking that as true, they recognize, makes it even more important that the system of so-called stockholder democracy works for those whose capital is ultimately at stake, not just for the agents who control it. The continuing creep toward direct stock market control of public corporations is difficult to reconcile with any sensibly constructed system of accountability toward human investors. Instead, what it maximizes is the disruptive power of momentary coalitions of agent money managers, which may act at any time on a corporation, rather than in a rationally ordered system of accountability focusing on sustainable and ethical wealth creation.

Perhaps fund managers would be more likely to think and invest in a manner more aligned with their investors' long-time horizon if their compensation was more tied to the performance of the funds they manage than to that of the asset manager who employs them.[320] Although, as with compensation for public company managers, this is a

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317. 15 U.S.C. § 78n-1(a)(1) (2012) (requiring that "[n]ot less frequently than once every 3 years" a company "include a separate resolution subject to shareholder vote to approve the compensation of executives" in its proxy materials for a shareholder meeting).

318. Professor Romano has made useful suggestions for reform on this point. *See* Romano, *supra* note 175, at 229-30 (arguing that rebalancing the cost-benefit calculation for submitting proposals under Rule 14a-8 would encourage more thoughtful submissions).

319. Coffee & Palia, *supra* note 6, at 606.

320. *See supra* note 160 and accompanying text (discussing fund manager pay structures).

complex task, subjecting a material part of a fund manager's compensation to the same realities that, for example, 401(k) or index investors face, should better align their interests. Moves in this direction would also move in a complementary direction with the incentives that would be created with tax reforms that priced the costs of fund-hopping and portfolio turnover, and together help solid, buy-and-hold fund managers adhere to fundamentally more sensible strategies, without as much fear of losing funds under management because of short-term market sector bubbles or busts.

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Finally, and consistent with these prior thoughts, human investors should have investment options tailored to their long-term investment horizon. Although many of these other proposals would help sharpen money managers' focus on the longer term, some investments are structurally better suited to the patient money of a twenty-five-year-old starting to save for retirement. A locked-in ten-year investment in a private equity fund of funds would arguably be a more appropriate place for retirement investments the saver will not touch for at least three decades, as compared to an actively traded mutual fund that frequently turns over its holdings in search of benchmark-beating returns. Unfortunately, providing an option to allow for human-investor access to private equity as part of the 401(k) portfolio requires overcoming numerous regulatory barriers.[321] But as between actually traded mutual funds and private equity, the latter is clearly a more rational choice for human investors. For this to be feasible, however, the private equity industry must be assured that it can aggregate pools of capital from ordinary investors for lengthy periods. It is an unwise paternalism to facilitate worker access to churning mutual funds, while denying them the arguably most rational choice after index funds.

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321. Sponsors of self-directed plans, such as 401(k)'s, have a safe harbor from liability to plan beneficiaries if the investment options available to beneficiaries are structured in certain ways. *See* 29 U.S.C. § 1104(c)(1) (2012). The safe harbor acts as a barrier to the development of a private equity option because it is only available if the plan offers investments from which participants can achieve liquidity on a relatively frequent basis. *Id*.; 29 C.F.R. § 2550.404c-1 (2016). Similarly, private equity-style funds might have to register under the Investment Company Act of 1940 for ordinary investors to be permitted to invest in them. 15 U.S.C. § 80a-2(a)(51) (2012).

Most of all, however, it is time to ask whether we have lost our focus on what is most important in the corporate governance debate. As this concentration on human investors reveals, it is the economy's ability to create and sustain good jobs that remains most important to most people. The current corporate governance system, however, gives the most voice and the most power to those whose perspectives and incentives are least aligned with that of ordinary American investors.

If empowering short-term investors turns out to be optimal for our society and its human citizens, that seems like a very improbable and unsustainable triumph of the law of unintended consequences. Call me old-fashioned, but it would be more comforting to know that those with the power over the capital—equity, debt, and most important, labor—of ordinary Americans were duty-bound to align their thoughts and actions with those they supposedly represent. American optimism makes me have confidence when we pull together toward a common goal, but be consequently skeptical when the many are asked to accept that what is good for the plutocrats is good for them.