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Contesting Capital Allocation:

A Sociological Perspective on the Interaction among Hedge Fund Activists, CEOs, and Directors

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Contesting Capital Allocation:
A Sociological Perspective on the Interaction among Hedge Fund Activists, CEOs, and Directors

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Dedication

To my children, Jason, a school teacher, and Austen Anne, a neuroscientist, activists of the highest order, whose love, kindness, passion, and commitment sustain and inspire me.

Contesting Capital Allocation:
A Sociological Perspective on the Interaction among Hedge Fund Activists, CEOs, and Directors

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Using ninety-nine semi-structured interviews with S&P1500 CEOs, directors, and hedge fund managers, this study examines why and how hedge funds pursue activism with target companies, and why and how firms either acquiesce to or resist these pressures. When including friendly activism together with hostile activism, it finds that the degree of engagement of hedge funds with their targets is substantial. Likewise, the degree of engagement of CEOs with their preferred institutional investors is also nearly constant. Together, this level of interaction strongly suggests that the idea of the separation of ownership and control is an increasingly anachronistic concept describing the current relationship between managers and their shareholders. It also finds that, because hedge funds represent a distilled form of capitalist action, CEOs and boards have little space to engage in symbolic management. Because of the loss of power to institutional shareholders over the past several decades, epitomized by hostile hedge fund activism, the substantially increased engagement of management with their shareholders can be seen as a mechanism for recouping power. Dedicated hostile hedge fund activists derive their power not from exercising social influence over their targeted firms, with whom they have no history of repeated and recurring interactions, but from exercising social influence over other institutional investors by cultivating reputations based on legitimate action. Similarly, dedicated hostile hedge fund activists' expertise, a second source of power, is also not attained from repeated interactions with their targets but from their greater experiences in

capital allocation, from past business experiences, and from hiring analysts and consultants with the necessary expertise. By contrast, friendly hedge fund activists do exercise social influence over their target firms derived from longer-term recurring interactions with them. While this accords them shareholder power, this power is limited by their aversion to exercising coercive tactics. Paradoxically, management can appropriate the shareholder power of friendly activists to the extent that such allies can counter the power of hostile activists. Directors were found to be severely disadvantaged by the paucity of their interactions with shareholders, a circumstance that they are beginning to rectify through increasing their dialogue with them.

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Chapter 1: *Introduction*

An axiom of economics is that capital will find its highest return. This rather sociological concept, similar to the idea of the "invisible hand" of the market, hints at larger social forces that structure much of individual economic action. On the ground, we see this reified notion of capital expressed when bankers seek attractive returns by lending to borrowers; when company management teams make investment decisions based on projects' return characteristics relative to other uses of capital; when entrepreneurial individuals plow their life savings, along with capital provided by family and friends, into new ventures they believe will generate attractive returns; and when investors buy shares of publicly traded companies they believe will increase in price at a rate greater than what might be attained from shares in other companies. In short, the mystery of capital seeking its highest return is actualized in the capital allocation decisions of individuals and organizations.

This is a qualitative study about the control over capital allocation decisions based on ninety-nine interviews of hedge fund managers, CEOs, and directors. While there are individuals and organizations who allocate their capital to non-publicly traded businesses such as farmland, commercial real estate, public-private infrastructure investments, or commodity futures, this study is keenly interested in those who invest in and run publicly traded companies. Among public companies are some of the largest employers who directly affect the lives of millions of people. Wal-Mart alone employs over two million people. The employment levels at other major firms are far from trivial: McDonald's employs nearly a half million individuals, and Target, Hewlett-Packard, and General Electric each employ over 300,000 persons. The business strategies these companies choose to pursue, from revamping food menus, store layouts, or product offerings, to investing in research and development or plant expansions, or to selling off divisions or acquiring other companies or divisions, all involve decisions over how to allocate capital. Because of their size, the capital allocation decisions of public companies can have wide social impact, and because of their visibility, their business practices often serve as models

adopted by other public, private, and municipal organizations. Who has a say in these decisions is, therefore, of enormous importance.

Such capital allocation decisions – both those which investors make as well as those which businesses make – significantly influence the growth trajectories of companies and ultimately their long-term success or failure. Investors' approval of Facebook's performance and future prospects resulted in a share price in 2014 nearly triple the level just two years earlier. In the world of mergers-and-acquisitions, richly valued stock is valuable currency. Facebook was able to buy WhatsApp, the largest corporate acquisition in 2014, for over $19 billion using just $4 billion in cash with the balance paid in Facebook shares (Albergotti, MacMillan, and Rusli 2014). The rapid growth at Facebook is reflected in the increasing number of workers whom Facebook employs, growing nearly 50% in 2015 alone. The capital allocation decisions which investors made, preferring Facebook shares over the shares of some other company and thereby bidding up the price of Facebook, influenced the capital allocation decisions Facebook itself would later make, decisions which would have a significant effect on its ongoing growth and hiring.

In 2013, Microsoft purchased the mobile phone division from Nokia for $7.2 billion, a massive capital allocation decision (Ovide 2013). It was also an astoundingly bad one as the company wrote down the value of the business barely two years later, resulting in a $7.6 billion charge to its income statement. This pair of ill-advised capital allocation decisions cost workers 7,200 jobs (Ovide 2015). The $46 billion merger between Heinz and Kraft last year resulted in a 6% workforce reduction, or 2500 jobs, an outcome common to many mergers and acquisitions involving more slowly growing, seasoned businesses (Gasparro 2015). These capital allocation decisions which businesses make have profound consequences not only for the people who work at these companies, but also for these companies' suppliers, competitors, and consumers. In short, how capital is allocated by investors as in the Facebook example, or by management teams and their boards, as with the Microsoft and Kraft Heinz cases, is highly consequential and warrants closer sociological scrutiny.

While this study is interested in those who invest in publicly traded companies, it is especially interested in those institutional investors – pension funds, mutual funds, some long-only[1] boutique institutional money managers (i.e., non-mutual funds), and hedge funds – who practice shareholder activism.[2] Activism is best understood as engaged disagreement and/or collaboration between institutional shareholder(s) and management over how capital is allocated, representing a critical breach of the separation of ownership and control. Implicit in the idea of the separation of ownership and control is that investors control the allocation of capital *outside* of firms through their buying and selling of shares on public exchanges – as investors did with Facebook shares – and managements and boards control the capital allocation decisions *within* firms – as with Facebook's acquisition of WhatsApp, Microsoft's of Nokia, and Heinz's acquisition of Kraft.[3]

The separation of ownership and control is a distinctly twentieth century phenomenon. Concurrent with the rise of the large industrial corporation in the U.S. in the late 19th and early 20th centuries was the emergence of dispersed ownership of corporate assets, a new ownership form that displaced entrepreneurial capital and individually owned

[1] The term 'long-only' means that an investment manager's strategy is restricted to security *purchases*, and thus does not 'sell short', the process of borrowing a security in order to sell it in the hopes that the price will decline, allowing the manager to buy back the security at a lower price and then return the security to the party that lent it out originally.

[2] As I am interested in the control of capital, I exclude the so-called socially conscious or socially responsible forms of activism and confine my treatment to efforts to influence the economic behavior of firms. The reader, however, should be rightfully suspicious of such an exclusion since all economic behavior has an ethical dimension. Also, an entire investment approach has evolved predicated on socially conscious priorities, although such investment vehicles rarely engage in activism to change the ethical behavior of firms. However, as a result of the consensus on global warming, increasing awareness of inequality, and the wide embrace of shareholder democracy, a movement has emerged that focuses on environmental, social, and governance matters (ESG) as well as on the concept of sustainable investing. I will touch on this in the concluding chapter.

[3] This bifurcation of capital allocation between the inside and outside of firms is not a categorical one, though O'Sullivan (2000) implies that it is. While the vast majority of stock purchases and sales merely represent capital circulating amongst investors and thus externally to the firm, many companies at some point in their corporate lives do issue secondary offerings of stock as a means of raising capital. In such cases, capital does flow from outside the firm to the inside through investors purchasing such newly issued shares. Additionally, if the demand for the existing shares of a firm's stock is strong enough to drive the firm's share price higher, this can have numerous benefits for the firm including an increased borrowing capacity *ceteris paribus*, a deterrent to being taken over by another firm, an increased ability to acquire other firms (as with Facebook and WhatsApp), and higher managerial compensation. Thus, even in the vast majority of instances when capital is circulating *outside* the firm through the trading of the firm's shares, this activity can still have effects *internal* to the firm.

firms that earlier had dominated the economic landscape (Roy 1990). This new class of owners, both because of their dispersed and fragmented character and because of the size and complexity of the newly evolved industrial behemoths, relinquished day-to-day say on matters of firms' operations and strategy to a new class of professional managers who possessed the training and expertise to better address these issues (Berle and Means 1932). Thus, the emergence of the separation of ownership and control evolved concurrently with what has been called 'managerial capitalism'.

During the 1970s and 1980s, however, *managerial* capitalism gave way to what became known as *investor* capitalism (Davis 2009; Fligstein and Freeland 1995; Useem 1990; Useem 1996). Making this possible was a confluence of economic, political, cultural, and technological developments that resulted in a significant re-concentration of ownership, the consequent rise of the institutional investor, the assertion of shareholder primacy, and the emergence of an active market for corporate control (Davis 2009; Krippner 2011; Useem 1996). Useem observes that in 1950, individual households comprised 91% of all corporate shareholders, but fell to just 43% by 1994 with institutional investors dramatically expanding their share ownership from 9% to 57%, to over 70% today. Chief among the proximate causes behind this rise of institutional investors was rapid pension fund growth, from $260 billion in 1975 to $3 trillion in 1996 representing an annual growth rate of 13%. In addition to pension fund growth, the arrival of the 401(k) retirement vehicle stemming from the Revenue Act of 1978 ignited the growth of the mutual fund industry which saw assets under management (AUM) grow from $241 billion in 1980 to $2.2 trillion in 1994, a 17% annual growth rate. Institutional investors, still intent on seeking the highest returns on their capital but no longer content with just allocating capital that circulated *outside* of firms, began inserting themselves into the decision-making processes *within* the firms which generate these returns, demonstrating a willingness to breach the separation of ownership and control through shareholder activism.

An overlooked irony in the rise of the institutional investor during this age of investor capitalism is that, just as CEOs and boards forfeited power to institutional

investors, so too have individual investors. No doubt this assertion risks hyperbole since the breadth of managerial discretion during the period of managerial capitalism stemmed from dispersed and therefore powerless individual investors. But where an individual investor could at least vote their proxy, in the intermediated world of institutional investors, professional money managers now exercise that right of share ownership. In this sense, the separation between ownership and control is as absolute as ever. While the lines of demarcation are getting blurred between institutional investors and CEOs and their boards, the separation between the ownership of capital in the hands of individuals and the control of that capital at the hands of institutional money managers remains in place. Institutional investors are doubly blessed, having reasserted their control over capital within public firms as well as maintaining their control of individual investors' capital.

Useem (1996) expertly analyzed this transition from managerial capitalism to investor capitalism and the rise of shareholder activism. Perhaps because activism has therefore lost its newness and the radical rupture it once represented looks far less radical from the vantage point of the new millennium, sociologists since Useem have widened their focus to matters of financialization, itself yielding tremendous insights into the structural transformations underway in neoliberal economies. While Krippner (2011) provides an invaluable contribution to understanding these transformations by involving the state to account for the transition from an economy centered on productive activities to one centered on financial activities, an objective of this project is to assert that how financialization articulates itself still depends very much on the character of the demands which specific actors central to the processes of accumulation make. In this regard, the interplay between hedge fund activists and managements and boards, as well as between hedge fund managers and other institutional investors, is critically important. Several sociologists have bemoaned the paucity of sociological research on matters of corporate governance and corporate control, issues central to shareholder activism. Mizruchi has noted that while sociologists used to pay attention to issues of corporate control between WWII and the early 1990s, few have done so in the past two decades (Mizruchi 2004). Focusing the sociological lens on issues surrounding the separation of ownership and

control could help "address significant questions concerning the structure and political power of corporate elites" (Mizruchi 2004:580). Davis (2005) asserts that "corporate governance is critical to understanding the contemporary world polity and the dynamics of its institutions" (p.156). Kang and Sorensen (1999) forcefully argue for a sociological perspective on matters of corporate control:

> The study of ownership organization and its effect on performance should not be left completely to financial economic research. The study of who controls the use of capital and how this control affects the creation and distribution of wealth in society has long been an important line of intellectual inquiry, originating with Marx. Studying the relationships of individuals and firms to property with a broader and more flexible approach may provide important insights into the efficiency and distributive consequences of modem capitalist firms (Kang and Sorensen 1999, 122).

This study is a modest attempt to refocus the sociological lens on such matters as corporate governance, ownership organization, and relationships to property which all bear critically on, and are informed by, "the use of capital." Interrogating shareholder activism in the spirit of Useem's original work but from the vantage point of 2016 rather than 1996 is one strategy for understanding not only "the use of capital" but also how such use is contested. Extending Useem's work, this project focuses specifically on hedge fund activism since hedge funds, an investor type absent from Useem's work[4], more closely approximate a distilled form of capitalism to the extent that they more aggressively pursue capital's highest returns. While other varieties of investment managers are also committed to maximizing investment returns, such commitments frequently intermingle with other considerations and constraints. Pension fund managers, for example, pursue optimal returns but always with the view of matching assets of the pension funds with the liabilities of retiree benefits that they must regularly pay. Furthermore, they must do so while paying heed to investment constraints imposed by ERISA law. Mutual funds too seek to maximize

[4] Useem identifies five types of investors that he considers to be institutional – pension funds, insurance companies, bank trust departments, nonprofit organizations, and investment companies (effectively the mutual fund houses).

returns, but must do so while simultaneously providing daily liquidity[5] and while adhering to the Investment Company Act of 1940 and other SEC regulations. Additionally, the overwhelming majority of mutual funds are further constrained by their investment objectives[6] and, perhaps more importantly, by the conflict of interest arising from the pursuit of other business opportunities with the very firms they invest in: a major mutual fund house is unlikely to pressure a company through shareholder activism if they also happen to have a lucrative relationship providing retirement planning or perhaps serving as the company's 401(k) plan sponsor (Davis, 2009). Even private equity and venture capital firms, while escaping much of the regulatory apparatus with which pension funds and mutual funds must contend, still must dedicate sometimes substantial resources to organizational concerns such as assembling management teams, developing and honing business strategies, and tapping personal networks for operational expertise or for additional capital. By contrast, hedge funds have no such liability or liquidity commitments, operate with few regulatory constraints, are mainly unconstrained by investment styles or mandates, have no incidental business relationships with their target firms that might constrain them from raising objections, and typically do not structure themselves in a way conducive to becoming intimately involved in running firms like PE and venture capital (Anson, Chambers, Black, et al. 2012).

Beyond the absence of such constraints, hedge funds are also positioned to more aggressively pursue capital's highest returns by virtue of their incentives and the characteristics of their funds' investors. Unlike professional pension fund and mutual fund

[5] 'Liquidity' refers to the speed with which an asset can be converted into cash. A checking account is highly liquid as one can make a withdrawal anytime of the day or week. Similarly, mutual funds are considered quite liquid since one can make a redemption any day, although it may take several days for the funds to arrive. Hedge funds often have lengthy 'lock-up' periods of months or years during which investors may not withdraw their funds. Even when lock-up periods expire, investors often can make withdrawals only once per quarter. Maintaining daily liquidity constrains a mutual fund to invest in similarly liquid assets; unconstrained by such liquidity requirements, hedge fund are able to invest in less liquid securities, thereby expanding the investable universe and thus the ability to deliver higher returns.

[6] By virtue of their participation in 401(k) plans, many individual investors are by now familiar with so-called style boxes – e.g., large-cap growth, mid-cap value, etc. – that are used to describe a mutual fund's investment objective. Managers of these funds are generally required to invest in a manner consistent with their stated investment objective. Hedge funds generally face no such constraints.

managers, hedge fund managers are compensated within a 2-and-20 regime; that is, the fund charges a management fee of 2% to cover expenses of the fund, but then levies a 20% fee on the growth of the assets of the fund stemming from positive investment performance. To see why the top twenty-five hedge fund managers make more money than the combined 500 CEOs of the largest corporations, take a hedge fund that began the year with $10 billion in AUM, and finished the year with a 10% return after fees bringing AUM to $11 billion. The manager of the fund has made 20% on the $1 billion resulting from investment performance, or, in other words, a $200 million 'performance fee'.

Also unlike pension funds and mutual funds, whose investors may be plumbers, teachers, firefighters, police officers, government employees, nurses and a host of other middle class and working class people, hedge funds with fewer than 100 investors require that their investors be so-called 'accredited investors.' An accredited investor is an individual with a net worth greater than $1 million, or has earned more than $200 thousand individually (or $300 thousand jointly) for each of the past two years. For hedge funds with more than 100 investors, the SEC demands that investors meet the higher standard of 'qualified purchaser', which is an investor with more than $5 million in investable assets (not net worth) (Anson, Chambers, Black, et al. 2012). Regardless of whether or not it is the case that such wealthy investors are more demanding of their money managers or have higher return expectations than the middle school teacher or plumber might have, it is a fact that hedge funds have far fewer clients than say the Fidelity Magellan Fund. And just as increased ownership concentration in the form of institutional investors creates greater pressure on corporations in the age of investor capitalism, it is similarly likely that having increased *fund* ownership concentration (i.e., fewer underlying investors) creates added pressure for a hedge fund manager to deliver outstanding performance as compared to the pressures felt by a pension fund manager.

In short, hedge funds for the most part are *unconstrained, lightly regulated, aggressive, pure capital allocators*. Hedge funds, therefore, more so than any other type of investment vehicle, may provide the best insights into the demands of capital, and thus understanding why it is that hedge funds in particular engage in activism should prove

immensely useful in understanding the evolution of capital allocation in contemporary capitalist societies. And from examining hedge fund activism we may obtain additional insights into how corporate governance structures and practices are changing, how relationships to property are transforming, and how the changing sources of shareholder power influence the outcomes of contests over capital allocation decisions.

HEDGE FUNDS

Why Pursue Activism?

An immediate explanation for why hedge fund managers are increasingly asserting their say on firms' capital allocation decisions is that doing so is simply another means for seeking higher returns. The extant research provides ample evidence that activism does generate attractive returns (Bebchuk, Brav, and Jiang 2015; Boyson and Mooradian 2011; Brav, Jiang, and Kim 2013; Brav et al. 2008; Clifford 2008; Klein and Zur 2009). While certainly true, this explanation is uninteresting: given the many alternative avenues available to investors for generating attractive returns on invested capital, why would hedge fund managers specifically choose to become active, a costly, time consuming endeavor with no guarantees for success?

In addition to the above differences among hedge funds on the one hand, and mutual funds, venture capital, private equity, pension funds, pooled funds at insurance companies and bank trust departments, foundations, endowments, and other long-only asset management firms on the other, is that hedge fund managers have enormous flexibility and potentially multiple tools in their investment toolboxes. In addition to traditional purchases of equity shares of publicly traded companies, hedge funds can invest in virtually any asset class or geography, they can use leverage (by borrowing funds to make purchases), they can invest in private (i.e., unlisted) securities, they can utilize derivatives such as stock options and futures contracts, they can invest in structured products such as collateralized debt obligations (CDOs were at the epicenter of the financial crisis), and they can hold very concentrated positions, the opposite of traditional, well-diversified portfolios (Anson, Chambers, Kazemi, et al. 2012; Anson, Chambers, Black, et al. 2012; Bratton 2006; Brav

et al. 2008; Briggs 2007; Clifford 2008; Kahan and Rock 2007). Perhaps most importantly, hedge funds can 'short' stocks.[7] Traditional 'long-only' investment managers face a binary decision: they can either invest in a company whose prospects – and price – the investor finds compelling by buying its shares, or, if either the prospects or price are not compelling, the investment manager can choose simply not to invest. Hedge funds have the third option of shorting stocks of companies for which they believe the market either is being overly optimistic or overlooking some serious problem. As the vast majority of activist events involve underperforming companies, why would a hedge fund pursue activism instead of simply shorting the underperforming company's stock? Given the array of investment techniques available to them, why would hedge funds even bother with activism? When hedge funds do engage in activism, on what basis do they believe that they possess knowledge and expertise superior to that of insiders enabling them to offer ostensible solutions to problems managers and directors are seemingly unable to address? More broadly, how do hedge fund activists legitimize their actions?

Shareholder Value

In order to answer these questions, it is critical to place shareholder activism in its normative context. A common defense of activism, articulated not just by institutional investors, but by CEOs and directors alike, is that investors have the *right* to intervene, a right that derives straight from the shareholder value model of the firm, the dominant paradigm of corporate governance advanced by financial economists, institutional investors and the media over the past 40 years (Fama and Jensen 1983; Jensen and Meckling 1976). This perspective, its adoption motivated in part as a response to the profitability crisis of the 1970s, insists that the stakeholders whose interests come before all others are the shareholders, the firm's true 'owners'.

[7] To sell a stock short, or more simply, to 'short' a stock, an investor first borrows the stock from another party, then sells the stock in the hopes that the share price will subsequently decline, then repurchases the stock at the now (hopefully) lower price, and then finally returns the repurchased shares to the party that originally lent out the shares. Traditional investing with which everyone is more familiar involves 'going long' a stock, which simply means buying the stock. Thus, a 'long' position in a stock is a bet that the share price will rise; a 'short' position is a bet that the share price will fall.

Despite the widespread acceptance of this view, there are dissenters. These criticisms note that there is no legal imperative for shareholder primacy, that shareholder value ignores the heterogeneity of actual shareholders,[8] that the metaphor "owners of the firm" is an inaccurate description of shareholders' legal rights, and that the view relies on an absurdly strong notion of market efficiency (Blair 2003; Dobbin and Jung 2010; O'Sullivan 2000; Stout 2007; Stout 2012). Dobbin and Zorn (2005) lay the accounting scandals of the late 1990s culminating in the collapse of Enron due to egregious accounting practices squarely at the feet of shareholder value ideology. Dobbin and Jung (2010) argued that firms adopted shareholder value prescriptions selectively: those which heightened risk, such as stock options and higher levels of debt, were adopted while those which might have mitigated risk, such as independent boards and higher equity ownership by executives, were not implemented. Goldstein (2012) noted that the increased size of managerial ranks and pay was the opposite of what shareholder value prescribed.

This dissent is not confined to academia. As one CEO interviewed for this study maintained: "If you really own the company then run it" (CEO5). And this is precisely what private equity (PE) investors do. Rather than do battle with a firm's management and board, PE investors take full control of a company by buying out existing shareholders and then run the firm as they see fit, sometimes keeping existing management and sometimes replacing management with hand-picked teams. To succeed at such intensive involvement with actually *running* a portfolio of firms, PE investors typically possess extensive

[8] It is an oversimplification if not reductionist to insist that all shareholders simply want the highest return on their investments. Unanswered is: over what time period and in what form? For example, owing largely to their different investment mandates, pension funds, foundations and endowments invest for the very long term which influences not only what they invest in but the return expectations they might have for these investments. Private equity, venture capital, and hedge funds often impose lock-up periods on their investors which relieves them of the burden of quarterly, if not daily, performance reporting. By contrast, mutual funds, by virtue of daily liquidity and daily performance reporting, must be sensitive to their short-term performance which affects the retention or loss of assets. In addition to the heterogeneity of investment horizons, some investors desire income over growth as drivers of their investment returns. Income oriented investors will prefer slower growing, dividend paying companies, for example, while growth oriented investors will gravitate to companies that deliver above average growth rates in profits and free cash flow. Finally, there is a growing number of investors who place increasing importance on the sustainability of corporate profit growth and who incorporate a firm's track record on environmental, social, and governance issues into their buy/sell decisions. Given such heterogeneous interests among investors, the mantra of "increasing shareholder value" fast becomes an ambiguous concept.

operational experience themselves and/or have rich networks of former CEOs and potential board directors whom they can call upon to assist with the management of these firms (Anson, Chambers, Kazemi, et al. 2012; Anson, Chambers, Black, et al. 2012). Shareholder activists, by contrast, typically do not bring such operational backgrounds and rich networks to bear on their target investments and thus occupy a middle ground between PE investors (and venture capitalists) on the one hand, and traditional investors on the other hand who do not engage in activism but display their displeasure simply by selling their shares. Despite this isolated dissent, the responses from nearly all CEOs, directors, and hedge fund managers who participated in this study reveal just how thoroughly normalized is this notion of ownership implicit in shareholder value ideology, and how this understanding of ownership provides a solid foundation upon which to legitimate shareholder activism.

Theoretical Context

The focus on hedge funds will permit an expansion of Useem's analytical framework in *Investor Capitalism* (1996). While his theoretical work on U.S. capital markets remains applicable to the evolving dynamics of corporate control, much has changed since the 1980s. The legislative and regulatory decisions that have occurred since then have largely favored shareholders over boards and managements, further tilting the balance of power toward investors (Gillan and Starks 2007). In addition, hedge funds, largely absent from his treatment of the late twentieth century investment landscape, have emerged as dominant players among institutional investors. While the hedge fund industry managed a mere $173 billion in assets in 1997, by the onset of the financial crisis in 2008, it was managing $3.3 trillion[9], a high water mark not yet superseded in the apparently interminable aftermath of the crisis (*Figure 1.1*). Just as ownership heft was a basis for power among mutual fund and pension fund managers during Useem's focal period, so

[9] By comparison, Goldman Sachs pegged the entire U.S. capital at $56 trillion in 2012, while the OECD estimated that pension funds controlled $14.7 trillion in 2014 (http://www.goldmansachs.com/s/interactive-guide-to-capital-markets; http://www.oecd.org/finance/Pension-funds-pre-data-2015.pdf).

too for hedge fund managers in the new millennium. Prior to the dot-com crash, hedge funds averaged less than 100 activist events per year as shown below in *Figure 1.2*; subsequent to the crash, a period during which their assets under management ballooned, they engaged in nearly 200 activist events per year, peaking at 343 such events in 2014 alone. A portion of these activist events are initiated by dedicated hedge fund activists which the hedge fund research firm *Preqin* tallies to be more than 400 funds globally with two-thirds headquartered in the U.S. ("Preqin Special Report: Activist Hedge Funds" 2014). Useem also argued that large investors exercise activism when their holdings become so large as to preclude selling without substantial price penalties. Many activist hedge funds, being of substantially smaller size, do not suffer the immobility Useem observed in large pension and mutual funds. The dedicated activist hedge funds, including the very large ones, which invest *solely in order to* mount activist campaigns would hardly be considered captives of their oversized positions. Also, unlike shareholder activism in the 1990s which focused on social issues and corporate governance reform, subjects of Useem's analysis, the hedge fund activism that generates the greatest returns to shareholders focuses on the reallocation of capital, typically through the sale of the firm or through a change in business strategy (Brav, Jiang, and Kim 2013). And unlike the corporate raiders of the 1980s, hedge funds rarely pursue the outright takeover of their target firms. By connecting the dots, as it were, between 1996, the year *Investor Capitalism* appeared, and 2016, it should become evident that not only has shareholder activism intensified, but it has also become routinized and thus a piece of the normative structure of capital markets, its disruptive character notwithstanding.[10] Its increasing frequency and its real effects on firms and workers underscore its ongoing significance for sociologists.

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[10] While Silicon Valley has laid claim to 'disruption' – disruptive technologies, disruptive apps, and the like – the ethic of disruption is one which investment bankers have always pedaled (Ho 2009), an ethic with roots ultimately in the notion of 'creative destruction' articulated by Schumpeter (1942). In this respect, shareholder activism, because of rather than despite its disruptive character, is primed for being embraced within the boundaries of normative capitalist behavior. That it is "part of the normal landscape" then merely highlights both its more routinized occurrence and greater legitimacy today as compared to the corporate raiders of the 1980s. The chapter "Hedge Funds" will discuss the legitimacy of hedge fund activism in greater detail.

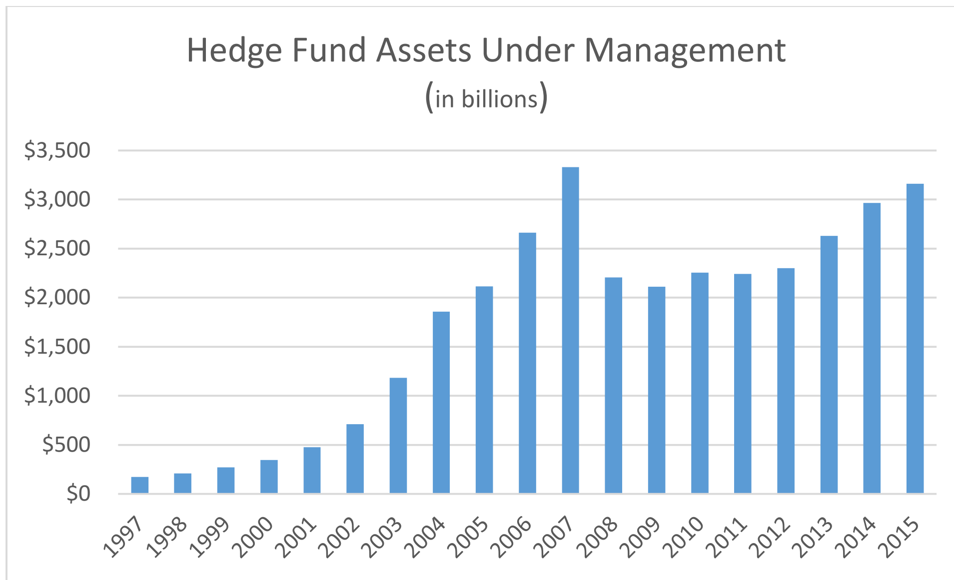

Figure 1.1: Hedge Fund Assets Under Management (Source: BarclayHedge.com)

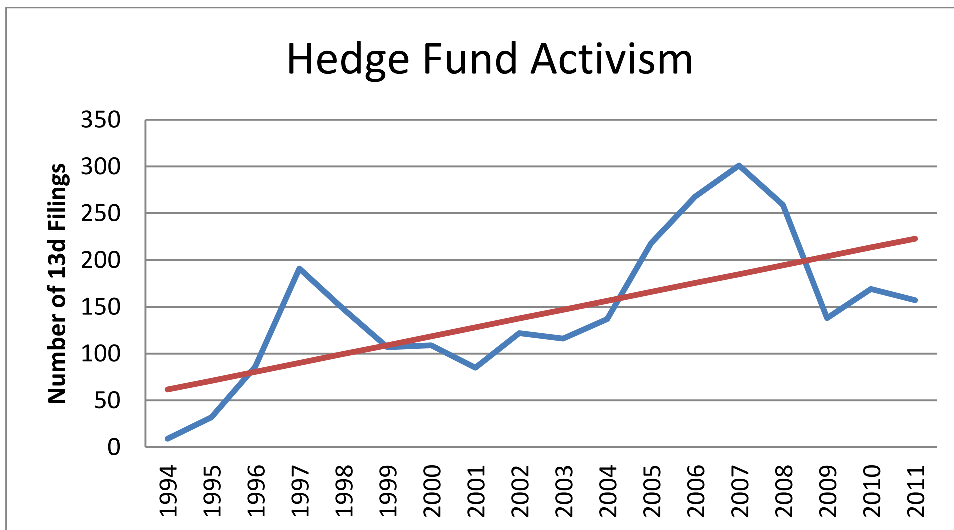

Figure 1.2: Hedge Fund Activism (Source: Dataset from Professor Alon Brav)

Examining hedge funds and hedge fund activism also will provide an opportunity to expand and clarify Kang and Sorensen's (1999) perspective on shareholder power. They theorized that shareholders have three bases of power: formal authority, social influence, and expertise. While hedge fund activists depend on standard types of *formal* authority

such as exercising their right to vote on director nominations and on major business decisions, Kang and Sorensen further understood formal authority to include holding executive positions and/or board seats in a firm, as is common with family-owned firms, an investor type in which they were quite interested. But hedge fund activists display this sort of authority, if at all, only *after* they press a firm with their activist agenda which might result in winning one or more board seats.

The social influence Kang and Sorensen (1999) describe derives from "repeated interactions between owners and managers over time" (p.136). It is true that, as we will see in the chapter *CEOs*, many CEOs pursue extensive interactions with the institutional investor community and, in the interest of cultivating a reliable base of long-term investors, will pursue "repeated interactions" with their larger and more knowledgeable investors. Similarly, we shall see that *friendly* hedge fund activists also place a premium on "repeated interactions" with the CEOs of their target firms. But interactions between hedge fund managers who are inclined to pursue more *hostile* varieties of activism and directors and CEOs often occur over short time periods that preclude the development of relationships based on trust; in fact, the very presence of a hostile posture by an activist is evidence that the exercise of any social influence over the CEO and board has not succeeded in producing the desired outcomes. Instead, the relevant source of a hostile activist's social influence arises between hedge fund managers and *other institutional investors*, including other hedge fund managers, through direct and indirect means.

Lastly, shareholder expertise for Kang and Sorensen (1999) also derived from engagement and/or governance participation with a firm over time. While this is absolutely true for many hedge fund managers, including some hostile activists who win board seats and friendly activists who establish longer term relationships with management, this also does not seem to fit with the shorter term character of most *hostile* hedge fund activism. Equally importantly, we shall see that hedge fund managers have additional sources of expertise such as corporate experiences of their own as well as superior knowledge in the field of finance as it pertains to capital allocation.

In sum, the unique character of hedge funds – unconstrained, lightly regulated, aggressive, pure capital allocators – points to a more robust and muscular form of shareholder power than that which Kang and Sorensen theorized, with important implications for understanding the allocation of capital within public securities markets and within public firms themselves. Indeed, hostile hedge fund activism can be significantly more confrontational when compared to the more traditional exercise of shareholder authority where management's wishes are often automatically approved through routine proxy voting. In the hands of the hostile activist, the proxy is no longer a benign governance mechanism but a potentially disruptive and transformative tool. But its deployment, as well as the overall success of an activist engagement, depends upon the perceived legitimacy of the activist. Although Kang and Sorensen are silent on legitimacy, it easily weaves into the three elements of their framework: on the one hand, an activist's legitimacy is inextricably dependent upon both authority and expertise; on the other hand, an activist's social influence is possible only to the extent that market participants perceive the activist as legitimate.

Interrogating hedge fund activism is a means for better understanding how the separation of ownership and control is eroding. This study adopts a broader conception of activism that includes not only the hostile variety which is the sole focus of the scholarly research cited heretofore and in the upcoming literature review, but also the friendly variety, what is sometimes referred to as 'constructivism', 'suggestivism', or 'relational'. The reason for this broader conception is that both approaches have the same goal in mind – to influence or change managerial and/or board decision making surrounding some issue(s) of firm behavior which ultimately will affect the allocation of capital. To be sure, there are differences. Hostile activists often apply pressure on matters of existential consequence, such as divestitures, the sale of the firm itself, other forms of reorganization, or boardroom takeovers, and they apply such pressures tenaciously. As best we can discern, friendly activists do not typically pursue existential matters, focusing instead on matters of strategy, governance, or communication, and are inclined to simply sell their holdings rather than fight if they believe their input is neither heard nor welcomed. While the

demands of hostile activists are typically public, those which friendly activists make are not by virtue of the quiet, one-on-one nature of friendly engagements, and thus further research is necessary to determine the degree of commonality or dissimilarity between the character of the demands of the two types of activists. The crucial commonality, however, is that both types believe it to be often legitimate and necessary to breach the separation of ownership and control in order to change firm behavior.

CEOS AND DIRECTORS

On the opposite side of the moat which hedge fund activists bridge with increasing frequency are the CEOs and boards of targeted firms. Why, and under what conditions, do CEOs and boards sometimes ignore, resist, accommodate, or acquiesce to hedge fund demands? Despite the extensive recognition among scholars of the dominance of shareholder primacy ideology, some have convincingly argued for a more nuanced view in which managerial capitalism persists despite the apparent hegemony of powerful investors. Useem (1996) himself, while drawing a clear distinction between managerial and investor capitalism, understood the limits of this binary by noting that executives had "mastered techniques for resisting, accommodating, and managing the pressures" from shareholder activists (p.208). Goldstein's (2012) finding of rising managerial ranks and pay during the shareholder value era similarly suggests that managerialism refuses to die a quiet death. Westphal has written extensively on the various ways that CEOs exercise symbolic management of investors and directors in order to appear compliant with shareholder expectations and demands while in fact preserving space for executive discretion and prerogatives (Westphal and Bednar 2008; Westphal and Clement 2008; Westphal and Khanna 2003; Westphal and Zajac 1998; Westphal and Zajac 2001; Zajac and Westphal 2004). From conversations with seventy CEOs and directors, this study identifies the attitudes these actors have towards shareholder activists generally and hedge fund activists specifically, and explores the ways these actors manage their relationships and interactions with their larger shareholders.

Brav et al. (2008) calculate that hedge fund activists succeed in getting their demands completely met 40.6% of the time, and enjoy at least partial success in another 25.8% of the observed cases between 2001 and 2007. We can recast this and note that boards and CEOs successfully either resist or at least attenuate activists' demands most of the time. But even an apparently unambiguous activist success such as attaining a board seat must be viewed cautiously. One finding from the interviews shows that some directors see giving an activist a board seat as a way of defusing if not disarming an activist: once on board, the activist (or her representative) no longer simply represents the activist's interests, but is legally bound to represent the interests of all shareholders. Indeed, one activist hedge fund manager rued how some of his handpicked appointments did not work out as expected: "They've gone rogue and they don't get nominated again" (HF25). Activists, or their appointees, who gain board seats are further bound by confidentiality obligations which thereby prevent the activist from trading on insider information. Thus, rather than an overt success for the activist as Brav et al. (2008) might cast it, such a resolution might be better understood from Westphal's symbolic management perspective. This project, then, will try to extend Westphal's notion of symbolic management to directors' and CEOs' interactions with hedge fund activists to ascertain whether and how boards and CEOs resist, accommodate, and manage hedge fund activists.

LITERATURE REVIEW

Hedge Fund Activism

The increasing prominence of hedge funds over the past decade, both as more legitimate institutional investors[11] and as powerful shareholder activists, has not escaped

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[11] According to SEI Investments, the average allocation in 2012 by institutional managers such as foundations, endowments, and pension funds to the hedge fund class was 17.8% of these institutions' total assets, a demonstrable inclusion of what for good reason is formally known as an alternative investment class. Of significant note, though with as of yet unknown ramifications, is that CalPERS, the California pension fund run on behalf of the state's public employees, *eliminated* its $4 billion exposure to hedge funds in 2014. CalPERS, back in 2001, was the first pension fund to invest in hedge funds, a practice that lesser pension funds quickly emulated. This path was paved by the Department of Labor in 1996 when, in its "Ludwig Letter" to the Comptroller of the Currency, it indicated that the same fiduciary standards outlined in ERISA

the attention of scholars. The near unanimous consensus on hedge fund activism that has emerged has been decidedly sanguine. Some assert that hedge funds fulfill their monitoring role better than other institutional investors as evidenced by favorable market reactions to announced hedge fund activism and by improved operating performance of targeted firms (Bebchuk, Brav, and Jiang, 2013; Boyson and Mooradian, 2011; Brav et al., 2013; Brav et al., 2008; Clifford 2008; Klein and Zur, 2009). However, some have challenged these more positive assessments (Coffee and Palia 2014; Gillan and Starks 2007). Greenwood and Schor (2009) present evidence that abnormal market returns only accrue to targets which are eventually taken over by another firm, and that targets which remain independent generate no statistically significant abnormal market returns. They also find no evidence that targets which remain independent show improved operating performance. They conclude that the "successes" enjoyed by activist hedge funds stem from putting targets "in play." Brav et al. (2008) also find that targeted firms exhibit an increased likelihood of being sold, lending some credence to Greenwood and Schor's (2009) findings. Brav et al. (2008) and Brav et al. (2013) find that hedge fund activism is further associated with an increased likelihood of CEO turnover and decreased CEO pay.

Perhaps most surprising in this research are findings on the characteristics of target firms: hedge funds target healthy as well as unhealthy firms. Boyson and Mooradian (2011) observe that, although average target firms have poor stock performance and subpar growth opportunities, they nonetheless have strong operating characteristics such as high return on assets and strong cash flows. They sum up the average hedge fund target as "a cash cow with poor growth prospects" (p. 170). Clifford (2008), comparing firms in which hedge funds adopt activist stances against firms in which hedge funds adopt more passive stances, also finds that activist targets sport much higher returns on assets and equity than do passive targets. Similarly, Brav et al. (2008) find that hedge fund targets are very profitable albeit slow growth firms.

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law applicable to traditional stock and bond investments, could be similarly applied to the investment in derivatives and funds employing derivatives which would include hedge funds.

Although the research is suggestive, but not conclusive, that hedge fund activism generates above market rates of returns, only a small fraction of hedge funds pursue activist actions. Brav et al. (2008) document 236 activist hedge funds – out of several thousand hedge funds – between 2001 and 2006 which engaged in 1059 activist events. If activism is pursued because of the opportunity for generous returns, why do not more hedge funds pursue activist agendas? Perhaps there is far more activism which quantitative approaches have failed to detect. Despite the apparent richness of empirical data now available on hedge fund activism, it remains unclear why hedge fund managers do or do not engage in it. A hedge fund manager who adopts either a friendly or hostile activist posture vis-à-vis his or her target raises further questions. How do they legitimate their activism? What networks, if any, do they rely on, or what other avenues of social influence do they utilize when engaging in activism? Touching on perhaps the central paradox of activism is the question: why do activist hedge fund managers believe they possess knowledge and solutions superior to that of management, especially given that management has access to non-public information unavailable to the activist?

Director and CEO Interaction with Hedge Fund Activists

While the empirical literature on hedge fund activism already cited presents interesting findings on some of the effects on firms resulting from activism, it is silent on what governs CEOs' and directors' interactions with and responses to hedge fund activists. Stepping back from hedge funds specifically to examine such interactions with investors more generally, we do find research that takes the perspective of managements and boards. Khurana (2002) argues, for example, that boards exercise impression management in dealing with powerful institutional investors when selecting a new CEO by emphasizing charisma over substantive skills. Westphal has written extensively on the various ways that CEOs and boards resist stakeholder pressures. Westphal and Khanna (2003) show that directors are "encouraged" to resist shareholder pressures for governance reform by directors who sit on other boards who exact social costs and sanctions on such reformist directors. Westphal and Zajac (1994) found evidence that many firms *announce* long term

incentive plans (LTIPs)[12] for upper management, but subsequently issue trivial grant amounts or issue no grants at all despite the plan announcement. They later find that, despite such decoupling, markets nevertheless respond positively and these firms are less likely to implement governance reforms than are firms which do not announce LTIPs, suggesting that symbolic announcements alleviate multiple shareholder pressures (Westphal and Zajac, 1998). Equally interesting is that these effects were more pronounced when LTIP announcements were couched in shareholder value language. Similar decoupling and symbolic management of shareholders occurs through the announcement of share buybacks which are subsequently not implemented (Westphal and Zajac, 2001; Zajac and Westphal, 2004). Westphal (1998) showed how CEOs use social influence consisting in persuasion and ingratiation to deter directors from exercising their power in ways unwelcome to these CEOs, and later (Westphal and Bednar, 2008) similarly showed how CEOs use the same social influence techniques to mollify shareholders. Managers were also found to successfully mitigate negative reactions by securities analysts to negative corporate news through favor rendering, a form of ingratiation (Westphal and Clement, 2008).

This sizeable body of research, then, provides strong evidence of CEO's symbolic and impression management of investors and directors in order to appear compliant with shareholder expectations and demands while in fact preserving space for executive discretion and prerogatives. Westphal's research agenda is thoroughly skeptical of the idea of the so-called 'pressure-resistant' investor who is immune to such symbolic and impression management; on the contrary, his research consistently advances the notion that institutional investor resistance to symbolic and impression management is largely ineffectual. But such findings are clearly at odds with the research on hedge fund activism

[12] A long-term incentive plan (LTIP) is performance based compensation where the board measures the CEO's performance typically over a three to five year period using some agreed upon metric such as return on assets (ROA). Assuming the firm meets or exceeds the agreed upon performance target, the board will award an agreed upon number of shares, stock options, share rights, or some other form of stock. Usually, half of the award vests immediately, and the other half is deferred. LTIPs often represent more than half of a CEO's compensation and are intended to motivate the CEO to adopt a longer term orientation to his or her operational and strategic decisions.

just cited, a contradiction likely arising from the fact that *any specific treatment of hedge fund investors is absent* from Westphal's research: Westphal and Bednar (2008) identify 'pressure resistant' institutional investors, those who are the likely targets of CEOs' symbolic management and social influence behavior, as "pension funds, mutual funds, endowments, and foundations" and 'pressure sensitive' investors as banks and insurance companies (p.35).[13] Also absent is any treatment of director-shareholder interaction; Westphal and Khanna (2003) consider only director-director interaction. The body of research dealing specifically with hedge funds suggests, therefore, that hedge funds are unlike other kinds of institutional investors such that they very well may be effective in influencing or constraining managerial behavior.

FINDINGS

Hedge Funds

Responses from hedge fund managers participating in this project revealed several structural reasons why one hedge fund manager might pursue activism while another might not, such as the asset class a fund targets and the investment strategy it utilizes, the fund's resources and the attitudes of the fund's clients, and perhaps most importantly, the hedge fund manager's skillsets and dispositions. Numerous managers emphasized their attitudes towards conflict as a critical determinant for their engagement in either friendly or hostile activism, with friendly activists underscoring their aversion to conflict and confrontation.

Responses also revealed numerous mechanisms for legitimating activism, but paramount among these was shareholder value ideology: the *raison d'etre* of management is to generate the highest possible returns for its shareholders, and if it is unable to do this, or worse, places other interests ahead of those of its shareholders, then shareholders have a right to speak up. Sensitive to the delegitimizing power of the 'short-term' label, numerous hedge fund managers simply rejected the label, either by questioning its meaningfulness or by normalizing it. Lastly, activists legitimated their actions by

[13] These types of institutional investors are identical with those whom Useem (1996) identified.

emphasizing the obviousness of the issues they are agitating against, which becomes the basis for delegitimizing the target's management and board.

The most important mechanism for social influence by hedge fund activists, according to respondents, was reputation. Successful hostile activism requires that management teams realize that they're dealing with an investor who will not back down and that other institutional investors perceive the activist to be acting legitimately; in other words, the investor must have a reputation for past successful activism. With such a reputation, target firms are more likely to dialogue, less likely to resist, and other institutional investors are more likely to show support. Friendly activism too requires a sound reputation, since a management team may be more open to collaborating with an institutional investor knowing that it does not represent the existential threat that a hostile activist poses. A second mechanism for social influence was the use of the 13D filing as a flag to the investment community that activism may be in the offing, thereby generating interest in a target's shares. As an example of symbolic management, not by CEOs as Westphal and Zajac (1998) describe but by hedge fund managers, some filed 13Ds even when they had no intention of engaging in hostile activism, but exploited the signaling effects of the 13D to draw attention to their underfollowed target investments. An interesting finding was that some hedge fund managers outsource the occasional activist opportunity to other hedge funds that pursue activism full-time, highlighting the role of such networks for expanding an investor's otherwise more limited social influence and also the function that such outsourcing plays in these managers' impression management vis-à-vis their target investments, maintaining their appearance as non-activists.

Regarding a hedge fund manager's implicit or explicit claim to having superior knowledge as compared to management teams, several findings emerged from hedge fund managers' responses. Given the shorter tenures for CEOs, roughly six years as compared to nearly 10 years several decades ago (Kaplan and Minton 2012), it is not uncommon for very seasoned hedge fund managers to have been following a given company for a period of time far greater than the tenure of the sitting CEO, and therefore possess more institutional knowledge of the firm than that of the CEO, especially in the extreme cases

of a newly hired external CEO. Even with seasoned CEOs, some hedge fund managers bring their own direct operational experiences from their pre-hedge fund days, or hire experts that have this experience and or knowledge, that can neutralize any knowledge advantage a more experienced CEO might have. Hedge fund managers may have knowledge advantages deriving from the fact that most hedge funds invest in smaller companies which, by definition, will have less experienced and less knowledgeable executives that one would find at larger companies, a circumstance exaggerated in those cases where the small company is of recent vintage. Perhaps most importantly, respondents highlighted the fact that capital allocation, the very essence of the money management business, requires highly specialized knowledge and techniques which hedge fund managers employ full-time, applied again and again to an ongoing stream of new investment possibilities as well as to investments currently held, always with the same question in mind: what will be my expected return, over what time period, and with what level of risk? CEOs, by contrast, only occasionally contend with capital allocation, an effort that competes with setting strategy, motivating the troops, dealing with operational and human capital issues, measuring of the firm's vital signs, and staying abreast of legal and regulatory matters. Additionally, many CEOs will likely have had precious little experience in making major capital allocation decisions prior to ascending to the C-suite.

The Kang and Sorensen framework of shareholder power fits friendly hedge fund activists quite accurately: they have significant formal authority attained through significant share ownership; they bring knowledgeability and expertise; and they enjoy social influence with their targets through repeated interactions over time. Paradoxically, these attributes do not necessarily add up to shareholder power in the case of friendly activists because of their aversion to the use of coercion to get their way. On the contrary, I maintain that it is management whose power is enhanced in its relationship with a significant friendly hedge fund because such an activist will vote with management in a conflict with a hostile activist. Ironically, in the case of the truly powerful shareholders – hostile hedge fund activists – the Kang and Sorensen framework applies less harmoniously. Rather than enjoying social influence with management through repeated interactions, a

hostile activist depends for success ultimately on the social influence it can nurture with other shareholders.

CEOs and Directors

The most important finding emerging from the responses from CEOs who participated in this study is that most are deeply embedded with their institutional shareholders, while those from directors reveal a surprising level of disengagement. Although impression management is a fundamental element of any social interaction, most CEOs highlighted the benefits of establishing positive relationships with their fully legitimate shareholders – those who were both knowledgeable and owned significant stock positions. Respondents held moderately favorable opinions of the expertise of such shareholders as well as of their ideas and recommendations for improving the business or share performance. While it was rare for a CEO to adopt wholesale an idea advanced by a fully legitimate shareholder, numerous respondents acknowledged leveraging their sophisticated institutional investors for accessing new knowledge and for validating and/or calibrating management thinking. CEOs were also keenly interested in insuring that shareholders clearly understood management's thinking, goals, and strategies. Virtually every CEO dedicated substantial efforts and resources at trying to craft shareholder rosters populated mainly with fully legitimate shareholders, but acknowledged that such efforts were often difficult. Indeed, a structural advantage accruing to activists is that the mere announcement of activism can trigger significant share turnover with exiting shareholders selling to other hedge fund managers, foiling efforts to cultivate an ideal shareholder base.

By contrast, numerous CEOs were dismissive of less than fully legitimate shareholders, particularly those they deemed marginal such as corporate gadflies, labor unions, short-term investors, and short-sellers. They were especially leery of hedge fund managers, seeing them as short-term investors while implicitly acknowledging the power such managers could potentially wield. The fact that CEOs chose to not devote time and attention to hedge fund managers (because they see them as short-term holders) contradicts Westphal and Clement's findings that CEOs engage in greater levels of ingratiating and

persuasive behavior with shareholders who can potentially exercise higher levels of influence over corporate behavior (2008). In the parlance of the literature in which Westphal situates himself, it is unlikely that CEOs can use symbolic management to disarm or distract hostile hedge fund activists as they represent not merely a pressure resistant investor type, but an *ultra*-pressure resistant investor type by virtue of their being *unconstrained, lightly regulated, aggressive, pure capital allocators.* Lastly, numerous CEO respondents unexpectedly expressed support for much of the hostile activism that was visible to them through the media, placing blame on target firms for failing to create shareholder value. Interestingly, directors were more likely than were CEOs to underscore the disruptive and potentially damaging effects on a firm from the actions of a hostile activist.

While CEOs can recoup some of the power otherwise lost to increasingly more powerful institutional shareholders by thoroughly embedding themselves with their large and knowledgeable institutional investors, the opposite seems to be the case with directors. The strikingly little shareholder engagement directors pursue places them in positions of dependency on their CEOs, relying on them to communicate what is on shareholders' minds. With shareholder engagement thus outsourced to management, directors are further absolved from acquiring deep knowledge of the firms they oversee and advise, a posture already sanctioned by the boardroom norm that *directors do not manage*. Thus, directors' knowledge deficits both stem from little shareholder engagement as well as impede it, and these knowledge deficits coupled with their inexperience in interacting with institutional shareholders do not bode well for when directors have no choice but to confront hostile activists.

METHODOLOGY

This project hopes to continue to build on, clarify, and amend the growing body of quantitative work on shareholder activism generally and hedge fund activism specifically with qualitative insights obtained from semi-structured interviews of ninety-nine respondents. Thirty-four CEOs and thirty-six directors were recruited from a randomized

list of Standard and Poor's 1500 companies which is an index of the largest fifteen hundred publicly traded companies in the United States. No CEO made referrals to other CEOs, but two directors each made referrals to one other director. Thus snowballing was of little use with these elites. The response rate was about 8% for the three types of respondents. Hedge fund managers were contacted using both the Brav dataset and the Hedge Fund Research (HFR) dataset. The Brav dataset ostensibly consists of only hedge funds that have engaged in hostile activism. With the HFR dataset, only equity oriented funds were selected while excluding those funds identified as "activist funds" where shareholder activism is the very purpose of the fund. Thus, the goal was to utilize the Brav dataset as a source of hedge fund activists and the HFR dataset as a source of non-activist hedge funds in order to understand why some hedge funds pursue activism while other hedge funds do not. As it turned out, several of the HFR sourced hedge funds did indeed have activist experiences.

All CEOs and some directors were contacted using letters under the signature of Professor William Cunningham. Most directors were contacted via email using email addresses procured from the Alumni Contact List from the University of Chicago. All hedge fund managers were recruited through phone calls.

Interviews lasted on average one hour: CEO interviews averaged about thirty minutes; directors averaged about one hour; and hedge fund managers often lasted beyond one hour. With the exception of one hedge fund manager interview which was conducted via email, all other interviews were conducted over the phone and recorded with the respondent's permission. Interviews were professionally transcribed and then coded using inductive coding techniques as described in Emerson, Fretz, and Shaw (1995). Because females are underrepresented within the ranks of CEOs and directors, several female CEO/director respondents requested that gender not be included when describing respondents so as to insure that their identities remained confidential, a request I have honored. The lone female hedge fund manager made no such request. All company names have been masked, whether used when describing a respondent or whether a respondent mentions such names during the course of an interview.

There is nothing random about the ninety-nine individuals who ultimately agreed to participate in this study. While it is difficult to say with any degree of certainty, it is still useful to speculate on the motivations of respondents for participating as such motivations can help inform the degree to which the reader may be inclined to regard the respondents as credible and reliable. Most of the directors interviewed as well as several hedge fund managers were identified as alums of the University of Chicago, including the Booth School of Business, the Law School, and the College. It was my intention to exploit my own status as an alum of both the College and the Booth School of Business and the sense of solidarity, and thus willingness to help, that alums feel towards those with shared experiences. All of the CEOs received a personally signed letter from Professor Cunningham inviting them to participate. Professor Cunningham's status, including as Lead Director of Southwest Airlines, Chairman of Lincoln Financial, and past President and Chancellor of The University of Texas, likely elicited a sense of professional courtesy and respect on the part of those who agreed to participate. In short, the participation of virtually all respondents appeared to be a simple act of generosity and goodwill rather than an opportunity to grind an ax. One CEO did seem disappointed that the object of inquiry excluded socially conscious activism as he expressed his exasperation with the relentless stream of proxy resolutions advanced by church groups and labor organizations. Given that socially conscious activism was likely an ax he desired to grind, I found no reason to doubt the reliability and credibility of his responses regarding business and financially oriented activism, the actual object of inquiry.

It would have been unsurprising to encounter resistance or defensiveness from elite respondents dialoguing with a sociologist, but I believe I encountered virtually no such postures by virtue of my own business *bona fides* and Professor Cunningham's valuable endorsement. My familiarity with investment jargon and shorthand, with economic and investment principles and theory, with corporate hierarchies and organizational structures, with the variety of forums at which management and investors interact as well as my own participation in these forums, lent me credibility and perhaps trustworthiness as an interlocutor. Of course there were exceptions. One director answered questions tersely if

not abruptly, akin to one adopting a minimalist prose at a deposition, but the shortcoming of the exchange was in its brevity and the lack of much usable data, not in any sacrifice of credibility. Another respondent, a hedge fund manager, provided detail up to a point, but would then deflect. The most useful data came through specific examples for which I relentlessly prodded my respondents with varying degrees of success. The fact that no respondent interrupted, reacted dismissively, or otherwise cut off my statements regarding confidentiality left me with the impression that all respondents valued these assurances, thus implying that their responses would likely be more rather than less candid. Indeed, there were several instances when a respondent prefaced his or her response with some variation of "…and I'm trusting that this will remain confidential…"

My familiarity with the world of investments did pose one risk to the interviews. In order to better identify actors' assumptions about their world and about their own actions – the taken-for-granted – ethnographers, and even mere interviewers, must adopt a certain naiveté regarding the subject matter. While I did pursue this ideal posture, the more familiar a researcher is with a given subject matter, the more difficult it understandably is to interrogate such subject matter as if it were unfamiliar. The reader can judge my success or failure at this.

Just as every interaction a CEO has with the investment community involves some degree of impression management, so too were respondents' interactions with me likely imbued with impression management, further compounding the task of discerning respondents' attitudes and beliefs. The ability to disentangle fact from fiction, substance from spin, varies from individual to individual but always involves evaluating internal consistency, comparing responses with known facts about the subject matter and with comments from other respondents on similar issues, and privileging examples over platitudes and specificity over generalities. It is my hope that the reader will find the inferences and conclusions I draw to be reasonable and sufficiently supported by the data contained in the responses from the ninety-nine subjects.

With so much quantitative research available on hedge fund activism, what is the point of a qualitative study? Some quantitative researchers see the value of qualitative work

in the early stages of researching a new branch of inquiry, where qualitative work can initiate the arduous task of mapping the new terrain and suggesting profitable avenues for further investigation, and subsequently, with the benefit of these maps and suggestions, quantitative researchers can set about the real work.[14] This study, however, demonstrates the value of follow-on qualitative work not only in bringing unique insights to bear on the subject matter, but in providing critical insights on the quantitative methods already widely embraced. Specifically, while it was not the objective of this project to precisely specify the number of activist events in which hedge funds engaged, this project reveals several reasons why such precision is elusive.

First, to the extent that any activism achieves an investor's goal of shaping or altering management behavior, friendly activism is as relevant to investigations into the control of capital as is hostile activism. But friendly activism is, by definition, quiet and out of the public gaze. An important study omitted from the literature review involves a case study of the Hermes *UK Focus Fund*, a British pension fund (Becht et al. 2010). In more than 80% of instances of activism that occurred between 1998 and 2004, the Hermes Fund engaged *privately* with its target to communicate its expectations for change by way of letters, phone calls, and on-site visits. It is possible, of course, that U.S. hedge fund managers, as compared to their UK counterparts, make their confrontations with management public and visible far more frequently. But even Institutional Shareholder Services and governance consultants acknowledge that substantial engagement between activists and management and/or boards takes place privately (Menza 2013). With so much *hostile* activism out of the public gaze together with some unknown number of cases of friendly activism, the inescapable implication for research on hedge fund activism is that reliance on publicly available data on activism can only result in a gross underestimate of its magnitude.

Second, virtually all of the research into hedge fund activism relies on 13D filings with the SEC, a crude indicator of hostile activism at best, and an inaccurate one at worst.

[14] This perspective was provided to me in conversation by Professor Wei-hsin Yu.

A shareholder is required to file a 13D with the SEC when their ownership in a company exceeds 5% of the outstanding shares *and* when the shareholder desires to effect some sort of change at the target firm. In the absence of such a desire, shareholders can file the less burdensome 13G. Thus, 13Ds are typically viewed as an indication of imminent shareholder activism. But activism can occur when investors own less than 5% of a firm's outstanding shares which would not result in any 13D filing. In these cases, activism can be detected if the activist makes his or her intentions public, but such publicity requires the participation of some major media outlet, participation which is likely if the activist's target is a large firm, but is unlikely if the target is a small-cap firm, let alone a micro-cap firm. And, given Becht et al. (2010), since much activism is likely private, the absence of any filing can make it impossible to detect.

Third, and perhaps most troubling for researchers relying on 13D's as an indicator of activism, the 13D sometimes indicates no such thing. Item 4 of the 13D is the place where an activist will describe their intent which can range from a simple "we're keeping an eye on you" to an anodyne "we want you to increase shareholder value," to something considerably more threatening, such as the removal of specific board members or "the exploration of strategic alternatives," code for putting the firm up for sale. But the following Item 4 comment did not even rise to even the mildest form of admonition; rather the opposite:

> On October 3, 2002, Acquisitor [hedge fund manager] wrote a letter to Aaron Todd, the Issuer's [Air Methods Corp] Chief Operating Officer and Chief Financial Officer. In the letter the Reporting Person *commended* Mr. Todd and George Belsey, the Issuer's Chairman of the board, on the value they were creating for shareholders with the pending acquisition of Rocky Mountain Holdings, LLC [emphasis added] (Acquisitor PLC 2002).

The letter referenced in the above Item 4 was included as an attachment to the 13D filing and reads in part:

> I am writing to *congratulate* you on your appointment to the board of Directors of Air Methods Corporation (the "Company") and to also commend you and George Belsey on the *good work* that you are doing for your shareholders. I realize that the value you are

> creating is, in our opinion, not yet fully reflected in the Company's stock price and that the pending acquisition of Rocky Mountain Holdings and the fact that the Company is now accruing for taxes even though not paying any, may have confused the market. We, however, have taken the view that the proposed transaction will be *good for the Company* and its shareholders and have, therefore, *increased our ownership* in AIRM in the past weeks. *I don't know of any better way of showing our support* for your efforts [emphasis added] (Acquisitor PLC 2002).

Of course, even benign letters and 13Ds such as this one may contain an implied threat if the fund manager has a track record of hostile activism, especially since the fund manager chose to use the 13D over the more benign 13G. But *in this specific case*, the congratulatory tone of the 13D is clearly the furthest thing from being an indication of any activism, let alone hostile activism, and yet it is included in the Brav dataset of hedge fund activism.

While the above example is from a hedge fund manager who did not participate in this study, there were also two from the eight respondents culled from the Brav dataset who attested to filing a 13D when they had no hostile intentions whatsoever. Among the reasons why a 13D filing might not be indicative of hostile activism is that the fund manager has an inadequate grasp of the legal and regulatory landscape leading to a misunderstanding of when a 13G ought to be filed as opposed to a 13D. One hedge fund manager (HF1) explained:

> A: We don't get active at the board levels. So, you know, for us, I think we were younger in our industry, we filed more [13]D's not realizing that, you know, since we're not looking for board representation, we're not looking to be truly aggressive in any fashion, we're better off, you know, with a [13]G filing.
>
> Q: So…it sounds like the [Company A] and the [Company B], they could have easily been G's?
>
> A: [hesitates] …yes, I would say so.

HF1 simply misunderstood the appropriateness of a 13G filing over a 13D filing: by his own admission, hostile activism did not capture HF1's posture toward his target firms, but he nonetheless filed a 13D rather than appropriately filing a 13G. A researcher relying on

the 13D as indicative of hostile activism would erroneously include HF1 in their dataset. HF2 describes a similarly erroneous 13D filing:

> A: So, that we've been 13D filers on. We had not been active in beating up management because we happen to know this CEO and he is an old friend and when we acquired the shares years ago, we believed that they were undervalued back then and we acquired a nice position in it to support a friend and also to make money and it was working out for a while, but then when the markets just collapsed, it was not working out the way we wanted to. And we say 'support a friend' – we knew he had a vision for growing the business and he too was hit with the delays due to the financial crisis.
>
> Q: And so it was your friend, but in a 13D, you're articulating your demands.
>
> A: Well, yeah, we were saying that we believed the stock is undervalued and we may buy more stock. We may look into other avenues to seek appreciation of the value of our shares. We didn't hammer away at him because we knew what – we had spoken with him enough and he had articulated his vision to us and we felt very comfortable that he had a credible plan.
>
> Q: Pardon my ignorance, but couldn't you have just filed a 13G?
>
> A: Yeah, I guess we could've. We definitely could've.

To "support a friend" is hardly the stuff hostile shareholder activism is made of, and indeed, the 13D notwithstanding, HF2 had no intention of pursuing hostile activism towards this target and should have simply filed a 13G.

In sum, two of the eight hedge fund managers from the Brav dataset admitted to using 13D filings for purposes other than as an indication of activism, a fact that, at a minimum, should engender a modicum of caution among researchers relying on 13Ds as their primary filter for ascertaining the presence of shareholder activism and also among those interpreting the findings from such studies. When the less than fully reliable 13D is considered in conjunction with the frequent occurrence of non-public activism, it becomes clear that an adequate methodology for accurately identifying the character of shareholder engagement, let alone precisely estimating the frequency of activism, is a much more elusive goal than is generally acknowledged.

Importantly, such findings suggest that qualitative approaches may have value not just in mapping unchartered territories i.e., in discovery, but in validating – or invalidating – research techniques and findings in well-plowed fields as well. While qualitative researchers are no doubt breathing a sigh of relief, they are already entirely cognizant of the rich knowledge accessible through qualitative methods independent of or in concert with quantitative methods. In talking to people we have the opportunity to examine how they understand their universe, what meaning they assign to what they do and to the words they employ. To every CEO, a 'short-term investor' is an investor who has less status than a 'long-term investor' and is a potentially destabilizing force creating price volatility. To many (though not all) hedge fund managers, a short-term investor is merely an investor employing one legitimate investment technique out of many. The very phrase 'short-term' is of limited utility, they would argue, as *all* stock prices represent the discounted value of some estimated stream of future free cash flow: if XYZ's share price jumps from $40 to $50 in a single trading session simply on the announcement that some known activist has purchased a significant stake in XYZ, the $10 increase, while occurring in the short-term, nevertheless reflects the discounting of higher than previously expected *future* profits resulting from whatever change the activist is pushing for.

While these meanings that actors assign to words and ideas are interesting in their own right, they also guide and justify the actions they take. No CEO, for example, will expend time or energy cultivating relationships with short-term investors; on the other hand, many institutional shareholders, being far more ambivalent to the short-term/long-term distinction, would press a firm to find a buyer, an action that typically generates an instant price increase upon announcement, if they believed the sale price might be higher than the present value of the discounted future cash flows from the firm as an ongoing, independent entity. Critics of the preceding hypothetical case of activism at XYZ might pillory the move with a pejorative use of the phrase 'short-term' while proponents would reject this understanding.

No doubt, much meaning arises that gives sense to actions after the fact, as it were, when such actions are themselves already guided and shaped by real facts on the ground.

The CEO who does not devote attention to trust building with a short-term investor does not do so because such energies will likely be squandered if the investor liquidates her holdings in a month. Despite the reasonableness of this calculus, CEOs nonetheless adopt pejorative language regarding short-term investors which cements current behavior and guides future behavior. Institutional shareholders acquired significant power in the 1970s and 1980s from the proliferation of mutual funds which placed enormous assets under their control, and they have been wielding this power ever since in the form of increasingly frequent shareholder activism. Despite this empirical reality, institutional shareholders are very cognizant that successful activism must be seen as legitimate, and they therefore lean heavily on shareholder value ideology to justify their actions. In short, language, ideas, meaning and understanding, belief and perceptions – these are all vitally important for making sense of social action. Moreover, it is likely that such meanings and understandings facilitate the transition of interactional styles and modes of behavior from initially being seen as new and bewildering to being taken for granted.

Such understandings, however, can have their own path dependency, guiding action even when the underlying reality may have shifted. Two hedge fund managers provided examples of their activism involving boards to support their view of directors as 'know-nothing' directors. Respondent HF3 described a board he had had a seat on in which half of the directors did not know whether the company was cash flow positive or cash flow negative, summing up by maintaining that "half the directors are waltzing through life." In another case, respondent HF4 expressed his frustration over the makeup of one board which oversaw an insurance company:

> They had one of those ridiculous insurance company boards which had the city counselor and every other kind of person on it, none of whom understood anything about insurance. (HF4)

These disparaging characterizations are difficult to reconcile with a corporate governance world governed by the Sarbanes-Oxley Act of 2002 (SOX) and by stock exchange rules which dramatically increased the expectation of board professionalism and director liability (Chhaochharia and Grinstein, 2007). SOX, for example, stipulated that board audit

committees should be comprised solely of independent directors and required the disclosure of the presence of a financial expert on the committee. SOX also removed the responsibility for selecting outside auditors from management and placed it in the hands of audit committees. Concurrent with the passage of SOX, the New York Stock Exchange (NYSE) as well as other exchanges modified their listing rules pertaining to corporate governance matters. The NYSE required that a majority of directors be independent, that board committees be independent, and that all audit committee members be financially literate. As it turns out, each example which HF3 and HF4 describe is over a decade old[15], having occurred about the time when the law was first enacted and clearly before it had yielded any changes in board composition or practices. Despite the broad consensus that boards are far more capable and conscientious today than in the past, these anachronistic tropes[16] of know-nothing directors are still embraced by these two managers and continue to exercise influence over how they currently perceive and interact with directors. Thus, not only can understandings and beliefs cement in place new modes of behavior that are responses to new realities, they can also impede the adaptation to such new realities by contributing to the persistence of older modes of behavior.

Beyond providing answers to the specific questions this project raises, the broader objective of the project is to arrive at a better understanding of the control over the allocation of capital in the twenty-first century in light of the emergence of hedge fund activism. The hegemony of shareholder value ideology as reflected in the widespread implementation of its prescriptions such as stock-based compensation, independent boards, and strategically focused firms is at odds with the, at least perceived, persistent agency problems which presumably give rise to hedge fund activism. Lucrative stock-based

[15] HF3 acknowledged that his example occurred "ten, twelve years ago." HF4 described an insurance company that had recently demutualized. There was a wave of demutualization in the mutual insurance world in the early 2000s.

[16] This is an example of drawing inferences through the process of matching up what a respondent believes with known facts about the world. Had both of these respondents provided contemporary examples of unprofessional boards, such reporting would have posed a serious challenge to the consensus view that boards have been upgraded by virtue of SOX. Given that they chose examples that are quite stale, however, justifies the characterization of their beliefs as anachronistic.

compensation packages were supposed to align CEOs' interests with those of shareholders and more independent boards were supposed to result in better monitoring of CEOs and their teams. Given these now normative practices, the frequency of shareholder activism generally and hedge fund activism specifically seems to suggest that these prescriptions have not had their desired effects. The logical conclusion that many hedge fund activists appear to have drawn is that the solution to the agency problems arising from the separation of ownership and control is simply to bridge the separation. It also appears to be the conclusion that many CEOs are drawing. While there continue to be proxy battles, and while CEOs no doubt continue to engage in symbolic and impression management, this study shows that CEOs are also stepping across the bridge to solicit and embrace the input of large, sophisticated investors. The odd men out – including too few women – are directors who, despite their significantly improved professional qualifications for board service, hardly resemble what anyone would associate with serving as a representative for constituents: directors continue to largely defer shareholder engagement and communication to management. There is some evidence, however, that this dew claw of corporate governance may finally be slipping to the wayside.

As the modern corporation permeates nearly every aspect of modern life, sociologists need to give more attention to who controls firms' capital allocation decisions and to what ends. The quaint world where the control of the corporation was independent of its 'owners' has given way to a world in which those who control capital external to firms are now exercising increasing control over the capital that circulates within firms. Instances of public and hostile activism are hardly isolated breaches of the separation of ownership and control; on the contrary, visible hostile activism is likely just the tip of the larger activist iceberg. Moreover, little remains of the separation as many CEOs are in constant dialogue with their investors, are keenly interested in what their fully legitimate shareholders think and want, sometimes partially adopt their ideas or modify their own based on investor input, and in fact have internalized the values of large institutional shareholders. While some might point to the very instances of hostile and public activism as clear evidence that some managements and boards continue to insist on the sanctity of

managerial discretion and that the separation of ownership and control in fact remains a salient concept for understanding the relationship between institutional investors and firms, this is not necessarily the case. No doubt there are cases where activism is a disciplining mechanism for recalcitrant CEOs and boards, but hostile activism today is, in the main, precipitated by disagreement over substantive issues rather than by the insistence on managerial prerogatives. No CEO respondent denied the right of an institutional shareholder to exercise their voice.

The public perception that public hostile activism reflects the power that institutional investors generally and hedge funds specifically wield is consistent with the argument here that the separation of ownership and control is significantly eroding. Institutional investors including hedge funds are exerting greater control over the allocation of capital within firms, a reality that was novel when Useem examined the investment landscape twenty years ago, but which today is the norm. This greater power, particularly in the hands of unconstrained, lightly regulated, aggressive, pure capital allocators, i.e., hedge funds, matters tremendously for the strength and the complexion of economic growth, for how firms behave and function, and for how wealth is distributed, all matters of great interest and concern to sociologists.

Chapter 2: *Hedge Funds*

INTRODUCTION

We introduced this study by noting the erosion of the separation of ownership and control over the past forty years as institutional investors became increasingly less content to merely allocate capital that exists *external* to firms and have demonstrated a greater willingness to weigh in on how this capital is managed and allocated *internal* to firms. This shift has coincided with the ascendance of shareholder value ideology, reflected in the ubiquity of shareholder rights and shareholder democracy discourse, finding its real world expression in the growth of a proxy voting and proxy consulting industry serving regular (i.e., non-activist) investors, in the growth of private equity investors, and, occupying a middle ground, in the growth of shareholder activism. In the forthcoming chapters, we will see how this breach in the separation of ownership and control by many institutional investors has been reciprocated by many CEOs who pursue intensive and extensive engagement with institutional shareholders they deem legitimate. We will also observe that, while many directors demonstrate a conscientious commitment to their oversight and advisory responsibilities, the reciprocity evident among CEOs vis-à-vis their institutional shareholders is largely absent among directors.

This chapter begins the analysis of the erosion in the separation of ownership and control from the perspective of hedge fund managers. While hedge funds are not the only sponsors of shareholder activism, this study justifies the focus on hedge funds because of their unique characteristics, including fewer conflicts of interest, lower regulatory burdens, and substantially greater investment flexibility, as compared to other types of institutional investors (Anson, Chambers, Black, et al. 2012). Hedge funds more closely approximate a distilled form of capitalism to the extent that they more aggressively pursue capital's highest returns and thus represent pure capital allocators. Understanding why it is that *hedge funds* engage in activism, then, should help us better understand the evolution of capital allocation in contemporary capitalist societies as well as their role in the financialization of the U.S. economy.

The very uniqueness of hedge funds, however, then presents a paradox: Given their significant flexibility and the variety of investment tools and techniques at their disposal, why would any hedge fund manager bother to become active in a target firm, a costly, time consuming endeavor with no guarantees for success? This chapter will attempt to shed light on this question by drawing on twenty-nine semi-structured interviews of hedge fund managers. It will also attempt to examine several other important questions. Engaging in activism implies that a hedge fund manager believes himself to be pursuing a legitimate activity: pushing activism to its hostile and logical conclusion, many activist events involve proxy contests which, in order to be successful, require the support of many other investors, support which obviously would not be forthcoming if they viewed the activism as illegitimate. Thus the question arises: Why do hedge fund managers believe they are acting legitimately when engaging in activism when they often may not even own five percent of the target company? In a more tactical vein, how do hedge fund activist investors cultivate their social influence, if at all? What information networks do they rely on? When do they decide to solicit or join forces with other activist investors? Finally, engaging in activism implies that a hedge fund manager believes herself to have superior knowledge as to how something ought to be done at a firm in comparison to the knowledge that the firm's management and board possesses. What is the basis for such beliefs in the possession of superior knowledge? Relatedly, what is the nature of their expertise that gives hedge fund managers the confidence to launch an activist campaign? These questions, and their answers, will provide the structure for this chapter.

Answering these questions, furthermore, will provide an opportunity to expand and clarify Kang and Sorensen's (1999) perspective on shareholder power. They theorized that shareholders enjoy three sources of power: formal authority, social influence, and expertise. When exercising their right to vote on board seats and major business decisions, hedge fund managers are utilizing their **formal authority** as shareholders, but they also often exercise *informal* authority through private communications or even through public criticism through media outlets or through letters to boards attached to publicly available regulatory filings. Furthermore, any formal authority is limited by the fact that the median

hedge fund activist stake in a target is only 9.5%, a stake that while large comes nowhere near a majority stake (Brav et al. 2008). The **social influence** Kang and Sorensen (1999) describe arises from "repeated interactions between owners and managers over time" (p.136). It is true that, as we will see in the chapter on CEOs, many CEOs pursue extensive interactions with the institutional investor community and, in the interest of cultivating a reliable base of long term investors, will pursue "repeated interactions" with their larger and more knowledgeable investors. Similarly, we shall see that *friendly* hedge fund activists also place a premium on "repeated interactions" with the CEOs of their target firms. But interactions between directors and CEOs and hedge fund managers who are inclined to pursue more *hostile* varieties of activism often occur over short time periods that preclude the development of relationships based on trust; in fact, the very presence of a hostile posture by an activist is evidence of the absence of any social influence over the CEO and board. Thus, the Kang and Sorensen understanding of social influence as a source of shareholder power does not appear to work well for dedicated hostile hedge fund activists. Instead, the relevant source of a hostile activist's social influence arises between hedge fund managers and other hedge fund managers and other institutional investors through direct and indirect means. Lastly, shareholder **expertise** for Kang and Sorensen also derived from engagement and/or governance participation with a firm over time. While this is absolutely true for many hedge fund managers, especially friendly activists, this also does not seem to fit with the shorter-term character of dedicated hostile hedge fund activism. Equally importantly, we shall see that hedge fund managers have additional sources of expertise such as corporate experiences of their own as well as superior knowledge and experience in matters of finance as it pertains to capital allocation.

This chapter will begin with a description of the respondents. It will then propose to answer why hedge fund managers bother to engage in activism, initially by examining the conditions necessary for engaging in activism. Next, the chapter will examine the issue of legitimacy surrounding hedge fund activism, an examination which simultaneously expands on our initial answers as to why hedge fund managers get active. Logically following the discussion of legitimacy, the chapter will touch on hedge fund networks,

avenues of social influence that depend upon wider perceptions that an activist is acting legitimately. Lastly, the chapter will examine the crux of the matter – the belief by a hedge fund activist that they bring superior knowledge and expertise to bear on solving a target firm's problems and on ways to improve the target's financial and/or operational performance.

SAMPLE DESCRIPTION

Of the twenty-nine interviews, twenty-eight were conducted by phone and generally lasted between thirty and seventy-five minutes. One interview was conducted through an exchange of emails. Shorter interviews typically occurred with hedge fund managers who had never engaged in any sort of activism and thus had no examples to narrate. Eighty-three managers from the Brav dataset which contains *only* activist events were randomly contacted either by phone or through email; eight agreed to an interview. From the Hedge Fund Research (HFR) dataset, 143 randomly selected managers who were *not* classified as dedicated activists in the HFR dataset were contacted in a similar fashion; twenty-one agreed to an interview. As the Brav dataset explicitly aggregates activist events, all eight from his dataset engaged in an activist event at least once, two of which employed activism as their predominant strategy, whom I refer to as 'dedicated activists'. Despite the effort to exclude explicitly categorized *activist* hedge fund managers[17], eleven of the twenty-one managers culled from the HFR dataset engaged in activist events at least once, three of whom employed activism as their predominant strategy, while ten never engaged in any activism (*Table 2.1*).

	Activist		Non-Act.	Total
	Full-Time	Part-Time		
Brav	2	6	0	8
HFR	3	8	10	21
Total	5	14	10	29

Table 2.1: Sample Activists, Non-Activists.

[17] Also excluded were hedge funds that exclusively focused on commodities, fixed income, or currencies.

Of the full sample set, nineteen pursued some form of activism, either friendly or hostile, while ten hedge fund managers never pursued any sort of activism (*Figure 2.1*). Fourteen managers engaged in hostile activism at least once, and nine pursued friendly activism at least once, with four having engaged in both forms at least once[18] (*Figure 2.2*). Of the hedge fund managers engaging in hostile activism, five considered activism as their exclusive strategy and thus are categorized as 'always' engaging in activism (*Figure 2.3*). No manager engaging in friendly activism pursued this as their exclusive strategy. This makes intuitive sense: by its very nature, friendly activism involves longer-term relationships with target firms which likely limits the carrying capacity of friendly activists for such intensive collaborations, necessitating such funds to also invest using more traditional, less intensive methods. By virtue of this reality, the "Often" column reflects hedge fund managers who pursue *friendly* activism as a core strategy, while the "Always" column reflects activism as a core strategy for *hostile* activists. Additionally, the data suggest, and commentaries bear out, that managers who do not pursue hostile activism as a core strategy will pursue it predominantly as a last resort and thus only occasionally, creating a barbell effect of activist frequency for hostile activism (*Figure 2.3).* By contrast, if not a core strategy, half as many hedge fund managers will pursue "occasional" friendly activism than will pursue "occasional" hostile activism (*Figure 2.3*). This taxonomy can be summed up as follows: ***reluctant hostile*** activists mainly constitute ***occasional*** activism; ***dedicated friendly*** activists engage ***often*** with target firms; and ***dedicated hostile*** activists ***always*** pursue hostile activism. Each is a unique type of actor with unique styles of target engagement.

[18] Although most instances of hostile activism begin quietly, such non-hostile initiations of activism carry an implicit hostile threat, of which targets are well aware, and therefore are excluded from the *Both* column and the *Friendly* column in *Figure 2.2*. Thus, the *Both* column in *Figure 2.2* reflects friendly activists who don the hostile cloak *only* in situations where they believe their interests are at risk of serious harm because they believe management and/or the board is engaging in some form of corporate abuse or illegality.

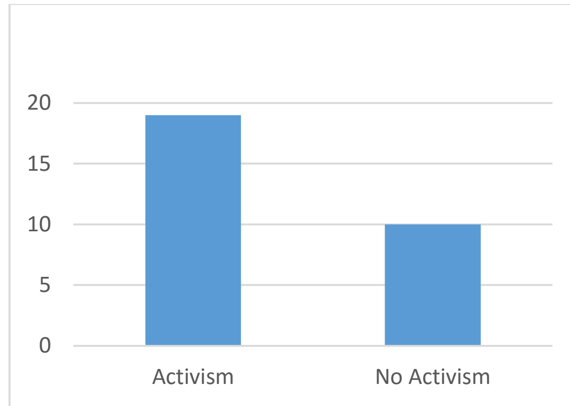

Figure 2.1: Hedge Funds Pursuing Activism (or Not)

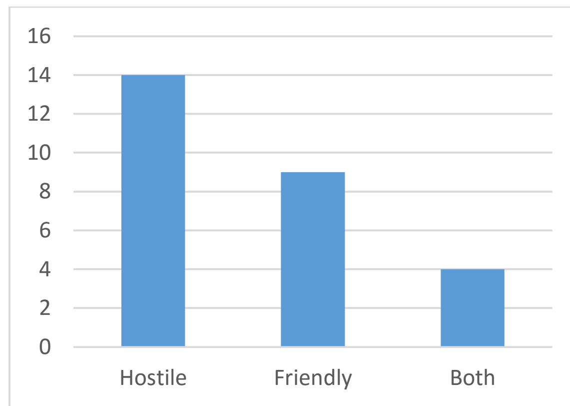

Figure 2.2: Types of Activism

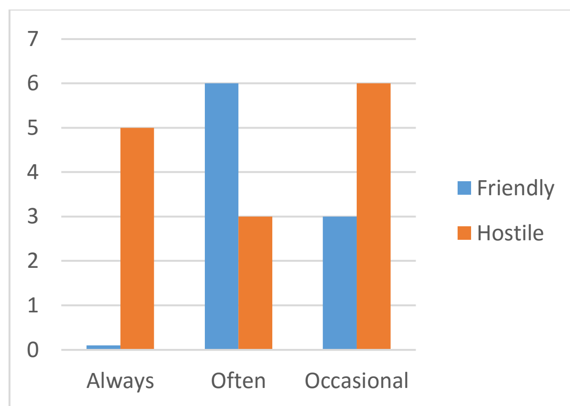

Figure 2.3: Frequency of Activism Types

CONDITIONS FOR ENGAGING – OR NOT ENGAGING – IN ACTIVISM

As the reader might already suspect, there is no single reason to explain the occurrence of activism or its absence among investment managers broadly, let alone among hedge fund managers specifically. To say that activism is rational is to a great extent true, though uninteresting: in what ways and under what circumstances is activism rational? For example, consider a hedge fund that predominantly engages in hostile activism and, equally importantly, markets itself as such. Any instance of activism pursued by this fund is *ipso facto* rational: the fund has to deliver on its promise to its investors. But it is not necessarily the case that each incidence of activism is rational *per se*. In fact, the very commitment to its investors to pursue activism may pressure the manager to pursue suboptimal activist cases. The appeal to rational action is also less than adequate in other respects. Aside from the observations made by behavioral finance scholars highlighting the multiple ways by which economic actors routinely make *irrational* decisions (Ariely, 2008; Kahneman and Tversky, 1979), many hedge fund managers who own shares in public companies and thus *could* engage in activism, *do not* ever engage in activism. If it is rational for some hedge fund managers to pursue activism but not rational for others, then we need to tease out the salient differences between such funds.

The presence of disagreement among investors regarding specific activist events further suggests that an appeal to a rational actor framework lacks predictive power. In a very complex world, it can sometimes be impossible to clearly specify what would constitute a rational decision. Rational actor theorists might account for disagreement between two actors by pointing to the difference in preferences between them. But while utility functions may differ between two people over how they prioritize family time versus work time, are not all investors interested in maximizing the return on their invested capital? We might explain away, however, the disagreement between Carl Icahn and CalPERS, the behemoth California pension fund, over Icahn's insistence that Apple initiate a $40 billion share buyback by suggesting that the *individual* interests and preferences of Carl Icahn might differ from the *organizational* interests and preferences of CalPERS (Berniker and Lipton 2014). But this avenue has limitations too, evident when *two*

organizations disagree, as CalPERS and CalSTRS did over the DuPont proxy battle launched by Nelson Peltz, or when *two individual* hedge fund managers disagree, as Carl Icahn and Bill Ackman did over the business prospects of Herbalife (Benoit and Pulliam 2014; Hoffman and Martin 2015). No doubt virtually all individual and organizational actors attempt to behave with logical consistency most of the time, but when a theory can simultaneously explain both '*A'* and '*not A'*, then we need to expand our explanatory framework.

When hedge fund managers choose to pursue or not pursue activism, to the extent that they strive to behave rationally, they do so in response to the *opportunities and constraints* of their environment. Among these constraints are: the asset class[19] a hedge fund manager chooses to target; the strategy the manager chooses to meet its investment return objectives; the resources available to the manager; and the expectations of a manager's investors. But in addition to the role that rational action plays in influencing who does and does not engage in activism subject to these opportunities and constraints, respondents also highlighted other factors that influence action, including skills and expertise appropriate or inappropriate for activism, dispositions towards conflict, and attitudes towards managements, boards, and other activists.[20] The following section will take a closer look at these various factors that influence whether or not a hedge fund manager pursues activism.

Asset Classes and Investment Strategy

The simplest explanation for pursuing, or not pursuing, activism is that the targeted asset class and strategy of a hedge fund either allow for activism or preclude it. For example, so-called event driven strategies are ones in which hedge funds place bets on the consummation of announced (or anticipated) mergers and acquisitions (M&A) by investing

[19] Examples of asset classes are stocks, bonds, commodities, real estate, etc.

[20] While one could argue that a manager who chooses to avoid activism because they do not have the skill set or because they cannot abide conflict is acting rationally, this would be a trivial observation. Far more interesting, and pursued here when it was possible, is an interrogation into the nature of a manager's skills, dispositions, and attitudes. To this end, the background of some managers can prove illuminating.

in the stock of companies that might divest some division or that might themselves be acquired, with the shares of either such firm likely appreciating if such actions come to fruition.[21] Such a fund manager who has amassed shares in either kind of firm might pursue activism to pressure the firm to sell itself or to divest a specific segment, and in so doing advance its own interests. But sometimes an event driven hedge fund manager may find the level of M&A activity grind to a halt if the economy is slowing or falling into recession, and on these occasions may exploit the recession induced bankruptcies by shifting its investment focus away from M&A and towards distressed debt securities (i.e., the bonds of companies in or nearing bankruptcy). But now as a debt holder of a company rather than an equity holder, the manager no longer has the opportunity to pursue activism because a bond holder does not enjoy shareholder rights, shareholder votes, and shareholder power.[22]

Many other asset classes similarly preclude activism. A hedge fund that specializes in currencies, managed futures, commodities, or structured debt is extremely unlikely to ever engage in activism. But even hedge fund managers who invest exclusively in equity securities and thus enjoy certain rights and powers as shareholders might still be precluded from pursuing activism by virtue of their investment strategies. One manager who declined to participate in this study explained in an email:

> You may not know but we are a "quant" manager. Most quants like us have many positions (2300 globally) and relatively high turnover, so activism is not potentially part of our process and, in fact, our investors would be mildly alarmed if we diverted scarce resources to it. (HF *non-participating*)[23]

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[21] Alternatively, the manager might place bets that profit if such deals fall through.

[22] Instances of distressed debt investing show up in Brav's dataset as instances of activist investing. This is questionable. It is true that some investors who purchase the debt (i.e., bonds) of companies in or approaching bankruptcy do take on 'active' roles in such companies. It is further true that, by virtue of their large holdings, such active distressed debt investors may also negotiate to receive some allocation of the newly issued stock as a component of their reward for marshalling the firm through bankruptcy. But such active roles occur in the context of court supervised reorganizations in which the equity of the old, failed entity is wiped out, and fresh equity is issued for the new, transformed entity, such issuance only occurring *after* such a transformation is complete and the entity emerges from bankruptcy. By contrast, activist investing is commonly understood as engaging with underperforming (and sometimes high performing) firms to encourage or to force changes on firms that will benefit *existing* shareholders, an endeavor that is manifestly distinct from the death and resurrection process of distressed debt investing.

[23] The manager still declined to participate even after I explained that I needed to have participants who did not pursue activism. The explanations provided by those who do not pursue activism help shed light on why

So-called “quant” managers typically employ individuals in possession of sophisticated quantitative and computer programming skills such as math and physics PhDs who devise arcane trading algorithms using as inputs company financial data, macroeconomic data, and market trading behavior. As such, they have little interest in matters of corporate governance or managerial decision making in the belief that such matters are already captured by the data which feeds into their algorithms. Not only are they uninterested in such matters which often form the basis of activism, they also have such short holding periods in the stocks they invest as to render the adoption of an activist posture virtually impossible. Three respondents who did not pursue activism – HF14, HF18, and HF26 – also deployed short-term trading strategies that rendered activism impractical.

Apart from “quant” funds, other strategies can also preclude activism. One manager, HF16, would not pursue activism because his strategy involved mirroring the buying and selling patterns of management insiders. Although this strategy utilizes publicly available information of insider activity, HF16 was concerned that any hint of activism on his part might set off alarms among regulators that he was perhaps privy to non-public inside information. Another manager, HF12, only invested in the S&P 500 Index and in futures on the index, and thus, by not investing in individual firms, would never engage in activism. While not engaged in short-term trading like HF14, HF18, and HF26 were, both HF12’s and HF16’s investment strategies were yet additional examples of how the adoption of one strategy over another can foreclose the option of pursuing activism.

An interesting characteristic of more than two-thirds of the hedge fund managers in the sample is that they practiced *value investing*. Value investors, put simply, target low-priced stocks based on metrics such as low price-to-book (P/B) or low price-to-earnings (P/E) ratios. But as investment professionals are fond of observing, cheap stocks are cheap for a reason and thus often are associated with companies that have suffered some operational or strategic misstep, or have consistently failed to deliver on promises and

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others do choose to pursue it. Also, and equally important, the attitudes of non-activists towards activists contributes to a fuller picture of the normative standing of activism among hedge fund investment managers generally.

guidance made to the Street. Value investors who sift through the litter of such beaten up stocks will invest in those in which they have identified some potential positive catalyst – a new CEO, a new product lineup, or some new strategy to turn things around. Such an investment approach requires patience, as HF10 articulates:

> …my best ideas have been just, you know, buying a stock and being patiently waiting for something to happen instead of trying to force it to happen…Our fund is based on that data, so we're going long[24], extremely cheap stocks on a price-to-book basis as our main metric and waiting for things to happen whether it's just the business coming back or management doing something, but usually it's the business coming back and then on the other side where it's selling short, incredibly expensive stocks that have little chance of living up to a marketing euphoria.(HF10)

HF10 describes the classic long/short formula employed by many hedge fund managers in which they buy long positions in undervalued stocks, and sell short overpriced stocks or stocks they believe will decline in value for other reasons. Critically, value investing requires patience and is thus an inherently long-term investment strategy.

But patience is never a limitless virtue. Value investors sometimes discover that their investment thesis based on the expectation for some positive change in a company's underlying fundamentals does not come to fruition. It is at such junctures that a hedge fund manager faces a choice between simply selling shares or becoming active by prodding or pushing management to take the steps necessary – in the eyes of the fund manager – for improving the company's prospects which would hopefully result in a higher share price. This trajectory – patience, frustration, activism – characterizes much of the activism found to occur with hedge fund managers who only infrequently and *reluctantly* engage in activism, in contrast to *dedicated* activists who do not progress along this trajectory but immediately jump to activism.

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[24] "Going long" simply means to *buy* stocks and is the opposite of "going short" where an investor borrows shares, then *sells* them with the hope that the shares decline in price, at which point she can buy the shares back and return them to the entity that initially lent her the shares. "Going long" earns investment profits when share prices increase; "going short" earns investment profits when share prices decline. Importantly, "going long" has nothing to do with the length of time the shares are owned: both short-term investors and long-term investors can "go long."

The phenomenon of value investing should partially answer one of the questions that motivated this investigation: Why would a hedge fund manager engage in activism when they have so many tools at their disposal, tools unavailable to traditional fund managers (e.g., mutual funds and pension funds)? Among the more powerful and distinctive tools available to hedge fund managers is the ability to "go short" when a manager believes a security will decline in value. But in the case of value investors, an investment style that dominates the sample of this study, they own shares that *are already deeply depressed* with little chance of moving substantially lower, therefore precluding the avenue of shorting. Value investing, therefore, introduces *structural constraints that limit the flexibility* of hedge fund managers, simultaneously rendering activism a more viable course of action (*Table 2.2*).

Investment Style	Active	Not Active	Total
Value	14	4	18
Other	3	4	7

Table 2.2: Value Managers vs. Others.

More than three-quarters of self-identified value managers pursued some form of activism, while less than half of non-value oriented managers did. Interestingly, every one of the four *value* hedge fund managers who did not pursue any activism attributed this to running too small a fund, which highlights the saliency of resources in whether or not a hedge fund manager pursues activism.

Resources

In addition to the influence of a manager's investment objective and strategy on the decision to engage or not to engage in activism, the non-participating hedge fund manager quoted earlier points to a second factor that can influence the decision – the resources of a hedge fund which are linearly related to the fund's assets under management (AUM) on which the fund levies its fees. Gantchev (2013) finds that an average activist campaign that

ends in a proxy fight, thus referring to hostile activism, carries an expense of nearly $11 million. As HF20 observed:

> It does take a lot of money on a 13D and for proxy fights. It's not a cheap endeavor. And so smaller hedge funds absolutely cannot do it. It takes an army of attorneys every time you start filing 13D's. (HF20)

While an expense of this magnitude barely impacts the overall costs of running some of the largest hedge funds that have AUM in the billions, it can be a prohibitive expense for smaller hedge funds that have AUM only in the millions. Of the ten funds from the sample that never engaged in either hostile or friendly activism, five managers stated that the principal reason for not pursuing hostile activism was that their funds were too small to justify the expense. Three additional managers, while not highlighting the size of their funds, nevertheless maintained that they found the cost-benefit of hostile activism unattractive.

While available resources doubtless exert some influence on whether or not a hedge fund pursues activism, it is unclear exactly what the threshold level of resources might be above which activism becomes more feasible. Brav et al. (2008) provide ample descriptive statistics for targets but is silent on the characteristics of hedge funds actually engaging in activism, and thus we do not know the size of these funds. This omission, however, is not the fault of researchers: many hedge funds do not disclose their fund sizes, and even when they do disclose, a fund's size is a moving target dependent on the fund's performance record and on the general movement in market prices. What we will later show is that much activism targets smaller companies, an obvious solution to the problem that resource constraints creates. Thus, a $200 million hedge fund could not take meaningful positions in DuPont from which to launch an activist event, but it could take a meaningful position in a micro-cap stock.

Resources also cut the other way. A $10 billion hedge fund would be precluded from investing, let alone pursuing activism, in a micro-cap stock. Any price improvement in the shares of a micro-cap stock resulting from some sort of activist involvement would

have a diminimus effect on a large hedge fund's overall performance. Hedge funds of this size, therefore, must pursue larger targets, such as a DuPont, in order for the cost-benefit of an activist effort to make financial sense.

Fund's Investor Base

In contrast to most mutual funds that may have tens of thousands of individual investors, most hedge funds, in order to maintain their lightly regulated status, will have no more than 499 individual investors, and often less than 100 (Anson, Chambers, Black, et al. 2012).[25] Thus, again in contrast to mutual funds, a hedge fund manager is quite likely to have a certain familiarity with his or her investor base and be aware of their likes and dislikes. Thus, an obstacle to pursuing activism, alluded to by the out-of-sample manager quoted earlier, is the attitude of a fund's investors. HF28 explained that not pursuing any activism was in part due to his expectation that his investors would frown upon it:

> …many of our investors actually prefer that we're not in the press and…what they basically say is we want you to be making money for us and not focused on being on TV. (HF28)

Of course, in addition to being a causal factor of the fund's avoidance of taking any activist positions, the attitude of HF28's investors also likely reflects the outcome of an assortative mating process between investors and fund managers whereby those investors who desire that their hedge fund engage in activism will invest in funds that hold themselves out as activist investors, and those who have no such desire will gravitate to funds with no record of activism. Thus, HF28's not having engaged in any activism is certainly due to the fact that his investors would frown upon it, but also due to the fact that they simply want him to hew to the investment objective and strategy that he has practiced in the past, at which he presumably has demonstrated some level of success, and for which his investors have signed up.

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[25] It is interesting that the most powerful institutional investor vehicle – the hedge fund – is available only to accredited investors, those with net worth exceeding $1 million excluding their homes, or qualified purchasers, those with investable assets exceeding $5 million, which for all intents and purposes means that hedge funds are accessible only by the wealthiest individuals.

On the flipside are those funds that bill themselves as activist funds. As mentioned at the beginning of this section, investors in such funds clearly invest with the expectation that the fund manager pursue activist engagements. Just as HF28's investors might be alarmed if he started engaging in activism, investors in a known activist fund would likewise be alarmed if their hedge fund manager suddenly ceased practicing activist investing. A rather jaundiced, though entirely plausible, account of publicly hostile activist funds was given by HF21 who frequently practiced non-public, friendly activism:

> …they have to be showing activity in order to keep kind of raising money. When you have an activist who's pitched his investors…they need to show activity and they need to show, you know, heads on the wall, if you will, their trophies. They do, they do, because otherwise they have no – they have no marketing story. They have no pitch. So, in a perverse way, it's sort of become self-fulfilling and it's just a different – it's a different ballgame. (HF21)

Or, as one manager who exclusively engaged in activism stated, "We promised the investors and we did what we said we were going to do" (HF3). Thus, in both the case of an activist fund manager and one, like HF28, who does not practice activism, investors in hedge funds gravitate to one or the other – or to both – depending upon these investors' preferences. And while it would be inaccurate to assert that the attitudes of a hedge fund's investors "explain" how the hedge fund manager invests, be it in the pursuit of activist investing or of any other investment strategy, it is undoubtedly true that a fund's investing latitude, to greater or lesser degrees, is *constrained by the expectations the fund's investors have* about what strategy or strategies their manager is likely to deploy. Such expectations are formed by how the manager markets herself to her potential investors and investors' knowledge of how the fund has invested in the past.

Such constraints further answer the question of why hedge fund managers engage in activism when they have so many other tools at their disposal. The great majority of hedge fund managers – one exception being so-called global macro managers who employ multiple strategies across multiple asset classes – commit themselves to a specific strategy or to a limited set of strategies, and this commitment is also a commitment to their

investors. While certainly not the style-box straightjacket that constrains most mutual funds, such commitments constrain hedge fund managers' ability to radically alter their investment strategies, whether it be in the adoption of activism as a new strategy or in the reduction of activism as an existing strategy. Thus, while strategic and stylistic options theoretically afford hedge fund managers' latitude far beyond most other types of institutional investors, hedge fund managers can, practically speaking, only deploy a very limited set of such strategies and styles.

Hedge Fund Managers' Skillsets

A natural constraint on the breadth of strategies any given hedge fund manager deploys is their own human capital. The skillsets of a fundamental, Graham and Dodd[26] styled value investor, an investment approach that characterized two-thirds of the hedge fund respondents, and those of a "quant" or systematic trading manager, like the non-participant quoted earlier, are so dramatically different as to effectively rule out the possibility that a manager practicing one strategy could easily adopt the other. The value investor is long-term oriented, holds few positions, carefully reads through 10Ks, 10Qs, management's discussion and analysis and industry news outlets, and trades infrequently. The "quant" is short-term oriented, holds many positions, applies computer-driven trading algorithms, and trades frequently. And neither manager could easily transition to the math intensive world of convertible bond arbitrage or managed futures investing that specializes in currencies, commodities, and sovereign credits. Thus, despite the dizzying array of investment strategies and asset classes available to hedge fund managers, each domain demands highly specialized skills and knowledge and thus naturally limits the flexibility of a manager to abandon a disappointing asset class or strategy in favor of more promising ones.[27] We will later see, however, that if a particular asset class or strategy disappoints for

[26] Graham and Dodd authored *Securities Analysis* (1934), considered by many practitioners as the bible of value investing.

[27] In addition to global macro funds, already mentioned as an example of a type of fund capable of pursuing multiple strategies, are so-called multi-strategy funds which, as the moniker implies, have separate in-house teams that specialize on different asset classes and different investment strategies. An interesting inquiry, not

an extended period of time, a manager may have no choice but to explore alternative strategies, among which might be activist investing.

The limitations imposed by specialized skills and knowledge also applies to the adoption of activist engagement as an investment strategy. Three managers cited a lack of appropriate skills which they believed necessary for engaging in activism:

> I have not engaged in activism, per se. It is not an area of expertise. It requires a willingness to publicly battle companies/boards/managements. It is necessary to have strong legal teams in place that are willing to do battle and well versed in the nuances/legal wrinkles. It is very expensive. Like anything, it requires expertise and experience (HF29).
>
> …you gotta figure out, okay, this guy is a schmuck, but then who's better, you know and that takes a lot of work and, you know, and a lot of HR skills that frankly I'm not confident I have (HF10).
>
> So, I would say, you know, basically, it's kind of the lack of sufficient assets under management to warrant it [activism]. And I would also say that we don't think, at this point, that's necessarily our skillset, you know. If you're going to do activism right and keep yourself out of trouble, presumably you have to engage a lot of legal help and what not, because, you know, once you publicly start doing those things, then you're sort of arguably constrained from buying or selling whenever you want to, a lot of times, I think there's notification requirements if you file the 13G and so, you know, unless you have a lot of money under management and unless that's your skillset, it doesn't, in my opinion, doesn't make a lot of sense (HF24).

From assembling legal teams, to selecting new managerial or boardroom talent, to avoiding the many regulatory tripwires that can put one crosswise with the SEC, these respondents highlight the fact that pursuing activism is not merely a matter of phoning the CEO and voicing displeasure or of writing letters to the Chairman of the Board. On the contrary, like any other investment technique, it requires "expertise and experience." Developing certain kinds of expertise and experience, furthermore, like the development of any human capital,

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pursued here, would be to see if global macro and multi-strategy funds do *not* engage in shareholder activism by virtue of their inherent investment flexibilities.

requires an investment of time and effort. An investment in one set of tools can logically crowd out the investment in other sets of tools, and thus making the decision to dedicate time and effort to developing expertise as an activist can steal resources away from a fund's existing core strengths.

On the other hand, with the proliferation of hedge funds over the past fifteen years, many opportunities to generate excess returns have been competed away resulting in a devaluation of any given fund's province of expertise. Because there are now thousands of hedge funds, many funds end up replicating similar strategies thereby eliminating the value of these strategies. Many funds also pay close attention to the moves of reputedly highly skilled fund managers and attempt to mimic their trades, again competing away the opportunity for attractive returns. As a manager's expertise and experience become devalued, these managers now have an incentive to acquire new skills and may choose to adopt activist investing. HF9 co-manages a hedge fund with her partner and describes just this sort of an evolution in investment strategy:

> I think what's happened over time is, you know, you have to change your strategy when you run the hedge fund because it's harder and harder to make money, right. So, he started – you know, he started out like 20 years ago, you know, doing shorts and long and then he stopped doing shorts and just did like deep value, right. And then, you know, he's done small cap, almost all small cap, so you know…at that point he sometimes became a little bit involved with management, you know, as an advocate or in friendly situations with management most of the time – working as a board member in some cases to just giving support and then in some cases, he would give – basically, he used to work at [well-known consulting firm] so he would sometimes work with his colleagues to make [well-known consulting firm] level, kind of, analyses for management, thinking they would just really wanna hear from him. "You know, we've done this enough, and guess what, we really think you should raise prices" or whatever and, you know, surprise, surprise, management just wasn't interested. So, I think he just came to the realization at a certain point that it was going to be really hard to make money unless he knew that the board was going to be a supportive board for investors and to that end started to do more activist investing (HF9).

Few money managers are exceptionally successful, and of those that are, fewer still are consistently so. Many hedge funds fail[28], often returning the depleted remains of their initial assets back to their investors. With greater numbers of entrants into the business, it becomes "harder and harder to make money," forcing managers to abandon strategies that once worked but no longer do and to adopt new strategies. For some, this improvisational trajectory leads to activism. In the case of HF9's co-manager, his prior experience at a top, nationally recognized consulting firm facilitated his acquisition of the new set of skills necessary for activist investing.

HF9 transitioned to activist investing slowly over a period of years, beginning with occasional friendly engagements with management teams. Only after gaining experience and by drawing on his expertise as a consultant did he pursue hostile activism exclusively. Thus, both the deliberate and careful cultivation of such experience and expertise, as well as the recognition by HF10, HF24, and HF29 that they did not possess either, highlights how critically important both are to practicing activism. One manager who practiced hostile activism exclusively, highlighted the consequences of engaging in activism without the prerequisite "expertise and experience":

> Okay, in terms of activism, it's a highly litigious strategy and if you make the wrong mistake, the outcome of that mistake could haunt you for multiple years and hurt your mandate, your – your – your brand and what I mean by that is I don't know if you've ever looked at Mario Gabelli's 13D filings, but in Mario Gabelli's 13D filings, he has to dedicate pages upon pages of disclosure for securities laws violations he did in violating the 13D rules and agreed to an SEC Consent Decree years earlier for violating 13D group rules, okay…If you are a Johnny-come-activist-lately, and you – you go into an investment and you're like a lot of these new young guys do is that they 'wolf pack' and they call their buddies and they behave and act in concert, yet don't file the 13D upon the group reaching 5% and individually go up to 4.9% or go to 5%, etc., right? That is one of the first things the target company's legal counsel looks for and once an activist is caught and does that violating…that attorney who – you know, they're mercenaries – the attorney who represents

[28] In 2007, 1,197 new funds were launched, but 563 were liquidated according to Hedge Fund Research. During the financial crisis, 2008 through the first half of 2010, 1,898 new funds were launched, but 2,911 funds were liquidated.

> the defense in that company can follow and watch that activist wherever he goes next and that attorney can go to the target company and say, "I have the secret sauce. I know what these guys do. I can break this person," and you're basically dogged and tracked down and your mandate – and your ability to operate as you used to – has been neutered, okay (HF25).

Like any investment strategy, activist investing requires highly specialized knowledge and expertise. The outcome from pursuing activism in the absence of the necessary skillset is not merely the risk that such activism will prove ineffective and thus a squandering of resources, but that it could actually end up seriously harming a fund. Again, while strategic and stylistic options afford hedge fund managers enviable latitude, their actual ability to deploy any given strategy – including activism – is severely constrained by the specific knowledge and expertise they actually possess or can easily acquire.

Hedge Fund Managers' Dispositions

The presence or absence of the necessary resources, skills, and experiences, the asset classes a manager focuses on, the strategies she employs, and the attitudes of her investors, however, are not the only factors influencing whether or not a hedge fund manager engages in activism. Equally important is the disposition of the manager, or as HF29 observed, the "*willingness* to publicly battle companies, boards, [and] managements" [emphasis added]. This "willingness" often reduces to a manager's penchant for or aversion to conflict, as one such manager explained for not pursuing activism:

> There are all sorts of limitations – economic limitations – that one has if one tries to do activism with too small a base. So, you know, that's also a limitation that I have, but I think that even if I didn't have that limitation, I still wouldn't do it. I think – I don't think it suits me temperamentally. I don't like getting into fights with people (HF6).

Interestingly, while HF6 was one of the ten hedge fund managers who never practiced any sort of activism, friendly or hostile, the remaining nine *could* see themselves pursuing an activist engagement if it were not for their small size (HF10, HF15, HF23, HF24) or if it were not for their particular strategy which precluded activism (HF12, HF16, HF18, HF26,

HF29). By contrast, it was predominantly the managers who engaged in *friendly* activism who articulated personal dispositions incompatible with hostile, public activism:

> We tend to be more proactive as opposed to, you know, trying to be negative because we don't want to invest in companies where we see management as being poor. We want investments where we like management. And if anything, if we're going to be involved, we try to be helpful in terms of pointing things out... I don't want to be in a negative situation. You know, when I was running my business, you know, the last thing you want to do is sit there and be dealing with negative energy all the time. What you want to be doing is concentrating on running your business and so if I got to deal with somebody in that situation, there's problems there that I don't necessarily want to face or deal with. (HF1)

> …all this activity was behind the scenes. It was not public. The whole public strategy is not really suited to us. It requires a certain temperament and a certain personality and, I don't know, it's not – we would rather more likely vote with our feet if we're not getting, you know, traction with management. We find it very distracting, it's – it's consuming. It's a personality thing, I think. (HF21)

> I think it's [hostile activism] not a terribly efficient way. I think some people are really good at it, right, Carl Icahn, Bill Ackman are really good at it, but it's a very time consuming kind of a different job than what we have been trained for here. It works. Clearly it works, but it's just a different job and it's not a job that I feel I'm either good at or really that interested in participating in. (HF22)

As with hostile activists, every friendly activist shares the desire to influence managerial decision-making with the goal of enhancing the performance of the target firm. Where friendly activists part company with hostile activists is in the choice of target firms and in the manner in which they seek to exercise influence. Friendly activists want nothing to do with obstreperous management teams; hostile activists will gravitate towards them. While HF21 and HF22 suggest that resource constraints – it is "distracting…consuming" and "very time consuming" – might be a factor in their decision not to engage in hostile activism, and while HF22 references the absence of the requisite skillset which he has not "been trained for," the overarching reason for all three managers for not pursuing hostile activism is simply that they are not interested in doing so. Not only is HF22's lack of

interest clearly underscoring a dispositional attribute, but so too is his comment that "it's not a job that I feel I'm…good at." To be "good at" something is a concept with two components. The first is the objective and practical skills necessary for expertly executing a specific kind of activity. But the second and equally important component is the sense that one possesses a certain natural proclivity for the activity, perhaps even a passion. Any hedge fund manager could likely address the first component by investing the necessary time and effort into acquiring the objective skills necessary for hostile activism. But no amount of time and effort could address the second component, and this is precisely what many of the friendly activists have emphasized. They simply don't like "negativity" or believe that they don't have the "temperament" or the "personality" for confrontation, and instead emphasize dispositional attitudes that favor cooperation, as HF21 later highlighted in our exchange: "We generally end up in good relationships with management."

On the other side of this dispositional coin are the dispositions of those dedicated to hostile activism. HF5's fund strategy is exclusively activist investing. He offered the following take on why managers pursue or do not pursue activism:

> They're not – they're not suited – it's not in their, you know, in their DNA. You know, I don't think it's the kind of thing – you can't teach a course in activism in college. I mean, you could do it, but that's just the mechanics. You gotta really want it, you know…I think you can tell from talking to me that there's gotta be a passion for it. I mean, it's not something you just go and say, "Well, this is just another way to make money," like, you know, like arbitrage…I kind of think of it as if you go to the race track. There are some people who, even though there's a big take at a track, they're very good handicappers and they can, you know, sit there and sift through the – the racing form and they can win over the season, you know, they're – they're that good at the statistics and, you know, they can actually make money at that just by picking the horses and, you know, but that to me, I don't know. First of all, I don't think I have the skill for it. But I don't wanna just be the guy sitting in the stands. I wanna be like the trainer, you know, who actually makes the – the horse run faster, you know. So, it's just really, you know, it's really what you – what you feel a calling for, I think. (HF5)

Just as several managers quoted in the previous subsection on skillsets – HF10, HF24, HF29 – believed they didn't possess the skills necessary for public, hostile activist investing, HF5 similarly does not have confidence in his skills to sift through the financial equivalent of racing forms – 10Ks and 10Qs and other sources of financial data – to pick stocks that are likely to appreciate in value over ones that are less likely to. However, he strongly believes in his aptitude for activist investing. More importantly, this aptitude is propelled by his disposition toward activist investing, a disposition which he relates in terms of being "suited" for something, of it being in his "DNA," and of having a "passion" and a "calling." It is a desire to train thoroughbreds, to make them "run faster" rather than simply to bet on them, to be up close rather than distant in the stands. HF5's passion for dedicated hostile activist investing stands in contrast to those managers – such as HF1, HF6, HF21, HF22 – who explicitly acknowledged the absence of such a temperament or suitability.

To sum up, several factors condition whether or not hedge fund managers will pursue activism with their target companies. By far the simplest factor is the asset class a hedge fund manager specializes in, together with the manager's chosen investment strategy or strategies: a managed commodity futures hedge fund manager will never engage in activism, nor will quantitative managers trading in hundreds of equity securities over short time periods. By contrast, value investing in equity securities is conducive to activism as it typically limits the ability of a hedge fund manager to short already depressed securities: when things do not work out as expected, an investor can either sell or go active, but not go short. Whether or not a manager pursues activism is further structured by the manager's available resources as determined by the size of the manager's AUM. In addition to structural influences on hedge fund managers' pursuit of activism are the attitudes of a fund's investors, the human capital characteristics of fund managers, and managers' dispositions vis-à-vis conflict. There is, undoubtedly, a rational choice component to all of these factors tilting one manager towards hostile activism, another away from hostile activism and towards friendly activism, or even away from any activism altogether: it is

rational to invest consistent with one's asset class, strategy, available resources, or with a fund's investors' expectations, and it is rational to play to one's strengths reflected in one's specific human capital and dispositions. But it is the specification of these constraints, not the appeal to rationality, which helps us understand why some hedge fund managers might engage in activism while others choose not to.

THE LEGITIMACY OF ACTIVISM

While these structural and attitudinal factors help describe the conditions under which activism is more likely to occur than not, these factors are but preliminary considerations to larger issues concerning legitimacy, to be discussed here, and knowledge, which we will treat last. A value oriented hedge fund manager, running a fund of sufficient size, possessing the necessary skills, and not averse to confrontation might choose to go active on a target firm in some hostile fashion, but to have any chance of success, the fund's underlying investors, and most importantly, other institutional investors must perceive that the activist's move is a legitimate one. This is necessary because activism is about changing firm behavior, not about taking over a firm. A private equity firm typically pursues the latter route where the only factor in the success of the outcome is a sufficiently high price that the private equity firm is willing to pay to all of the target's existing shareholders. Hedge fund activism, by contrast, is offering other shareholders the promise of an *idea* of increasing so-called shareholder value, not actual money, and thus the idea, as well as the idea's proponent, must be credible and legitimate.

Hedge fund activism is hardly the first time institutional investors breached the boundary that separates ownership from control. The 1980s were rife with investor interventions in the affairs of the corporation, but noteworthy is that the language associated with that period is the language of illegitimacy. Rather than 'activists', investors seeking to gain control of a firm were called 'corporate raiders' who used 'junk bonds' to buy firms often in order to engage in 'asset stripping'. Perhaps the most objective pronouncements on the illegitimacy of the period came through the jailing of several prominent actors such as the "junk bond king" Michael Milken and the investor Ivan

Boesky for insider trading. As a result of the widely perceived illegitimacy of corporate raiding, companies could implement anti-takeover defenses such as poison pills, defenses which themselves would later be deemed quite illegitimate but at the time were perceived as understandable responses to a state of siege (Solomon 2014). Another consequence of the perceived illegitimacy of corporate raiding was the passage of legislation across many states that made hostile takeovers far more difficult to execute (Holmstrom and Kaplan 2001). By contrast, the perceived legitimacy of contemporary 'activism' is likely an important reason why no such legal impediments have arisen. In fact, courts, regulators, and stock exchanges have only tilted more favorably in the direction of shareholder rights in the new millennium making activism easier rather than more difficult. Legitimacy matters.

The illegitimate aspects of corporate raiding can offer some insights into the perceived legitimacy of today's shareholder activism.[29] Rather than attempting to take over entire firms, today's shareholder activists have more limited ambitions that are confined to corporate governance structures, capital allocation decisions, and sometimes to matters of strategy (Brav et al., 2008). This more limited scope, together with the fact that most targets are so-called underperformers, burnishes the image of today's activists as being engaged in the lofty cause of promoting economic, market, and firm efficiency, rather than being engaged in something akin to plundering corporate assets. Of course, shareholder activists have targeted high performing companies too. Subsequent to the Great Recession – which did lasting damage to aggregate demand in the U.S., in response to which companies have reinvested at rates significantly below trend resulting in substantial increases in corporate cash balances – much activism has targeted such platinum names as Apple, pressuring them to distribute chunks of their the vast amounts of cash. Even these actions, though, stand in stark contrast to the frequently demanded 'greenmail' of the 1980s in which a company would buyout the shares owned by a corporate raider at a premium to the going price, an

[29] Private equity has a much greater affinity with 1980s-styled hostile takeovers than does today's shareholder activism, and yet PE also carries greater legitimacy today than did corporate raiding back then, a transformation worthy of its own analysis.

affront to all remaining shareholders and thus widely perceived as illegitimate. Today, companies execute share buybacks in the open market whereby any shareholder can freely tender their shares; or if a company opts to pay a special dividend or to raise their dividend, all shareholders benefit. Thus, even activist pressure for "returning cash to shareholders" is seen as legitimate.[30]

Though there are skeptics of contemporary activism, their voices represent a minority view. Much of the academic research on hedge fund activism highlights the improved performance of firms that have experienced activist interventions (Brav et al., 2008; Clifford, 2008; Klein and Zur, 2009). But there is also a curious element in this research that strives to legitimate its subject, revealed in the repeated emphasis that, contrary to popular perceptions, hedge fund activists are purportedly long-term holders of the shares in their target firms (Brav et al., 2008; Brav et al., 2010; Bebchuk et al., 2015). Given the stigma attached to so-called short-term investors, critics of hedge fund activism often characterize hedge fund activists as short-term oriented, thereby trying to delegitimize them. Arguing instead that hedge fund activists are actually more long-term oriented serves to distance such funds from the taint of short-term investing, thereby helping to legitimize hedge fund activism.[31]

In later chapters we will see that, even among CEOs, many accepted the legitimacy of institutional investors who pursue activism, and even among those who professed reservations, they still acknowledged investors' rights to lobby for board seats or to advance proxies. While some directors were particularly forceful in emphasizing the

[30] Instances of greenmail have made a reappearance – Icahn with WebMD and Corvex with ADT in 2013 – eliciting this observation from Spencer Klein, an attorney with Morrison and Foerster: "…outsized returns for one investor at the expense of others…may undermine the *legitimacy* of "constructive" activists and diminish the recently observed enthusiasm of large institutional investors in supporting activist efforts." (emphasis added; from http://corpgov.law.harvard.edu/2014/01/22/greenmail-makes-a-comeback)

[31] Brav et al. (2008) imputes a median holding period of 1.5 years for hedge fund activists although their tabulated figure is only 369 days, which falls to 266 days in their updated 2010 study. Even for the instances of longer holding periods, however, it is important to recognize that such lengthier periods are likely an artifact of hostile activism: the target is resisting, leading to a struggle, which takes time to resolve. Leaving aside the fact that many might disagree that 1.5 years represents a long-term holding period, it clearly does not represent what is generally implied by the term 'long-term investing', namely, patience with management in realizing returns on an investment. Also, certain types of investors by definition are long-term holders, such as private equity and venture capital which show up in the Brav dataset, misclassified as hedge funds.

hazards of activism to a firm, most also embraced the right to pursue activism as a privilege of 'ownership'. Unsurprisingly, even though several respondents found fault with specific instances of activism, no hedge fund manager endorsed any sort of prohibition on activism. Even though some respondents did not engage in activism because it did not fit with their investment strategy, because they considered themselves too small, or because they recognized that they possessed neither the necessary skillset nor the right dispositions for pursuing activism, none of these non-activists begrudged those who did pursue activism, revealing no philosophical aversion to activism.

While mapping the evolution of shareholder activism from the illegitimate practices of the corporate raiders in the 1980s to the legitimate ones of today's hedge fund activists is beyond the scope of this project, interrogating how hedge fund managers legitimate their activism can nonetheless reveal mechanisms that might expand our understanding of how legitimacy is socially constructed. In examining the comments from hedge fund respondents, including from those who engaged in either friendly or hostile activism as well as from those who never engaged in any activism, several such mechanisms emerge. First and foremost, and most unsurprisingly, every respondent presumed shareholder value ideology as a fundamental truth. The perceived legitimacy of activism would not be possible without the already established legitimacy of shareholder value ideology which posits shareholders both as 'owners of the firm' (rather than the more legalistic and more circumscribed 'owner of shares') and also as the primary stakeholders whose interests come before those of any other stakeholders. From this shareholder centric ideology flows the language of shareholder rights and shareholder democracy. On the basis of this ideology, or for that matter any ideology centered on rights, one who protests or otherwise resists the violation of such rights is by definition acting legitimately.

A second way that some hedge fund managers assert the legitimacy of activism is by either rejecting the short-term/long-term dichotomy or by rejecting the very stigma of short-termism itself.[32] The rejection of short-termism as an indictment of hedge fund

[32] Unlike certain academicians bent on legitimating hedge fund activism, no hedge fund manager insisted that hedge fund activists were long-term investors.

activism is related to the first mechanism: *all* shareholders enjoy shareholder rights regardless if they are short-term or long-term investors. A third means for asserting legitimacy when pursuing activism is to assert that one's activism focuses on an issue or issues that present obvious problems with obvious solutions: a critique of something that is obvious should not be controversial, therefore rendering the critique legitimate. Of course, if there is some obvious problem afflicting a firm, it begs the question: Why do insiders not see the problem, or if they do, why do they not implement the obvious solution? Thus, this third mechanism leads to the fourth means of legitimizing activism, namely by characterizing the target as illegitimate: it is *ipso facto* legitimate to contest illegitimacy. If insiders neither see nor fix obvious issues, they are either not up to the task for want of competence, and are therefore illegitimate, or they are engaged in self-interested behavior at the expense of shareholders, i.e., entrenched and again therefore illegitimate.

Legitimating Mechanisms: Shareholder Rights

No hedge fund respondent ever argued in defense of shareholder value ideology, extolling for example the merits of shareholder value over those of stakeholder views of the firm. On the contrary, shareholder primacy was a taken-for-granted concept, viewed by every respondent as axiomatic, the violation of which was justification enough for hostile activism:

> Many times management feels like it's their company, right? Like there's some reason the company belongs to them – and it doesn't. It belongs to the shareholders. It belongs to us and they're supposed to shepherd the company with best intentions for us as constituents, right, because we hold [shares]. And there's many times that's not the case…and so I think there are times when it's [activism] warranted when management teams are not doing that…I think activism plays a role in keeping management teams honest. (HF1)
>
> …in many cases, I think, you know, they [activists] do a good job with, you know, making management heed the shareholders instead of, you know, their own little fiefdoms. I mean, when you can make all the rules and, you know, and do whatever you want, it's a lot of temptation not to look at shareholder's best interest. There has to be

> somebody – you know, there has to be some direct accountability, I think. (HF23)

From this viewpoint, shareholders are not mere owners of shares; they *own firms*: companies "belong to the shareholders." The duty of management, if we are to judge them as "honest," is to run firms on behalf of the shareholders, and when they fail to do this, shareholders have the right to step in and to hold them accountable. From the perspective of every hedge fund manager interviewed – including hostile activists, friendly activists, and non-activists – activism is simply a logical consequence of shareholder value ideology. This blurring of the separation of ownership and control as a result of the ever increasing emphasis placed on the rights of shareholders has advanced so far that four of the ten hedge fund managers who did not have any experience engaging in activism would have liked to have done so but could not because of their small AUM.

While hostile activism may represent a kind of activism of last resort, shareholder rights also justify the more routinized interventions of friendly activism:

> We liked him [the CEO] and we never – at one point I think he asked one of us to go on the board, we didn't, but we said, "You know, we'll stick with you, we'll come down every quarter; we'll copy you." We became his sort of kitchen cabinet. He got free consultants. We didn't charge him anything; we were shareholders. (HF3)

> …if you see or observe things that you think might make it stronger or better or whatever it might be or enhance the reasons you came into the name in the first place, it'd be silly to sit on your hands and not say anything. (HF13)

With both HF3 and HF13, contributing ideas to management is wholly consistent with their role as shareholders. Implicit in these remarks is that *not* breaching the separation of ownership and control, the traditional view of shareholding, is behaving in some sort of inadequate fashion as a shareholder. Indeed, for some, shareholder rights thus entail obligations. One manager of a larger fund who pursued friendly activism felt he should be doing more, not less, on the hostile activist front:

> I will say sometimes I feel a little bit guilty that I don't take the management people on because, you know, it would help a lot of people that are working in those firms. It would help our investment. (HF17)

And another manager who practiced hostile activism exclusively, hinted at a breach of duty by those institutional investors who do not vote their shares, a dereliction that has a direct effect on this manager's activist efforts:

> …people who ignore the voting rights, especially institutional investors, are really not using a tool and, in fact, you could argue that there might even – well, I wouldn't go so far as to say they're breaching their fiduciary duty to their investors, but they're certainly ignoring a tool that I think, you know…can add value to a portfolio. (HF5)

In short, the legitimacy of activism stems naturally from a full appreciation for and exercise of shareholder rights which imply active engagement. Respondents, in fact, hint that it is passive ownership and not active engagement that risks being illegitimate.

However, not all shareholders are created equal. Shareholder rights exist on a sliding scale, weighted by the size of an investor's holdings:

> If you own 20% of something, you should have something to say in the way it's run…Why should a management team, just because they happen to be the management team have all the say and you have none? I mean, this just doesn't make any sense. I mean, you have a way bigger vested interest than they do. (HF17)

For this manager, having a large ownership stake in a firm, by definition, is sufficient justification for having "something to say" on how the firm is run. This seems especially true for HF17 given that a large shareholder likely has a greater stake in the firm than does the CEO, and HF17 is correct on that point: more than 80% of CEOs own less than 1% of their firms' outstanding shares (Coates, John, and Kraakman 2010). HF17's comments, however, betray a myopic understanding shared with many institutional investors of what it means to have a "vested interest" in the firm. Unlike institutional shareholders, including hedge fund managers, who own shares in companies that are part of diversified portfolios, CEOs' ownership stakes, when considered in combination with their employment ties to

their firms, render their personal financial profiles highly undiversified. Those institutional shareholders who bemoan the low ownership stakes many CEOs have in their firms are effectively asking CEOs to assume levels of risk that no institutional shareholder would assume for themselves. Behind this myopia is what can only be described as willful ignorance of the fact that, while an institutional shareholder can liquidate in short order their shareholdings in a company, a CEO's financial well-being is tied to that company for years.[33]

Placing a twist on theories of rational economic action, HF17 further believes that not only do rights exist on a sliding scale, so too does rational action:

> For me it's pretty clear. If you get somebody that has a big stake in something, you know, they're gonna try to behave in a reasonably intelligent way, right? And if they're more competent than the management team, then they are likely to add value, right? (HF17)

Not only does a larger ownership stake augment the right of an investor to have a say in firms' affairs, it also increases the likelihood of behaving "in a reasonably intelligent way." While this argument on its face is of dubious merit, a more charitable interpretation might simply be that, not only should a large holding legitimate an investor's activism *vis-à-vis* the target firm, it also likely legitimates the action in the eyes of other institutional investors. One hedge fund manager who disagreed with Starboard Value's activist pressure on Darden Restaurants to spin off Red Lobster nevertheless was swayed by their nearly 10% stake in the target:

> As dumb as it sounds, I still think one has a better chance buying Darden at $47.00 than buying some other stock that's expensive that doesn't have an activist in it just because at least Starboard has and Barrington Capital [a second activist] has their own skin in the game. (HF15)

[33] Indeed, the insistence that shareholder value ideology implies "ownership" rather than a more limited relationship to a company valorizes share ownership at the expense of other forms of "vested interest" such as the CEO's arguably more substantial vested interest stemming from her career commitment, or for that matter, the substantial vested interest that any worker has in a company at which they are employed.

With most any sphere of action, having "skin in the game" legitimates an actor and renders her action and decisions credible. Similarly, an activist with a large position – with "skin in the game" – is perceived as legitimate as it demonstrates to other investors the strength of the activist's convictions. Indeed, the conviction (and likely the track record) of Starboard reflected in the fund's substantial stake is enough to possibly override HF15's own assessment of the right strategic move for Darden. Indeed, reflecting the legitimating effect of having "skin in the game," an entire strategy has emerged among retail and some smaller institutional investors of simply shadowing the investment decisions of known activist investors.[34] As we will see when examining hedge fund networks, having legitimacy with other institutional shareholders is a critical factor determining the outcomes of activist engagements: without the support of some critical mass of shareholders, an activist stands no chance of realizing her goals.

It is important, however, to distinguish between illegitimacy and disagreement. Given the heterogeneity of investors and the limitations on what is knowable, there may be disagreement over an activist's agenda that does not imperil the legitimacy of the activist. As just mentioned, HF15 disagreed with the approach Starboard Value was taking vis-à-vis Darden:

> If you look at the multiple of Darden, it's not cheap. If you compare it to other restaurants, I think they were right for fighting against the Red Lobster's sale to that private equity group, but I think they're better off instead of doing this real estate REIT they're talking about, they're better off – there is a multiple – there is a high multiple for certain restaurants if you start looking like Chipotle. So I think they're better off spinning off like Capital Grill into one spin off and these junk restaurants into another spin off. (HF15)

There is no hint here that HF15 believes that Starboard Value is acting illegitimately in their activist pressure on Darden; there is only a disagreement over the specific actions each investor believes would be best for Darden. Indeed, as we saw just above, despite this

[34] Of course, this dynamic creates its own perilous feedback loop as it may influence the very decision to go active on a target firm in the first place if the activist anticipates copycat investing which would enhance the activist's odds of winning any proxy contest.

tactical disagreement, HF15 viewed Starboard as quite a legitimate activist since they had "their own skin in the game" which, on this basis alone, would likely result in a higher return than what might be obtained from investing in some other restaurant stock.

By contrast, sometimes disagreements can reveal a more critical assessment of an activist's legitimacy, as is evident in this response from HF1:

> A: So, we're in a name now where there was an activist involved and he didn't get what he wanted and we bought his shares and are very happy to sit <inaudible 18:30> for the next three to five years because we think there's a substantial upside to what they are doing in the business.
>
> Q: What was the activist trying to do?
>
> A: He wanted the company to sell themselves.
>
> Q: And you disagreed with that?
>
> A: Hundred percent, yeah. It was too early for them to sell themselves. The business that they're building wasn't ready to be sold yet. They had a number of products they were rolling out over the next 24 months and until those products got rolled out, you'd be a moron to sell your business at a discounted valuation just because you decided that you wanted to sell it now. There's no logical reason to sell it at that moment in time. (HF1)

This is far more than the tactical disagreement HF15 had with Starboard in which HF15 still expressed respect for Starboard. This is a vehement disagreement, devolving into disparagement, over the very existential status of a company: should the company remain independent, or should it sell itself? HF1 continues:

> You know, he thought he could make a quick score is my assumption. There are guys that are in business for that. There are people that are in business to make a quick score. You know, it's their right, you know. It's not the way I invest, but it's their right. (HF1)

Here, HF1 assails the legitimacy of the activist by associating the activist with the illegitimate taint of short-termism: "he thought he could make a quick score." He also delegitimizes the activist by linking this short-term behavior with irrational action which is inherently illegitimate: the activist was a "moron" who did not act "logically." Crucially, however, the illegitimacy of the activist's actions does not, in the mind of HF1, undermine

or erode that investor's right to engage in activism: in a shareholder centric universe, such a right is sacrosanct. This perspective was echoed by respondents who acknowledged the occurrences of illegitimate activism:

> I also believe that shareholder activism deserves its controversial and tainted reputation. I think there are plenty of instances where, you know, activists have done more harm than good. (HF8)

> Q: You're saying that an activist can actually muck up the works for someone with a longer term view?
> A: Absolutely, they can. Absolutely, they can.
> Q: Do you think there should be any constraints put on that sort of behavior?
> A: No, no. I think it's a free market. (HF21)

HF8 clearly acknowledges that some activism can rightfully be perceived as illegitimate, and yet HF8 reported three occasions in which he *himself* engaged in hostile activism, clearly believing it is his right to do so. And despite HF21's jaundiced view of some activism, he too is opposed to abrogating the right of an investor to engage in activism. In short, just as disagreement does not imply illegitimacy, neither does the perception of *localized* occurrences of illegitimacy imply that activism is broadly illegitimate nor justify an abrogation of the right to pursue activism.

To summarize, shareholder value ideology, which enjoys nearly unanimous acceptance among market participants, accords primacy to the interests of shareholders ahead of all other stakeholders. When firms fall short on fulfilling this obligation or in some other way fail to acknowledge that the firm "belongs" to shareholders, then shareholders, particularly those with sizeable positions, are within their rights to legitimately challenge managerial and board decisions. Furthermore, situating hedge fund activism within a discourse of rights can place the legitimacy of such activism beyond reproach. In a shareholder *value* world, such rights are violated by definition when a firm somehow fails to fully realize its value for shareholders. It is no wonder, then, that the near majority of reasons given for hostile activism – not by the respondents in this study but in the 13D filings aggregated by scholars – are nothing more elaborate than "to enhance shareholder value" (Brav et al., 2008). The obvious danger here is that any firm – well-

performing as well as underperforming – can be vulnerable to activism if an investor sees some path to a higher share price. And such paths may be numerous, giving rise to disagreement among investors over tactics and goals. While respondents in this study mainly saw shareholder disagreement as not jeopardizing the legitimacy of specific activism, some respondents did. But even in those instances when respondents did question the legitimacy of a specific activist event, they did not question the activist's right to engage in activism nor the legitimacy of activism broadly speaking. While shareholder value is bedrock for the legitimacy of activism, we will examine in a later section the specific ways in which insiders can violate shareholder value, enabling activists to delegitimize them.

Legitimating Mechanisms: Rejecting the Short-Term Label

A second mechanism for legitimating activism is by either rejecting the short-term/long-term dichotomy or by rejecting the very stigma of short-termism itself. In the following chapter, we will see that virtually every CEO distinguishes between short-term and long-term investors and expends much effort towards cultivating a shareholder base comprised of the latter. Recall that, despite the widespread perception that hedge fund investors are short-term oriented, two-thirds of respondents practiced value investing which is inherently long-term oriented. Given this orientation among hedge fund investors, it is not surprising therefore that, even among this aggressively profit maximizing group, some, as we have already seen, viewed short-term investing as somewhat illegitimate.

Despite the efforts of some scholars to legitimate hostile activism by claiming that activists are long-term investors (Brave et al., 2008, 2013), *hostile* activism by definition is a tactic reflecting the loss of patience: the investor wants management or the board to do something *now*, "a quick score" in the words of HF1. Others had similarly disparaging views of hostile activism, characterizing it as short-term oriented, thereby casting it in an illegitimate light:

> I think what they [hostile activists] intend to do is trying to make some change happen and get some change happen quick and then the stock goes up and then they sell it, you know. I generally think

> they're not long-term shareholder oriented too much, so I mean I just think it's a bit of a game if you ask me, to some degree. (HF10)

> You know, we just kind of are a bit skeptical. Like we think they're [a hostile activist] in it for the quick buck usually. (HF21)

> You know, sometimes I think activist investors are just too immediate for the – you know, the immediate bang and not enough – maybe the company's pared too close to the bone. There's no – there's not enough left for growth. (HF23)

"A bit of a game," a "quick buck," "the immediate bang" – this sort of disparagement clearly indicates that these managers are suspect of some hostile activism and view it as lacking the legitimacy of long-term investing. But they are also not making categorical statements. HF10 actually believed that "Carl Icahn does some relatively smart things." Similarly, HF23 remarked: "I think most activist investors are really sharp people and I think they bring a lot of value to the table for shareholders." In no case, furthermore, did any manager casting aspersions suggest restricting the *right* of investors to engage in activism.

But numerous other hedge fund managers dismissed the short-term/long-term distinction altogether:

> This is a sort of a nonsense in some [corporate] managements. I mean, there's no such thing as, you know, if the stock is at $1.00 and I want it to be at $2.00, who wants it to take a long time to get to $2.00? Most people would like to get to $2.00 quickly. This – this – this notion that Marty Lipton has put out that somehow activists are interested in short term appreciation is – is, you know, so transparently self-serving…Share prices are supposed to be discounting the future, so – so if the price moves up today five bucks, there's nothing short term about that. It's – it's discounting a future expectation. So, from a financial theoretical standpoint, I find the distinction absolutely meaningless, but it seems to have a lot of meaning for a lot of people. (HF4)

> I think we're all owners, but there's always a price to give up our ownership, right? So I don't know if it's really the right way to call it is that you're a renter or an owner. I mean, this whole short term/long term thing in the activism world and the target companies,

> that's bullshit red herring; it's just a political label and a ploy. (HF25)
>
> No. I don't find that meaningful. If you own the shares today, you own the shares… the distinction between what's good in the short run and the long run I think is largely artificial and largely used by boards and management to protect themselves from criticism. (HF28)

Interestingly, each respondent rebutted the short-term/long-term distinction by attempting to delegitimize critics of activism by characterizing them as "self-serving" and "protecting themselves from criticism" by employing "artificial" distinctions, "political label(s) and ploy(s)." Like CEO20, whom we shall hear from in the next chapter, who also refuses to distinguish between renters and owners, saying of short-term holders that "they're the owners today," so too do HF25 and HF28 rely on the legalistic view that short-term holders and long-term holders both enjoy identical rights as shareholders: "we're all owners." By rejecting the short-term/long-term distinction, these respondents simultaneously reject the illegitimacy associated with short-termism, thereby preserving the legitimacy of hostile activism in the face of such critiques.

Alternatively, some respondents simply rejected the value-laden character of short-term investing while accepting the distinction itself between short-term and long-term investing:

> Look, whether they're willing to admit it or not, everybody who invests in the street has a definition of long term. That's halfway between the bid and the ask and so they are all wanting instant success. They want to buy a $10 stock and they want it $20 tomorrow morning, and so if you can promise them that and deliver, then you're a hero and it's more attractive than if I say to him, it's a $10.00 stock and give us three years with the right management and you'll have a $20 stock. Look, that's human nature. (HF3)
>
> I mean, they're trying to make money the way they make money. I mean, there are many ways to skin the cat. (HF21)

Rather than accepting the view that short-term investing is somehow illegitimate, HF3 normalizes it, reframing short-term investing in terms of basic "human nature." Similarly,

HF21 acknowledges that many strategies exist in the investment world, all with the goal of making money, which makes short-term investing as legitimate as any other investment approach, including long-term investing.

Thus, while some hedge fund respondents did find the short-term nature of hostile activism objectionable, most either rejected the distinction between short-term and long-term investing altogether, or for those who did accept the distinction, felt that both types of investing simply represented differing approaches to the public markets which were both legitimate. On balance, then, most respondents defended the legitimacy of hostile activism by neutralizing the short-term indictment in one of these two ways.

Legitimating Mechanisms: Attacking Obvious Problems

In addition to buttressing the legitimacy of hostile activism on the pillars of shareholder primacy and defending it against the criticism of short-termism, a third way of legitimizing hostile activism is by highlighting the obviousness of target deficiencies: seeking to redress glaring and/or egregious problems should, by definition, not be controversial and should therefore be legitimate. Respondents provided examples of corporate deficiencies they believed to be obvious:

> Continuing with a foreign subsidiary that's lost money for 10 years, was not taking hold in the foreign jurisdiction, at some point, bite the bullet, sell off what you got and you'll improve your earnings ratio dramatically because you won't have to account for the losses in Timbuktu . (HF3)
>
> A company that doesn't have deeply cyclical issues [and] has made four or five acquisitions over the last 10 years, all of which have washed out and you're concerned that the CEO's got another $2, $3 billion dollars he's going to plow into a bad acquisition without consulting the investors, shareholders, then you've got to worry. (HF3)
>
> I think hedge funds are most successful – it's like activists are most successful when they have like really basic goals like pay the cash out in a dividend, you know, close the R&D facility that's not resulting in anything. You know, those kinds of things are really good at; when you get into, you know, change the marketing

> strategy or, you know, develop better technology or even like sell the patent for more than they're going for – I mean, that stuff is hard. (HF9)

From the point of view of these respondents, the irrefutably problematic character of that which they are challenging legitimizes the activism they pursue. There are, however, numerous objective difficulties that arise from justifying activism on the basis of the obviousness of the problems. First, what is obvious to one actor may not be obvious to another. HF9, for example, highlights as a "basic goal" the termination of an "R&D facility that's not resulting in anything." Most observers, though, aware that many scientific breakthroughs often happen by accident or at best are difficult to predict, would hardly consider the assessment of a firm's R&D efforts a straightforward exercise. Even within his own response HF9 also groups efforts to "develop better technology" – which certainly sounds like an endeavor that would be pursued in a firm's R&D facilities – in the category of "stuff is hard." Second, respondents also provided examples of engaging in activism over issues that, while appearing obvious to the respondent, appeared quite complex, such as this example from the semiconductor space:

> The company was a designer of semi-conductor architectures and there was an ecosystem of developers, but [company name] was mainly for appliances in the home, which was their strong market, and they kind of missed out emerging big opportunities, including mobile phones and other mobile devices and mainly ARM holdings <inaudible 25:24> to dominate that market, which is a market that [company name] could've controlled. [company name]'s business was declining and they were spending a significant amount of money now to try and play catch up and enter the mobile market that was already being dominated by ARM. Intel was trying to penetrate the market, but ARM was dominating it and *what became clear* is that [company name]'s core business, while declining, was still profitable, but they were spending a tremendous amount of money flailing away trying to get into a new business. *What became clear* is what they need to do is stop spending so much money on a failed effort, focus on the remainder of the core business. (HF8, emphasis added)

Only an investor with significant familiarity with semiconductor companies or one with actual industry experience would consider the foregoing analysis remotely obvious. Contending that a problem is obvious, therefore, is often closely tied to an investor's knowledge and expertise, an issue taken up in the final section of this chapter. Lastly, the frequency of disagreement among institutional investors over specific instances of activism, discussed in the earlier subsection on shareholder rights, further chips away at the efficacy of legitimizing activism on the basis of obvious and uncontestable corporate shortcomings: we should not see disagreement if an issue is obvious.

Legitimating Mechanisms: Delegitimizing the Targets

Where there are problems or deficiencies within management ranks or the board that generate widespread agreement among institutional shareholders and thus could reasonably be considered obvious, then the question arises as to why insiders are not taking steps to address these issues. The answer shareholders are inclined to provide is that insiders are likely illegitimate, an accusation they can assert in two ways: they can call into question the expertise and/or knowledgeability of CEOs and/or directors, or they can impugn their integrity. It is also possible to pursue both avenues concurrently. For example, if a knowledgeable CEO exerts his influence to construct a board comprised of friends who lack the appropriate and necessary expertise, an activist might assail the integrity of the CEO for cronyism and also push to replace the directors who are not sufficiently knowledgeable. As the knowledgeability of insiders as compared to activists will be discussed later, the focus here will be on the second way of delegitimizing targets – by impugning their integrity.

The easiest targets to delegitimize were CEOs and boards engaged in, ostensibly, egregiously self-interested behavior. Upset over the underperformance of one micro-cap firm and having gained a board seat through activism, HF2 censured the lavishness of board dinners:

> So, the fancy board dinners and this was not a board that ate burgers and fries. They were eating lobster tails, great bottles of wine, which mind you was also beyond the daily limitation of the T&E budget

> that was prescribed in the company's employee manual. But who cared, it's one big party, right? (HF2)

Had HF2's stock ownership enjoyed a doubling in price, such board behavior would likely have gone unnoticed as it probably differs little from any other professional dinner fare. But given the underperformance of the firm – it had fallen woefully short of management's own goals – such behavior was grist for delegitimizing the board. Another respondent highlighted an example of blatant self-interest:

> Hertz is tripping all over itself in part because the CEO decided to close their New Jersey headquarters and move the corporate office – and there are thousands of people that work there at the corporate office – and move them all to next to his retirement home in Naples, Florida. So, as you might imagine, a lot of people didn't make the move. So they haven't filed their accounting statements for three quarters now; they're delinquent and happy and they keep losing managers seems like every other week and all of this was so, you know, the company headquarters could be down the road from this guy's Florida house. You know, this is unbelievable that stuff like that happens. (HF19)

What makes the vignettes painted by HF2 and HF19 uniquely interesting is that the objective facts of each firm's underperformance – missing performance targets in the case of HF2 and experiencing reporting delinquencies in the case of HF19 – are, to these hedge fund managers, in themselves an insufficient basis upon which to *justify* activism. Underperformance, either actual or expected, might be a sufficient basis for the private act of simply selling one's shares, but hostile activism, a public act, has the additional burden that activists appear as legitimate actors. Creating the perception that a hedge fund manager's activism is legitimate can benefit immensely from the perception that the target is illegitimate, which can be accomplished by impugning the integrity of CEOs and directors by highlighting egregious self-serving behavior – the "unbelievable…stuff." Underperformance of a target firm is an objective, mainly value-neutral fact.[35] Illegitimacy,

[35] I am here speaking from the perspective of a typical institutional shareholder who does not consider performance measurement a problematic exercise, let alone one that is socially constructed, value-laden, and reflective of wider power disparities among social actors.

by contrast, connotes moral outrage and even disgust. By portraying a target as not merely falling short of some set of financial metrics but also as violating norms of behavior befitting market participants, an activist implicitly asserts his alignment with these norms, thus maintaining his own legitimacy while delegitimizing the target.

Shy of such blatant acts, a CEO can compromise his or her integrity by contravening the shareholder primacy paradigm. Having too little stock ownership, engaging in empire building, exerting excessive influence over the board were the chief examples respondents provided to demonstrate ways by which CEOs placed their own interests above those of shareholders, and in so doing, compromised their legitimacy and all but invited activism. From the shareholder-centric view of the firm, significant CEO stock ownership is thought to be an excellent way to mitigate the principal-agent issues that exist between shareholders and management:

> You don't need somebody to try to convince management to do something in the shareholder's best interest when their interests are already perfectly in line because why else – why else would they go out and buy their stock if they didn't think they were creating value for the company? (H16)

It is no surprise, therefore, that respondents viewed the low stock ownership of certain CEOs as evidence of their potential or actual illegitimacy:

> …when you have management that's taking exorbitant salaries and they have very little invested in the equity…that raises an alarm. (HF2)
>
> There were some really obvious things that could've been done to make a company more valuable and as a shareholder you saw them, but management just didn't see it or, you know, their interests just weren't aligned for a number of reasons. It could've been that they didn't own enough stock, right? (HF9)
>
> He just wants to be the CEO because he makes a lot of guaranteed money and does not own a lot of stock. I don't think he's looking out for the best interest of the shareholders. (HF15)
>
> And a lot of management, you know, of these really underperforming companies, they never buy any stock. They have a

> little piggy bank to award themselves stock options. They're never investors in their own business and a lot of them don't even own much stock. It's horrible. (HF23)

Too little stock ownership is a serious cause for concern as it likely indicates that the CEO *might* be inclined to flaunt shareholder primacy as is the case for HF2 who, on the basis of low ownership, is on guard for the possibility of illegitimate behavior on the part of the CEO. When shareholders actually *do* observe underperforming firms, as in the remaining examples, they then highlight low ownership as an explanation for the poor performance, thereby indicting the CEO and rendering him illegitimate. HF9 does point to the two possible avenues for delegitimizing the CEO: "management just didn't see it," suggesting that the lack of expertise or knowledge explains why the CEO didn't take certain actions that would have increased the share price; alternatively, "their interests just weren't aligned," suggesting that the CEO illegitimately put his interests ahead of shareholder interests, thereby violating the essence of shareholder value ideology. HF15 demeans the CEO's character not by condemning the CEO's desire to get rich, a desire HF15 no doubt shares, but rather the manner in which he does this, namely by making "guaranteed money" as opposed to "own[ing] a lot of stock." HF23 sums up the general sense of illegitimacy surrounding underperforming firms led by CEOs with low stock ownership: "It's horrible."

The foregoing describes one way that hedge fund managers, and likely most institutional investors, delegitimize CEOs of underperforming firms – by highlighting CEOs' low stock ownership. No respondent, however, cracked open the door the slightest to admit that, were CEOs to own stock at levels that institutional investors might find satisfactory, such large stakes could easily imperil the financial well-being of most executives by placing them in a state of extreme under-diversification. Such ownership levels would be all the more unreasonable if one considers the fundamental error of attribution that many make when linking firm performance predominantly to the performance of the CEO (Jenter and Kanaan 2006; Khurana 2002). Would anyone consider it remotely reasonable for any oil and gas CEO to have most of their personal wealth tied up in company stock when the share price moves, not with each and every good or bad

decision of the CEO, but with the price of the underlying commodity, controlled in large part by Saudi Arabian production targets?

What respondents also fail to consider is that *too much* stock ownership itself leads to entrenched CEOs who are difficult to dislodge if and when the firm underperforms. Research has shown that firm performance has a non-linear relationship to CEO stock ownership. Griffith et al. (2002) demonstrate that bank performance improves as CEO stock ownership rises to 12% of the firm's outstanding shares, but declines beyond that point. Griffith (1999) and Morck et al. (1988) make similar observations for industrial firms. And, as we will later see, several respondents were quite suspect of founder CEOs, and yet these are often the very CEOs with the highest ownership levels in their firm's stock. All of these qualifications and contradictions, however, are absent from respondents' criticisms of low CEO stock ownership when the goal is to justify activism against underperforming firms. The legitimacy of activism requires the perception that target CEOs are illegitimate, a perception that is neither advanced nor assured with the admission of a more nuanced understanding of the dynamics and realities of managerial ownership, especially if these nuances are not widely understood.

Empire building – increasing the size of a firm mainly through acquisitions which may have little merit on their own – was another object of criticism that served to delegitimize CEOs in the eyes of respondents. We will later see that institutional investors generally are skeptical of the wisdom of acquisitions as evidence of a misallocation of capital, but for present purposes, the propensity of some CEOs to pursue size for the sake of size was also seen as evidence of self-interest and therefore illegitimate. "I also think," HF5 maintained:

> …that they're subject to that, you know, certain other influences like, you know, motivations like – like empire building, you know. They just wanna get bigger and bigger and bigger…and that's not really what necessarily drives shareholder value. (HF5)

Empire building can often be at odds with delivering shareholder value, and as we have already seen, *anything* not consistent with shareholder value ideology and the primacy of

shareholders is by definition not legitimate. Another respondent drew a direct line between the illegitimacy of empire building and the legitimate exercise of shareholder activism:

> It's so cliché, but most executives want a bigger company. They like being the CEO of the company; they wanna buy stuff so it gets bigger. They don't want to give the money back, they – this is part of their identity. And it's so obvious like in so many cases that they're all – a lot of times they have that cash because they wanna buy something. If you don't take it away, they're gonna buy something stupid. (HF9)

Rather than attributing empire building to the desire for financial gain, HF9 attributes it to the psychological gains accruing to the CEO, equally self-interested and equally unrelated to increasing shareholder value and therefore illegitimate. Although empire building will generally result in "stupid" acquisitions, HF9 attributes this not to any sort of knowledge deficits, but to the vanity and illegitimate self-interest of the CEO.

The pursuit of size is also evident in the reluctance to divest assets, what we might call empire maintenance rather than empire building:

> There is no good reason to hold it; it was just – you know we kind of like to be a big company and management would like to have a big company because they get their compensation benchmarked to multi-billion dollar companies and if you're a $7 or $8 billion company and your compensation is earmarked to a company that size and if you can consolidate the revenues from these infrastructure assets, everything is better for you as a CEO; there's no downside. As a shareholder, you're saying look, you've got assets that are trapped there, monetize them and give me the money back or redeploy and do the engineering business. (HF7)

Asset retention motivated only by the desire to maintain high compensation is purely self-interested behavior and therefore highly illegitimate. Note also that the complaint of "no downside" points to one element that legitimizes CEO compensation – pay at risk. This complaint echoes HF15's complaint over CEOs who make a "lot of guaranteed money." Legitimate CEOs make money the way shareholders do, namely by having pay that moves up or down depending on the firm's performance and not by having guaranteed pay that relies on the arbitrary, and illegitimate, inflation of the firm's assets.

Regarding boards, respondents delineated between two sources of illegitimacy outside of knowledge and expertise deficiencies – cronyism and self-interest. One hedge fund manager provided a useful taxonomy of directors sitting on a hypothetically entrenched board:

> Board composition is a combination of three different board types – disengaged Directors, these are Directors who mean well, would do well if they were engaged or knew better, okay? The next on the scale of culpability is co-opted Directors. A co-opted Director is someone who knows better and knows things are not doing right. They know some of the things they need to do, but because the guy who put him on the board is their golf buddy, they don't wanna rock the boat, okay? They're co-opted. They may be called independent, but as you and I know, there's a lot of types that are really not, and not socially independent. And then there's the worst ones, the most culpable ones, and those are board members who are co-conspirators. (HF25)

The first type, disengaged directors, bears more on knowledgeability which will be discussed later. The second and third types – co-opted directors and co-conspirators – describe different degrees of cronyism, with co-conspirators clearly a more deleterious variety than merely co-opted directors. One hedge fund manager relayed his experience with a board he deemed to be entrenched based on the observations of two individuals he successfully placed on a target's board:

> This board was made up of seven people that quite honestly had no business being on a board. It was the CEO had handpicked this board and it was a bunch of his cronies. And they were making $200,000.00 plus a year and, you know, these – these other six people outside the CEO, they relied upon this board income. They were not independently wealthy as they had to be on this board – the exact type of board member you don't want. So, the CEO was basically able to do whatever he wanted to at the board meetings. (HF20)

Deeming these co-opted directors as illegitimate, his two appointees successfully removed the CEO and forced the remaining directors to resign. Another hedge fund manager, after becoming active with one firm and subsequently accepting a position as President of the

company, presented findings of fraud to the board and offered this indictment of the directors:

> So, I presented those findings to the independent Directors and I learned that there was essentially one credential for board membership of this company and that was their longstanding loyalty to the crook…but the independent Directors would have nothing to do with that and defended their crony. So, I had to fight with them. (HF8)

While this too is an example of cronyism, the directors seem to be co-conspirators rather than merely co-opted since, once presented with evidence of deliberately falsified financial statements, they resisted attempts to remove the CEO who was also the Chairman of the board (and later convicted).

Unlike the other avenues for painting a target as illegitimate, illegitimacy arising from cronyism is absolute. Perhaps investors would prefer that a CEO own more shares, but at least she likely owns some and current pay is likely heavily comprised of stock-based compensation. Perhaps shareholders are unhappy with the track record of acquisitions a CEO has made, but at least there may be cost savings and even some synergistic benefits, even if they are less than what was originally hoped for. From the perspective of institutional investors, however, a board which is unduly controlled by the firm's CEO has no silver lining and is wholly antithetical to shareholder primacy in that it contravenes the very apparatus set up to preserve shareholder interests – the board – in order to advance and protect the interests of the CEO. We will revisit cronyism later in our discussion of the knowledge and expertise of CEOs and boards.

These examples highlight the various ways by which hedge fund activists legitimate their own activism and delegitimize target CEOs and boards. Hostile activists legitimate their activism by linking it to shareholder value ideology and to the related notions of shareholder rights and primacy. While some respondents subscribed to the widespread perception that short-term investing lacks legitimacy, others did not. These latter respondents defended the legitimacy of activism by defusing the association of hostile

activism with short-term investing, either by disputing the legitimacy of the very distinction between short-term and long-term investing, or by denying the illegitimate taint often linked with short-term investing. Respondents also legitimated activism by arguing that they simply are tackling obvious problems with their targets, but we also saw that this can be a highly contingent proposition depending on the activist's knowledgeability and expertise. Granting that there may be instances where problems truly are obvious led us to examine targets' behavior more closely and to explore how activists strive to delegitimize CEOs and boards by calling out insiders for low stock ownership, empire building, and cronyism. Importantly, we found that the value-laden nature of the language assailing CEOs and/or directors who fall into any of these three categories, the thinly veiled moral condemnation, and the impugning of CEOs' and directors' characters, all contribute an essential emotive element to the construction of illegitimacy, an element which a mere reliance on objective measures cannot possibly succeed in doing.

Unlike the corporate raiders who engaged in hostile takeovers the success for which did not depend upon the power of an argument but upon a sufficiently high buyout price, today's activism, which can proceed all the way to a proxy vote, does require convincing other shareholders that a hedge fund manager's activist agenda is legitimate. The fact that this is necessary underscores the reality that hedge fund activism itself does not have a lock on legitimacy. We saw the presence of disagreement even among fellow hedge fund managers over specific instances of activism, disagreement that ranged from the merely tactical to more full-throated objections. And of course, while still a minority, it is nonetheless a vocal minority that casts aspersions on hedge funds engaging in activism. Furthermore, there is no naiveté in the marketplace blind to the fact that hedge fund managers are themselves vigorously pursuing their own self-interest. Because the legitimacy of the activist is thus not guaranteed, the characterization of targets as illegitimate becomes an ever more important element of a hostile activist engagement: delegitimizing targets legitimizes the activists.

Absent from this discussion, for what should be obvious reasons, is any mention of *friendly* activism. First, whether a hedge fund pursues active engagement with a target only

occasionally and by happenstance, or whether it is their principal and preferred manner of investing, friendly activism only occurs if welcomed by a target's management and board.[36] Second, friendly activists want nothing to do with either CEOs or boards that they perceive as illegitimate, and should they discover illegitimate behavior subsequent to investing in a firm, it is a near certainty that they will exit the shares, voting with their feet rather than with their voices:

> You know, more often than not, when we sell things, it's because management is, you know, doing things we – it's beyond disagreement, we just think they're doing bad things. (HF21)

Friendly activists are also fundamentally long-term investors as would be expected given their desire to engage cooperatively and to develop relationships based on trust. From the other side of the fence, we will see that CEOs have no desire to waste time on short-term investors in part because such investors foreclose opportunities for trust building, a necessary condition for the mutual exchange of ideas. Given the long-term orientation of friendly activists, they did generally subscribe to the long-term/short-term distinction and even accepted the stigma often attached to short-term investing, a view tempered by shareholder value ideology which accords equal rights to all investors.

Legitimizing their own activism while delegitimizing target insiders is clearly a critical mechanism by which hostile activists seek to influence other shareholders. We next examine other mechanisms which activists use for exercising social influence.

[36] Again, we distinguish between a target eager for the input from a knowledgeable and sophisticated institutional investor which gives rise to friendly activism, and a target which 'welcomes' an activist because of the implied threat of hostility, which would not constitute friendly activism. For example, HF5, a known hostile activist, takes the following approach:

> Beating up on the CEO and, you know, a lot of times they're justified and they're – they're funny and, you know, I like reading them as much as anybody and I'm pretty good at writing them too, you know, but I have to – I've learned over the years like to restrain myself, at least initially, because if you come out, you know, and you go for the jugular, you know, once you start, you know, insulting management, even if it's justified, makes it very difficult to reach a negotiated settlement. (HF5)

SOCIAL INFLUENCE: REPUTATION, NETWORKS, AND OUTSOURCING

The foregoing discussion of legitimacy focused on discreet activist events, but, for those activists who engage in activism with some regularity, the dedicated activists, legitimacy is constructed for the long haul by cultivating a reputation for legitimate hostile activism. The intended audiences for such a reputation include both CEOs and boards, as well as other institutional investors:

> Of course, I always feel there has to be, you know, an implied threat. I mean, not that you come out and say it, but just through your reputation, they know that they can't just blow you off. (HF5)

By "implied threat," HF5 is referring to the readiness to take the issue at hand all the way to a proxy vote, for if an investor is not prepared to do this, the target can simply ignore the investor's complaints as mere empty threats. Responses from CEOs also indicated that among the first things management will do when confronted with a would-be activist is to investigate the shareholder's past activist engagements with other firms so as to determine whether the threat is credible or not. Needless to say, the greater the activist's reputation, the more likely it is that management already has all the information they need regarding the activist's credibility. HF5 continued:

> We will, if necessary, we will deal with the proxy fight and even a law suit. So, if we've shown that we're not going to collapse, you know, the tent, people are less likely to do that because they know that we're not just gonna go away. So if they sue us, that's not gonna work. That's not gonna work and it's kind of like, you know, the first time we were sued, which was back around '97, I think, I had to make a decision, you know, and it's kind of like a bully, you know. If a bully asks you for your lunch money and you give it to him, well what do you think is gonna happen the next day? So as painful as it is to have to – to go through the fight, you know, litigation is not fun, you have to let it be known that – that you're willing to do it and that makes it less likely that it's gonna happen. (HF5)
>
> I hope our previous actions would cause the board and management teams to take our concerns more seriously and there may be potential for that because of what we've done previously that we don't need

> to go down the path of filing 13D's and doing proxy fights because they know we will do so. (HF20)

According to the confrontational logic of both of these hedge fund managers, a firm will likely be more inclined to negotiate when confronting an activist who has a reputation for not backing down and not going away, even when sued. Equally if not more important, though, is that an activist enjoys a favorable reputation with other shareholders:

> Our credibility with other shareholders is one of our most important assets. So, it's really, you know, it's just like anybody who builds trust. You know, you have to show that you're doing the right thing. It constrains you because sometimes you may be tempted to do something that – like take green mail. You know, then you destroy your credibility because people say, "Well, we don't trust you." (HF5)

Because activism requires shareholder support, an activist must appear to be acting legitimately, and in so doing, he cultivates a favorable reputation among other shareholders which increases the likelihood that, should matters be put to a proxy vote, they will side with the activist. To behave illegitimately – for example, by accepting greenmail – an activist tarnishes his reputation and jeopardizes future support from fellow institutional investors.

Equally interesting is the function that reputation plays for friendly activists in contrast to the preceding hostile activists:

> Because we are engaged and I think we're trying to be helpful, that's another reason why they are open to meeting us. Because we don't have a reputation as being sort of an ax grinding, you know, loud activist investor, we're constructive, that helps too. You know, when Dan Lobe shows up, you know, is management gonna be friendly to him? All things being equal, I'd say no. We don't do that. It's not necessary. You know, our track record speaks for itself; we generally end up in good relationships with management. (HF21)
>
> We do look for opportunities to interact with them, to talk with them, to see how they're thinking and, conducive to that is our reputation, you know, which we can point to empirically as being good, informed, long term shareholders. (HF25)

Not having a track record or reputation for being a hostile activist is crucial for the activist interested in taking a friendly and constructive approach with managements. Knowing that the shareholder takes a "constructive" approach and has a reputation for "being good, informed, long-term shareholders," management can be open to engaging with him in ways that are mutually beneficial. Indeed, the hostile activist HF20 admitted to this negative aspect of having a reputation for being hostile:

> You know, the downside is that the first thing a management team does when they see you is they clam up. (HF20)

Outside of relying on reputation to garner the support of other institutional shareholders, a hedge fund manager might develop a network of like-minded shareholders in order to pressure a target. Unfortunately for hostile activists, this approach is fraught with risks. If an activist has collaborated with other shareholders regarding the activist's desire to pressure a target firm on some matter, then the activist risks being considered a member of a group. At this point, it is the group's aggregated ownership levels in the target that triggers certain reporting requirements. For example, if the activist only owns 1% of the target's outstanding shares, but the group in total owns 5.1%, then each member of the group must file a 13D. Additionally, each member of the group is liable for the behavior of other members of the group in the event any member commits any regulatory violations. Even more onerous is if the group surpasses the 10% ownership threshold in which case group members are subject to short-swing rules whereby a shareholder must disgorge any profits realized within six months of the initial purchase. Exceeding the 10% level also prohibits any group member from shorting the target's stock (Davis Polk & Wardwell 2006).

By virtue of these rather onerous consequences of belonging to a group, every hostile activist interviewed who touched on the issue of collaboration and networking disavowed ever having pursued such a strategy. Institutional shareholders do of course have conversations with each other at investor conferences, at company road shows, or at on-site company visits, during which times they may share their views and perspectives on particular firms or industries:

> I've not worked in concert. Do I communicate with other shareholders and exchange views and understand their analysis or understanding of a company and share my analysis and understanding of a company? I've done that. (HF25)

But it is important to bear in mind too that institutional investors are wary of others "talking their book" in order to generate interest in a name the other shareholder might already own, and if an investor has a particularly unique insight into a firm in which they have yet to establish a position, they will hardly divulge this potentially profitable information. Still, some respondents expressed skepticism that illegal collaboration was not taking place, known in the business as "wolf packs":

> They are not allowed to cooperate, but they clearly had conversations with others. (HF6)
>
> They of course aren't allowed to act in collusion, but it really stretches your imagination to believe they aren't. I don't know how the winking and nodding exactly takes place, but it seems inconceivable that they aren't. I see that on the bond side and in our business where subsidiaries have had issues and so on – you know dog gone well they've been talking together. (HF7)

However, we should recall from an earlier quoted response that the onerous consequences of illicit group formations extend beyond separate filings, joint liability, and profit disgorgement:

> …once an activist is caught and does that violating…that attorney who – you know, they're mercenaries – the attorney who represents the defense in that company can follow and watch that activist wherever he goes next…and you're basically dogged and tracked down and your mandate – and your ability to operate as you used to – has been neutered, okay (HF25).

It seems reasonable, therefore, to accept respondents' attestations that, being quite aware of the dangers of inadvertently forming a group, they generally avoided working in concert with other institutional investors on activist engagements. Of course, once matters move to a proxy vote, insiders and activists all engage in lobbying shareholders to win their votes.

While it is plausible that most hedge fund managers pursuing hostile activism will avoid inadvertent group formations because of the onerous consequences, these managers are nonetheless aware of the symbolic import of filing a 13D. As we saw in the Introduction, both HF1 and HF2 had filed 13D's even though they had no intention of engaging in activism. HF2 noted another instance, however, that despite again not being interested in getting active with one target, he exploited the hostile symbolism of filing a 13D in order to draw the attention of other investors to the company:

A: [Company C] was an example of a company that we had a good relationship with. Yes we filed a 13D but we did it to let the world know we were in the position. We had good open communications with the company. They did not give us inside information, but we felt very comfortable. We called them. They would return the call. We had additional questions about the quarterly numbers or annual numbers, they would respond to us. So, we felt very comfortable that they were in good hands and the chairman of it was a former Lazard Freres banker. He had money in the business, so we felt his intentions were right and he was doing right by the shareholders and ultimately he did. We started buying the stock at $1.70 a share and we probably averaged out somewhere around $6.00 a share and the company was sold for $12.70 a share probably five years ago.

Q: So this sounds like another case where I'm confused as to the filing of the 13D rather than the 'G'. It doesn't sound like…

A: Well, you know, we put the 'D' in there more as a placeholder in case the company did something that we didn't think was correct, we could just quickly amend. We wanted to let the world know we were there and that we were keeping an eye on the company.

Q: What does that mean you wanted to let the world know?

A: Well, the 13D is just like 13Gs do get picked up. They usually are published on Bloomberg.

Q: Yeah.

A: And sometimes they get published in Barron's or some other publications. We wanted people to know that we're invested in this. We like it, we think it's an undervalued situation. It is a way of generating interest in the name. You know, unfortunately, you know, a lot of these companies are overlooked, so you have to do something to get them on the radar screen. I think when we did file the 13D on [Company A], it did get picked up by Barron's.

Stock prices move higher by virtue of strong demand for a company's shares, but the demand for any good requires that there be a general awareness of that good's existence. In the world of equity securities, the principal mechanism by which awareness is generated for a firm's shares is analyst coverage. IBM, for example, is a familiar household name, but more importantly, it also has roughly twenty-five securities analysts from a like number of brokerage and financial services firms covering its financial and operational performance. All of these analysts generate periodic reports on the company which their firms then disseminate to their clients. Behemoth companies such as IBM enjoy trading volumes in the millions of shares every day. By contrast, many small-cap and micro-cap companies might not have any analysts at all covering their stock and thus might see only several thousand of their shares change hands each day. This is the situation HF2 confronts with several of his holdings – thinly traded companies with no coverage. While HF2 gives a perfunctory nod towards the possibility of going active on Company C, filing a 13D as a "placeholder" in the event "the company did something that we didn't think was correct," the reality is that HF2 did not adopt a hostile posture towards the company. On the contrary, HF2 had a great relationship with the company and had enormous respect for its Chairman, specifically noting the fact that the Chairman "had money in the business," what shareholder value adherents would refer to as being "aligned" with shareholder interests. Thus, rather than indicative of hostility, the 13D serves as an alternative mechanism for drawing attention to the company – "it did get picked up by Barron's" in the case of Company A – with the hope of stoking demand in its shares, thereby driving a higher share price.

Even when the objective is hostile, however, the Schedule 13D is a powerful mechanism for exercising social influence. In the 20-day window before and after a 13D is filed, a target firm's share price rises on average 7% (Brav et al. 2008; Bebchuk et al., 2010). More importantly, however, the average share turnover – an indication of the buying and selling activity in the shares – increases substantially during this window in anticipation of the rising share price. What is likely occurring is that longer-term holders are taking their profits by selling to other hedge funds who are buying on the basis of seeing

the 13D filing. By virtue of this rapid transformation of the shareholder base, it is possible for hedge funds to suddenly represent a majority of shareholders, an unwelcome sight for management as it likely forecasts an unsuccessful proxy contest, often leading to some sort of settlement or other action satisfactory to insurgents (Briggs, 2007). We will later see that this was exactly the experience of one of the CEO respondents.

An interesting finding pertained to the outsourcing of activism. Recall some of the structural constraints on pursuing activism including insufficient resources and inadequate expertise, and also recall that four of the ten respondents who never engaged in activism actually desired to do so. Given the desire to go active on targets but unable to do so, it should perhaps not be surprising that such hedge fund managers may look to leverage the experience and success of other activists:

> I've built a track record of, you know, working on activist deals where I've affected positive change that's built and unlocked value. So, hedge funds have retained me to do that on their behalf and…typically, those that give me a carry, it's not their core [strategy], it's an element of what they do and they rely on me to drive their activism strategy. (HF8)

It is unclear from HF8's comments how he and his collaborators deal with the just discussed SEC rules on group formation. Nevertheless, outsourcing activism in this fashion further shifts power to institutional investors by enabling more shareholders to pursue activism who otherwise would not or could not.

The outsourcing of activism also likely results from a concern that looms large for any institutional investor – losing access to management. Institutional investors are very dependent (some would argue too dependent) on management for their forecasts, for their commentary on operational results, and for access to corporate insiders outside of the C-suite. They use all of the data gathered from management and other sanctioned insiders to fine tune their models, their earnings and share price forecasts, and their overall investment theses. Management teams, however, have blackballed analysts and shareholders, for example, for asking overly aggressive questions on earnings calls or for writing less than glowing research reports. It is obvious that a shareholder who adopts a hostile activist

posture towards a target firm severely damages any collegiality and cooperative attitude that the firm may have displayed to the investor in the past. The greater risk, however, is that this action – public in nature – jeopardizes the access which the investor may presently enjoy with other firms. Another activist hedge fund manager reported that they work in concert with a number of hedge fund managers who bring target ideas to his fund in part because of this risk:

> There are definitely shy investors that we work with a lot and, you know, part of the reason is sometimes investors, you know, they don't want their name involved in a proxy battle. It's not good. You don't wanna be seen as antagonistic toward management and, you know, frankly it makes it much harder to deal with management in general if you're seen as an activist and then you go to a company meeting, right, or you try to do a company visit, you're not gonna get treated well. (HF9)

Although it is again unclear how this manager navigates the regulatory strictures regarding group formation, the "shy investors" defy the inherently public nature of hostile activism by outsourcing the task while enjoying both the benefits of anonymity and the potential gains that might ensue from HF9's actions on their behalf. Importantly, as only two of the twenty-nine respondents alluded to such outsourced activism, it is impossible to know just how extensive this practice is. Ultimately, this is an empirical question that can only be answered with additional evidence.

In sum, while there may be some cross-pollination of company and industry ideas and perspectives among institutional investors that occurs casually, hedge fund managers who engage in hostile activism generally eschew network formations as doing so carries the risk of running afoul of regulatory prohibitions on group formations. While some respondents suspected that some smaller activists ignore these rules, this study offers no evidence to suggest that this occurs often, a provisional conclusion consistent with the dire legal and practical consequences of participating in 'wolf packs'. The interesting implication from the relative absence of network formation among hedge fund activists is that the salience of reputation to an activist's social influence should be even greater than

was initially estimated. Indeed, the substantial trading around 13D filings and the significant share price increases associated with these filings would likely not occur if a hedge fund activist did not enjoy a favorable reputation among other institutional shareholders.

KNOWLEDGE OF THE FIRM: INSIDERS VS. ACTIVISTS

Thus far, we have examined the structural and attitudinal conditions that are conducive to conducting activism, the importance of constructing the perception that activists are legitimate and that their targets are illegitimate, as well as the importance of reputation. Still unaddressed, however, is perhaps the central paradox of activism: How is it possible for outsiders as compared to insiders to possess superior knowledge as to what is best for a firm? Not only are outsiders not in possession of all of the non-public information that is available to insiders, they also lack the intimacy which insiders have in relation to that information that is actually public. Are activist investors simply acting out of hubris?

It is easy to cast activists as interlopers. What does a Nelson Peltz know about the goings on in scientific research laboratories that are the engines of growth and innovation at companies such as DuPont and IBM, of the happenstance of scientific discovery, of the benefits from idea sharing across industrial segments of a single company? Surely the knowledge base of an outside activist – friendly or hostile – is dwarfed by the operational, financial, and product knowledge of an insider accrued over years spent across different functional areas inside a given corporation. Investors may have a rightful claim to superior expertise when it comes to understanding and deciphering income statements and balance sheets, but does such knowledge give them license to weigh in on operational matters, strategic direction, or leadership capabilities of a firm's senior management?

While there is a certain plausibility to this point of view, it needs to be tempered. Corporations do not function as islands but in a complex constellation of relationships with competing firms, with customers, with suppliers, with regulators, and with the financial community including investors, lenders, bankers, and rating agencies: the firm is a social

actor with *observable* behavior. Astute investors can acquire significant firm knowledge not only from a firm's published financial reports and from other investors, but also from observing a firm's public behavior within this network of relationships. That astute investors possess a rich body of firm knowledge is validated by the significant extent to which CEOs embed themselves with knowledgeable and legitimate institutional shareholders as we will see in the following chapter. Like Simmel's *Stranger*, astute investors occupy an external vantage point, both near and simultaneously distant, a vantage point unavailable to the firm and its insiders and thus acquire knowledge equally unavailable to the firm (Simmel 1971). In Granovetter's lexicon, were a CEO to rely predominantly upon the strong ties with her senior management team, her knowledge of her own firm would be inferior to the knowledge gained from relying on both strong internal ties and from the weak ties with knowledgeable investors (Granovetter 1973). CEO14 observed:

> …they get up every morning and they look at dozens of companies, including many in your sector and many all around and they're like bees. They're going flower to flower and they're learning stuff and I'd be a fool not to – they're spending time – I'm looking at my customers, they're looking at my competitors and they have ideas and they notice things and they have perspectives and but, boy, you'd be foolish not to – you know, at its best, sometimes investors are often offering what is just plain, good, free advice. (CEO14)

As we will later see, by the admission of many CEOs, the breadth and depth of knowledge of institutional investors can be quite robust, extending significantly beyond what might be obtained from a firm's financial statements and other filings alone.

Another source for outsiders of firm knowledge is simple face validity: a firm's actions should match its words. Given the regulatory restrictions on obtaining access to material non-public information, institutional investors must rely on what management says. But as HF1 observed:

> ...it's important to know what you're seeing and what they're saying is actually what you're getting and you'd be shocked how many times it is or it isn't. (HF1)

HF2 provided a more specific example of the lack of consistency between management's guidance and reality:

> They were in a managed care business and I think in their new business segment, they said we anticipate having 10,000 lives under management within the first year and during, I think, by the end of the first year or maybe it was after two years, whatever it was, it was a fraction of what they had told us. So, we had lost tremendous confidence in them. Typical questions to them – how could you project X and you have Y and we were getting – we were very uneasy with management. (HF2)

Both HF1 and HF2 discern problems with the firms they have invested in by virtue of a mismatch between what management says it is going to do and with what management succeeds in doing. In addition to comparing management's words and deeds, HF1 also described interviewing employees to ascertain the extent to which they too communicated a message consistent with management. In thus identifying inconsistencies, both HF1 and HF2 could determine the relative health of the firm they invested in or the likelihood that such inconsistencies foretold future underperformance.

It is one thing, however, to argue that investors' insights are valuable and additive, but quite another to assert that an activist investor possesses knowledge *superior* to that of insiders that would justify and legitimate any activist intervention with a target firm. It is also one thing to identify a firm with problems likely to result in underperformance, but quite another to pinpoint the actual source of the problems, let alone to come up with a remedy that has eluded insiders. To this point, several insights emerged from the responses of hedge fund managers that suggest some specific conditions under which an activist *may* have superior knowledge – and solutions – as compared to insiders.

First, not all CEOs are seasoned veterans. Many, in fact, by virtue of the increasingly shorter tenures of most CEOs, have only a handful of years of experience at the helm, some come from outside the firm bringing the strength of weak ties but missing an insider's intimate knowledge of the firm, and some are founders, quite insulated from their external environments and thus enjoy fewer weak ties but have substantial inside knowledge. Second, it is not just the knowledgeability of management against which we

should compare the knowledgeability of activist investors, but also that of directors, many of whom face constraints similar to those of investors in understanding the firms they oversee. Many directors have little experience running firms and thus have little in the way of operational backgrounds, do not have the intimate knowledge of their firms as management does, and often have to rely on the same reporting that external investors must rely upon, albeit with access to material nonpublic information.[37] Lastly, unlike private equity investors who do step in to actually run a firm and who thus need to be in command of a broader and deeper knowledge base regarding the target firm and its industry, an activist typically has more modest ambitions. A disgruntled investor – or a full-time activist – is likely concerned with a single issue or at most two or three often related issues that significantly lowers the knowledgeability threshold necessary for making a credible activist intervention in the firm. Most importantly, the overwhelming majority of issues that are of concern to activist investors, friendly or hostile, concern capital allocation, precisely where investors' expertise likely is superior to that of a firm's management.

Bases of Superior Activist Knowledge: CEO Experience vs. Institutional Investor's Experience

New CEOs

Given that the median tenure of CEO's today is about 6 years (Kaplan and Minton 2012), we know, to state the painfully obvious, that half of current sitting CEOs have fewer than six years. In some situations, therefore, management may be quite new:

> We've been doing this for a long time, sometimes many times we're buying something that is broken, so this new management has come in and they don't have a historical perspective on the business. (HF1)
>
> Interestingly, in many cases, because we are a fairly senior group that has been doing this for many years and in many cases…you

[37] It is also not uncommon, for example, for a newly seated director to get up to speed by reading Wall Street analyst reports on the firm and its industry, yet another acknowledgement of the high status of investor knowledge.

> certainly know these companies for 20, 25, 30 years. In some cases, we have more institutional knowledge than some of the people we're meeting with. You know, if you have a new management team, new IR person, new CFO, new CEO, when you meet with investors, particularly the people like ourselves who have been investing in the company for many years, we can provide certain context to – to our observations or suggestions. (HF13)

In contrast to new management teams, hedge fund managers as well as other institutional shareholders can possess a historical perspective on the businesses they invest in by virtue of having followed such companies for a significant period of time. While even long-term investors do not practice "buy-and-forget" investing and will sell out of a holding once they are convinced that shares are fully valued, this does not mean that the investor ceases to follow the company. Deep knowledge of a company is an asset for institutional investors and so they will continue to follow companies they do not own, looking for opportunities to re-enter the shares of highly regarded companies at more attractive valuations, and in the cases of poorly regarded companies, remaining on the lookout for some catalyst for positive change. Thus, by following companies over the long-term even when they do not own shares, institutional investors accrue valuable knowledge which can exceed that of new management teams. Such knowledge is obtained not only through observing the behavior of a firm through time, but also through interacting with a firm – by participating or listening in on years of quarterly conference calls, by engaging one-on-one with a firm's different management teams over the years at conferences or at headquarters, and by having read many "Discussion and Analysis" commentaries by the firm's previous CEOs. In these multiple ways institutional investors can acquire something approximating institutional knowledge of the firm that can eclipse that of less seasoned management teams.

In the following chapter, we will see how extensively CEOs embed themselves with their investors in order to calibrate their existing thinking, to obtain new information, or to simply promote their company and its stock, demonstrating that managerial interactions with knowledgeable investors are quite important. While such interactions can be extremely useful to CEOs, they are equally vital to most institutional investors. In fact, the

failure of a CEO to engage with shareholders can taint their view of such a CEO as it did with HF20 who held the CEO in low regard precisely because "…he was not the Street-facing CEO."

Knowing how to conduct, manage, and cultivate these interactions, however, is not necessarily a straightforward exercise and in fact may pose a challenge for a new CEO or executive team and for founder CEOs. This is where an institutional investor with a lengthy relationship with the firm can provide friendly advice and guidance:

> It's [our input] really more how do you either interact with Wall Street or balance sheet related. (HF1)
>
> …around the edges, we are trying to help, whether that's in business development, whether that's giving them our thoughts on capital structure, whether that's our efforts to help them get research coverage or Wall Street coverage or banking coverage. (HF21)

As HF1 intimates, there is a "how to" when it comes to cultivating relationships with the institutional investor community. And as we saw earlier in this chapter, having insufficient analyst coverage can be an impediment to a rising stock price, and so HF21 is all too happy to help out inexperienced management teams on this front. Knowledge of effectively communicating with institutional investors is clearly irrelevant to privately held companies, but is critical to the viability of public companies since institutional investors establish every firm's share price through the machinations of public equity markets, and this share price can be the difference between being in a position to acquire other companies or be acquired. One activist made this issue central to their 13D filing:

> A: The company was undervalued and they also weren't doing enough to promote themselves. They were not going to conferences, meeting with other investors, they were basically doing bare minimum as a public company. They filed their 10Q's, their K – their occasional 8K's and then they put up quarterly press releases. Beyond that, they really didn't do much.
>
> Q: So you didn't have an argument with their strategy or how they were running the business, it was, "Hey, don't put your lamp under a bushel"?
>
> A: Correct. Tell the world what's up here and they didn't want to do it. They didn't want to run the business that way and it probably

> hurt them at the end of the day for the lower price they got for the stock when they sold the company. (HF2)

While shareholder communication is no substitute for operational excellence, sound strategic direction, and effective execution to plans, it is nonetheless critical for CEOs to master the art of getting the message out. HF2 even implies that good shareholder communication is an essential element to greater market efficiency, attributing "the lower price they got for the stock" to poor communication. HF1, HF2, and HF21, as compared to the CEOs of their targets, bring superior expertise to these CEOs in understanding what constitutes appropriate and necessary managerial interactions with institutional investors, yet another example of hedge fund managers enjoying a knowledge advantage which can justify getting active in either a friendly or hostile way with their investment targets.

Seasoned CEOs

While it may appear that comparing the knowledge and expertise of seasoned institutional investors to that of new CEOs and relatively insulated founder CEOs is setting a low hurdle, institutional investors can level the playing field when confronting more seasoned management teams:

> …it may be that the manager knows how to operate a particular business within an industry better than we do because he's been there for 30 years and came up it. In many cases, we would hire expertise that was equal or better than his. (HF3)
>
> One thing we will do is we will hire consultants who know more about that industry than the people running the plants and so we'll go out and hire the best consultants and the best operators that we can find that will help educate us. (HF20)

Just as many companies will lean on their investment bankers for advice or hire marquee business consultants for strategic or organizational guidance, hedge fund activists can tap the same wells for expertise that they may be lacking in-house, just as HF3 and HF20 did. Additionally, numerous hedge fund managers in this study had different day jobs prior to running their hedge funds that would attenuate, if not neutralize, any knowledge advantage

that experienced insiders might have over institutional investors. While HF3 did not have working knowledge of some industries, he and his colleagues brought substantial operating experience from their days in the entertainment industry:

> Lots of the guys that were running this and myself and [name of iconic media executive] at the time had a pretty good working knowledge of radio, television, cable, satellite, productions, that kind of stuff, so entertainment industry, we probably could match as much expertise in this building as whoever was running the company that we were being activists about. (HF3)

Other hedge fund managers brought prior "real world" experiences as CEOs or directors at public companies prior to forming their hedge funds: four managers had experiences as CEOs of smaller companies before becoming hedge fund managers, and five had experiences serving as board directors either before or concurrent with their careers in the hedge fund world. And if the hedge fund manager herself did not have such prior experiences, she could, rather than looking to outside consultants and experts, bring such expertise in-house:

> We have people on the team who have worked at, you know, real operating companies, real businesses. That's part of what I think has added some strength and depth to their research analyst capability. (HF13)

Thus, hedge fund managers' equivalent or superior knowledge of the firms they invest in, when compared to that of insiders, can result from multiple sources: from extensive investment experience in companies that have new management teams who possess inferior knowledge, from purchasing the expertise they lack from consultants or industry experts, or from the knowledge and expertise they, or their analysts, obtained from having actual operational and/or leadership experience at other companies. Having this superior or equivalent knowledge, then, could provide a basis for engaging in activism.

Small Companies

In addition to the foregoing factors that may result in equivalent or superior knowledge for some hedge fund managers is that most targets of hostile activism are

smaller companies. Indeed, most hedge funds' equity investment strategies focus on smaller companies. Of the 24 hedge fund manager respondents who identified their target universe of stocks, 12 invested in either micro- or small-cap stocks exclusively, while only 3 invested exclusively in large company stocks; the remaining 9 had multi-cap approaches which invest in companies of all sizes. These observations are consistent with the findings from Brav et al. (2008) where the mean market capitalization of target firms is only $727 million in a heavily skewed sample of hostile activist targets: the top quintile, reflecting larger companies, represents a mere 11% of the sample with the remaining constituents – 89% of the sample – being mostly small cap with some mid-cap companies. Astoundingly, the *median* market capitalization of target firms from their sample is essentially micro-cap at $160 million.

There can be several reasons for this small company focus. The simplest explanation is that most companies are in fact small. Another is that the micro- and small-cap universe of stocks is generally considered to be less efficient than the universe of large company stocks, thereby yielding greater opportunities for outperformance: smaller stocks have smaller trading volumes and are less closely followed, if at all, by Wall Street analysts resulting in higher probabilities of inaccurate pricing. A final reason is that, like most public companies, most hedge funds are themselves small. While the investing public has heard of such hedge fund giants as Pershing Square run by Bill Ackman or Third Point run by Dan Loeb, both with AUM of more than $10 billion, they represent a tiny sliver of the hedge fund universe. According to the "2014-15 Annual Hedge Fund Operating Metrics Survey" conducted by Citigroup, 78% of the 5,216 hedge funds analyzed had AUM of less than $350 million; those with $10 billion or more represented a mere 0.8% of the hedge fund universe but commanded 32% of total hedge fund assets ("2014-15 Annual Hedge Fund Operating Metrics Survey" 2015). With huge AUM, large hedge funds simply cannot invest in small companies: if they take large positions, they hurt their own performance by creating large price disturbances in the stocks; if they take modest positions, these will have

no measureable effect on the fund's performance.[38] By contrast, hedge funds with smaller AUM have the flexibility to target small companies and exploit the greater likelihood of inefficient pricing: they can take modest positions which can yield meaningful effects on their funds' performance while avoiding price disturbances in the underlying shares.

This small company focus is relevant to the knowledge differentials between sophisticated hedge fund managers and the management teams of target companies because smaller companies are far more likely to have management teams that are less knowledgeable and have less expertise than those found in large companies, making it more plausible that some hedge fund managers have greater knowledge and expertise than insiders. Why this might be the case can be attributed to numerous structural characteristics of small firms that mostly involve a paucity of weak ties. First, as will be seen in the following chapter, CEOs' embeddedness with the investment community provides a rich source of new knowledge, albeit often incremental, as well as the calibration and validation of internal firm thinking. Given that many small-cap companies and virtually all micro-cap companies have little if any analyst coverage, they do not have similar access to these valuable knowledge sources. Second, the experience level of small company insiders is significantly more limited than what is found in large companies resulting in similarly limited knowledge and expertise. Small companies lack the breadth of management opportunities that not only serve as a division of labor at large firms but also as training grounds across several functional areas (e.g., production, accounting, marketing, etc.). Large companies will have multiple divisions and product lines, each with their own managerial hierarchies of presidents, senior vice-presidents, and vice-presidents. Smaller firms, by contrast, will have fewer divisions, if any, and much flatter hierarchies by virtue of a dearth of resources.

[38] Take, for example, a hedge fund with $10 billion in AUM and a small-cap company with a market capitalization of $500 million. The fund would have to own 20% of the small-cap company - $100 million – in order to achieve merely a 1% position of the fund's portfolio. Holding such a large position in an illiquid security would be unacceptable to most hedge funds. The same logic explains why many funds close their doors to new investors once AUM breaches a certain threshold beyond which they can no longer successfully invest in smaller companies.

Further compounding the knowledge and expertise deficits of small company insiders is the simple fact that many small companies are young and thus, compared to larger more established firms, lack the experience that accumulates over time. And as we saw earlier, the unseasoned nature of newer CEOs can stand in stark contrast to hedge fund managers and their teams who might boast several decades of experience. According to the law firm Wilmerhale, there have been 2,255 initial public offerings (IPOs) between 2000 and 2014, while Gao and Jain (2011) report that roughly half of the CEOs of such IPO companies are founders: not only is the leadership of all of these new firms short on experience, but this inexperience is exacerbated by the fact that founders have very firm-specific skills ("2015 IPO Report" 2015). Institutional investors are generally suspect of founder CEOs, and research provides ample evidence to justify this skepticism. Nelson (Nelson 2003) finds that founder CEOs are likely to foster 'founder-centric' structures which favor the founder retaining control over the firm and its direction, and such structures will include tight control over the board, a finding consistent with the on average lower level of board independence at small companies ("Governance Trends and Practices at US Companies: A Review of Small- and Mid-Sized Companies" 2013). While shareholders will generally find such control to be adverse to their interests, the relevant point here is that insular boards are more likely to suffer knowledge and expertise deficits because of the paucity of weak ties, and at the extreme, result in 'cronyism' just as some hedge fund respondents insisted, as detailed earlier. The research also finds that founder CEOs typically struggle to grow their firms beyond a threshold (Gedajlovic, Lubatkin, and Schulze 2004), to grow past their emergence stage (Boeker and Karichalil 2002; Nelson 2003), and struggle to handle increasing complexities that accompany firm growth (George 2005; Souder, Simsek, and Johnson 2012). All of these findings support the contention that founder CEOs, representing half of new companies that regularly come into existence, suffer knowledge and expertise deficits that are likely to attract the attention of sophisticated hedge fund managers and possibly prompt hedge fund activism.

Bases of Superior Activist Knowledge: Director's Experience vs. Institutional Investor's Experience

The comparison of knowledge and expertise of hedge fund managers with that of CEOs and executive management teams is not the only relevant comparison. Many of the major decisions a CEO and her team make must receive board approval, and thus the comparative knowledge and expertise of directors against that of hedge fund managers is also relevant. While the quality of boardroom talent is widely understood as having enjoyed a significant upgrade after the scandal plagued early-2000s and the subsequent regulatory response in the form of the Sarbanes-Oxley Act of 2002 (SOX), respondents articulated negative assessments of directors. Recall the board HF20 criticized for cronyism, a 2010 activist event:

> This board was made up of seven people that quite honestly had no business being on a board. It was the CEO had handpicked this board and it was a bunch of his cronies. (HF20)

To say that someone "had no business" doing something, we generally mean that the person does not possess the necessary qualifications, skills, or training, and thus HF20, in addition to delegitimizing the board on the basis of cronyism, also criticizes the knowledgeability and expertise of directors on this board. Recall HF8's discovery upon becoming President of one company that the directors were indifferent to the CEO's fraudulent behavior. We can infer from the opinion of HF8 that, if loyalty to the CEO was the *only* requirement for being a board member, being in possession of the necessary qualifications, skills, or training to effectively serve as a director was *not* a requirement. At best, however, these examples are mere intimations that directors possessed insufficient knowledgeability to serve on these boards as we lack better evidence to draw a firm conclusion. Using HF25's taxonomy of entrenched directors, it might still be the case that HF8's and HF20's target firms' directors are in fact knowledgeable, but co-opted. HF3 and HF4 also described what they believed were "know-nothing" boards, but their examples (omitted here) pre-date SOX. Thus, the ambiguity of all of these examples suggests that an automatic inference from the presence of cronyism to directors' knowledge and expertise deficiencies may not

necessarily be warranted *for post-SOX firms*, and furthermore, that the mechanism of delegitimizing boards by impugning directors' knowledgeability may actually be becoming a more difficult task.

This notwithstanding, the principal argument here – that the knowledge and expertise of some, if not many, directors is inferior to that of sophisticated hedge fund managers – finds support in two observations regarding the culture and structure of boards. First, as will be elucidated in the chapters on CEOs and Directors, the knowledge and expertise of most directors is inferior to that of most CEOs. Virtually all boards are hostage to the decades old normative arrangements that *boards do not manage* and that boards assign the responsibility of communicating with shareholders to CEOs despite the fact that boards represent shareholders. Both arrangements guarantee knowledge deficits for most directors. If some sophisticated hedge fund managers possess superior or equivalent knowledge of target firms as compared to that of those firms' CEOs under circumstances and situations described earlier, then it logically follows that their knowledgeability can easily eclipse that of those firms' directors.

Second, again given the fact that most targets of hostile activism are smaller firms, the directors at such smaller companies are likely drawn from other small companies, whereas the directors of large companies typically come from similarly large firms as well as from prestigious, non-business institutions such as prominent think tanks, foundations, or academic institutions. The reason for these differences is that smaller firms offer considerably lower compensation and lower reputational benefits than do larger firms (Knyazeva, Knyazeva, and Masulis 2013). Like the CEOs of small firms, directors of small firms therefore will not have the knowledge that comes from overseeing larger firms that are organizationally and competitively far more complex. Additionally, Ernst and Young (2013) found that smaller companies have smaller boards comprised of directors who serve on fewer outside boards, both of which imply fewer weak ties accruing to small company directors and thus more constrained access to new ideas and information (*Table 2.3*).

	Small-cap	Large-cap
Board Size	8.3	11.2
No. of Boards Served	1.5	2.1

Table 2.3: Board Size: Small-Cap vs. Large-Cap

This same report also reveals that small company boards are less independent and less likely to employ compensation consultants than large companies, both facts indicative of fewer weak ties than what large companies enjoy, reinforcing the idea that the knowledge and expertise of small company boards suffer from structural constraints, making it more likely that the knowledge and expertise of sophisticated institutional investors can exceed that found in small company boardrooms.

Bases of Superior Activist Knowledge: A Focus on Capital Allocation

While a handful of activist hedge fund managers, either friendly or hostile, weighed in on matters pertaining to firm strategy, leadership, or operational concerns, every activist hedge fund manager had on at least one occasion addressed some matter pertaining to the capital allocation decisions made in a firm. Such capital allocation decisions can involve decisions to develop a new product, representing the use of capital, or to terminate an existing product, thereby freeing up capital; to expand or shrink manufacturing capacity; to invest in new equipment or to simply maintain existing equipment; to buy versus lease equipment or office space; to divest or acquire business segments; or to acquire another firm in its entirety or to sell the firm itself. 'Capital allocation' also refers to decisions on returning cash to bondholders by paying down debt or to shareholders by initiating a dividend, by continuing or increasing an existing dividend, by paying a special dividend, or by repurchasing shares, all of which represent a distribution of capital to financial stakeholders.

Many respondents steered clear of nonfinancial issues, but felt entirely comfortable weighing in on matters of capital allocation:

> It's really more how do you either interact with Wall Street or balance sheet related. We're not going to give them operating strategy. If we have to give somebody who is running a business operating strategy, then we've got a problem. (HF1)
>
> We think we can bring a capital markets perspective that they might not have of their own… we're not very good at operational [issues]. (HF4)
>
> …so I think our activism has generally been limited to situations where capital allocation and the form of capitalization has not led to shareholder returns…we don't go in and say you know we know a lot more about running – we know a lot more about this industry than the CEO does; we may say, look you've been plowing money into this money losing operation. It's contaminating your company valuation… (HF6)
>
> I try, though, to limit my critique to the financial stuff. I don't actually critique the operator's business choices that often, where, you know, if you were visiting a restaurant company like, you know, the way they price their meals or where the – if they're gonna open a restaurant in this city instead of another city. I usually don't critique that because I don't think I'm really, you know, well suited to know more than the management. But on a lot of these financial topics, that's, you know, for me that's, yeah – If I don't know what I'm talking about, you know, I stay out of it. (HF19)
>
> I think it's hard for us to be sitting here in front of our computer screens and tell them they're not managing employees, etc., well, but it's easier for us to discern the appropriate and inappropriate capital spending plans, etc. So, it tends to – most of our commentary revolves around capital allocation. (HF22)

The *raison d'être* of investors operating within capital markets is to allocate capital to economically productive activities that have the potential for generating attractive returns when compared against alternative capital uses. It stands to reason, then, that hedge fund managers, "pure capital allocators" as I have called them, who do make the effort to actively engage firms in either a friendly or hostile manner, would first and foremost focus on matters pertaining to capital allocation, just as each of the foregoing five managers have described.

When hedge fund activists pursue demands that appear to involve matters other than those relating to capital allocation, such demands often ultimately tie back to capital allocation. Brav et al. (2008) lists the following activist objectives gleaned from activist 13D filings:

Objective	Percentage
[1. General undervaluation/maximize shareholder value	48.3%]
2. Capital Structure	
– Excess cash, under-leverage, dividends/repurchases	12.7%
– Equity issuance, restructure debt, recapitalization	6.1%
3. Business Strategy	
– Operational efficiency	12.4%
– Lack of focus, business restructuring and spinning off	9.1%
– M&A: as target (against the deal/for better terms)	7.5%
– M&A: as acquirer (against the deal/for better terms)	2.4%
– Pursue growth strategies	1.1%
4. Sale of Target Company	
– Sell company or main assets to a third party	14.0%
– Take control/buyout company and/or take it private	4.2%
5. Governance	
– Rescind takeover defenses	5.7%
– Oust CEO, chairman	5.6%
– Board independence and fair representation	15.0%
– More information disclosure/potential fraud	5.5%
– Excess executive compensation/pay for performance	4.7%

Table 2.4: Activist Objectives

Category 1, "General undervaluation/maximize shareholder value," is essentially a placeholder objective given by hedge fund activists who, for tactical reasons or because they simply do not know, do not yet reveal the purpose of their activism. While the only category that is specifically capital related is Category 2, Categories 3 and 4 all involve matters of capital allocation with the possible exception of "operational efficiency." While governance matters, Category 5, would seem to be non-capital related, this may not necessarily be the case. For example, institutional investors who watch a firm repeatedly

make poor capital allocation decisions, perhaps a string of disappointing acquisitions, will clamor not just for better capital allocation decisions, but for seats on the board and even for the removal of the CEO. In light of poor capital allocation decisions, an activist may push to rescind takeover defenses or to make the board more independent in order to provide more rigorous oversight of how capital is allocated. In short, many of the demands which activists press – including those that do in fact bear on strategy, leadership, governance – relate in the final analysis to how capital is allocated.

While CEOs are capitalists too, they fall short of being "pure capital allocators." Unlike hedge fund managers who devote virtually all of their time to assessing the potential return to any of a number of possible investment alternatives and who have devoted years to exercising and cultivating this expertise, CEOs are at best part-time capital allocators with the overwhelming majority of their time spent on insuring the optimal execution of capital allocation decisions already made. Compounding this is the fact that their paths to the corner office also afford them little experience making capital allocation decisions:

> I worked as an operating guy for a long time and, you know, unfortunately, you really don't get that. When you're an operating guy, you really don't get to allocate significant amounts of capital and until you're in the top five people in the firm. You may have, you know, twenty-five years of working experience before you're, you know, you're – or you're over 50 before you get into that top five people…so there are very, very few operating guys out there that have both operating experience and capital allocation experience. (HF17)
>
> I mean, usually it's on – on the capital side because I've been looking at balance sheets and companies for 25 years and XYZ CEO may have been the, you know, COO earlier or the controller before and has been looking at it from a high level for two years. I think that's very often the case and sometimes it's just – I just think people don't understand capital structures and financial engineering. It's like you said earlier, most – most executives are operators. They came up – they came up through this operations school. Even the CFOs very often times come up through accounting and auditing, which is very different than financial statement analysis and financial strategy. So, I think most of the management teams,

> especially in the smaller companies, they don't have experience. They don't really understand. (HF22)

> Most of the people who are in the C-suite, you know, sort of – you know, the CEO level, call it the CEO – typically comes up through operations, and may or may not have the mindset of an investor as it relates to capital allocation decisions. So it's incumbent on us. I mean, we're always looking at well, what are they spending the money on? (HF27)

Speaking from personal experience, HF17 explains the reality of most careers inside a corporation. While those at the very top make capital allocation decisions which become codified in a firm's annual budget or five year plan, those outside of the C-suite, including other senior and mid-level managers, are simply executing *to* these plans. These managers no doubt make capital requests during the budget planning process and hope that their projects receive approval and the appropriate budget dollars. They lobby internally and pitch their arguments to the executive team and perhaps even to the board. What they do not do is make the actual decision to allocate capital to this project or that. Once a mid-level manager advances to senior management and then to the ranks of the executive team, she will have had years of operational, product, marketing, and accounting experiences, but precious little experience with actually allocating capital, as HF17 emphasizes.

Additionally, the capital allocation decisions that CEOs make can suffer from conflicts of interest.[39] Depending on compensation structures, future career prospects, and other factors, a CEO for example may oppose any pressure to sell the firm, a major capital allocation decision:

> Now that doesn't mean that, you know, all companies should be sold, but you know, often management and boards are not objective in evaluating the prospect of a strategic transaction that may threaten their positions. (HF8)

[39] Even cases where CEOs' interests seem "aligned" with those of shareholders can reveal a conflict of interest. Institutional investors often applaud share repurchases, for example, as instances of managerial alignment with shareholders' interests, but *ceteris paribus*, share repurchases reduce outstanding shares thereby driving earnings-per-share higher, often resulting in higher stock prices and thus higher CEO pay. Thus CEOs may pursue share repurchases even if it is suboptimal, a point made by Larry Fink, CEO of the behemoth investment house Blackrock, who has criticized CEOs for overindulging in share repurchases at the expense of investing in their businesses.

In the interest of job security, a CEO may be reluctant to consider so-called 'strategic options' which might include the sale of the firm. Alternatively, if a CEO enjoys a particularly rich buyout package or some other incentive, he may not push as hard for top dollar when actually selling the firm:

> They had a strategic investor in the company, Bank of Fredonia, and we were concerned that management might be conflicted with a potential transaction with the Bank of Fredonia and they can sell a company too cheaply. That is because the managers would be hired by the buyer. (HF21)
>
> They were raising money at 70% of book to do it and we were a small shareholder and basically said, "Well, this is gonna be good for management because you're gonna run – you're gonna have a bigger AUM and you're gonna get paid a higher management fee and you get paid more money," but this can't be good for shareholders. You're paying 40% more for the properties than anybody else would have to pay me because you're raising money at 70% price-to-book. We strongly objected. We said, that, you know, that what they were doing, you know, bordered on the criminal. (HF28)

In the first example, it was not a lucrative buyout package that concerned HF21 but rather the likelihood that the buyer would retain the management team of the seller which would serve as a strong incentive for management to sell the firm too cheaply to the Bank of Fredonia. In the second example, the management of a real estate management firm was going to use the proceeds from a secondary offering[40] to purchase a portfolio of commercial properties, thereby substantially increasing both the firm's AUM and the compensation that senior management would subsequently enjoy due to the massively expanded fee base. This would come at the expense of existing shareholders because of the deep discount at which management was selling a piece of the company to new shareholders. While the

[40] When a firm transforms from a private entity into a public entity, it does so through an "initial public offering" or IPO. An already existing public company may raise additional capital by issuing debt or, in this case, by issuing newly minted shares to the public. Since the company is already public and has already gone through an IPO, this follow-on issuance of new stock is referred to as a "secondary offering."

example provided by HF28 is technically an instance of selling a firm too cheaply through the mechanism of the secondary offering, it is also an example of how the path to higher CEO pay is paved by generating higher revenues and by gathering more assets; in other words, CEO pay is greater for those running larger firms as compared to those running smaller firms. Thus, CEOs' capital allocation decisions can be influenced – to greater or lesser degrees – by a structural propensity to engage in so-called empire building, which as we saw earlier is widely seen as illegitimate.

While it is unclear the extent to which the poor capital allocation decisions that CEOs make derive from a lack of sufficient expertise, from conflicts of interest, or from some combination of the two, institutional investors are very skeptical of firms' spending behaviors. A report from the investment bank Credit Suisse sums up this skepticism succinctly:

> Capital allocation is a senior management team's most fundamental responsibility. The problem is that many CEOs don't know how to allocate capital effectively (Mauboussin and Callahan 2014).

HF19 asked rhetorically: "What's the point of making money if you're just gonna waste it after you've made it?" HF27 underscored the critical importance of paying attention to senior managements' capital allocation decisions: "Management can create or destroy more value more quickly through reinvestment decisions than just about any other activity." Noteworthy is that this skepticism finds support in considerable academic research which has demonstrated that CEOs often pursue less than optimal capital allocation decisions relating to capital spending and R&D decisions (Galasso and Simcoe 2011; Malmendier and Tate 2005; Malmendier and Tate 2008; Roll 1986) as well as value-destroying acquisitions (Fuller, Netter, and Stegemoller 2002; Jensen 1986). The consulting firm McKinsey found that two-thirds of acquisitions are value neutral or value destroying to the acquiring firm because acquirers typically overpay[41] (Dobbs, Goedhart, and Suonio 2007). More generally, a firm's capital allocation decisions that result in rapid

[41] In the case above concerning HF28's target, the flipside of the firm issuing new stock too cheaply is that it was paying a premium for the commercial assets it was acquiring.

asset growth is a reliable predictor of market underperformance (Titman, Wei, and Xie 2004). Again, given the generally superior expertise for allocating capital that hedge fund managers have relative to most CEOs and boards, it makes sense that this would be a principal area of focus for hedge fund managers who choose to become active with their investment targets.

Responses from numerous hedge fund managers in this study offered interesting examples of CEOs as poor capital allocators and hedge fund managers as possessing superior capital allocating skills. HF7 described their activism with a major North American grocer which owned a Canadian subsidiary, the value of which was not accruing to the benefit of the parent company. HF7 pressed the parent to sell the Canadian segment:

> …we're not telling the CEO that we know how to run a grocery store; we're just saying that you know you've got – you're a holding company, you're a portfolio company and the full value of your portfolio is not being recognized…so the company did announce a sale of their Canadian division and the stock went from $14.00 to $27.00 over the course of just announcing that transaction. (HF7)

HF7 professes no superior knowledge over the CEO as to how to manage the business, but does lay claim to having superior expertise in managing an investment portfolio, the framework he uses to describe the parent company's relationship with its underlying businesses. HF7 provided a second example more clearly identifying a stark capital allocation skill differential between institutional investors and firm management teams:

> …we went to management and said look, you've got literally billions of dollars sitting in these infrastructure assets [toll roads] earning low single digit rates of return…the company had $5 billion dollars in infrastructure and a billion dollars in cash and then multiple billions of dollars of engineering assets that was trading below the value of those infrastructure assets so we convinced them to monetize their infrastructure portfolio and then redeploy that capital. And so stock was trading at $40 and we said it's worth $90 and the infrastructure and cash is worth $55 or $60. And it's not about running an engineering company; it's about why you are sitting on assets that have a 3% real rate of return that are many, many multiples of your operating business when you should be selling those assets and buying back your own shares…We worked with the company's financial advisors, basically showed the

> financial advisors and the company why their models were wrong. They had a CEO that publicly said that one of the assets was worth $9.00 a share and when we finally convinced them to sell it, they sold it to Berkshire Hathaway for $24.00 a share… (HF7).

The company's significant ownership of toll roads had little to do with the firm's engineering focus; in the parlance of investment bankers, there were no 'synergies' between the infrastructure assets and the company's principal focus on engineering. But because the firm significantly – and inaccurately – undervalues its infrastructure assets, it does not see any pressing need to divest them. It is only with the impetus provided by the hedge fund manager who possesses superior valuation expertise that the firm is convinced of the benefit of divesting these infrastructure assets.

Accurate asset valuation is the critical foundation of any capital allocation decision. Inaccurate asset valuation can impede a CEO from divesting assets, just like the CEO which HF7 targeted for not divesting the toll roads, or it can result in squandering capital by paying too dearly for assets. A firm may deem an acquisition target as possessing marvelous potential synergies with the acquiring firm, and the target may have all the properties necessary for realizing the acquiring company's long-term strategic vision, but such lusty visions will be for naught if the acquiring firm inaccurately values the target and thus overpays. HF19 expressed frustration with a CEO who he believed ignored the importance of asset valuation when making acquisitions:

> They have this wonderful business with wonderful return for capital and the profit margins are forty-something percent, operating margins, I think 46%… they have this wonderful high return capital, high margin for special business with essentially no competition in the marketplace and it flows off a lot of capital. Because the margins are so good, it's just a mountain of money. And so what they choose to do with the money is make acquisitions. And the CEO is the fella that put the company together from the beginning, so he's created this really successful business, so he, you know, the criticism for constructive, you know, review and he laughed and he thinks he's <inaudible 6:39> his job, so he doesn't need advice from anybody and what he wants to do and what he has done is he makes acquisitions with the company's cash. Well, and he pays valuations that no matter what happens with what he's buying, it's almost

> inconceivable to get a decent return on invested capital. He pays eight to ten times revenues for businesses and if you do the math, you know, the businesses perhaps they grow five or six fold to earn their market cap. What's happened is the return on invested capital over the last few years has actually been shrinking. So, this is an example where he has a wonderful business with wonderful prospects – and I'm not taking issue with what he's buying or why he's buying it, I'm just – he's paying prices that are so high that it can't possibly be financially smart. (HF19)

To HF19, this is a clear example of poor capital allocation: as a result of overpaying for acquisitions, the firm's return on capital has been gradually eroding. In making his case that the CEO executes poor capital allocation, HF19 also highlights the founder status of the CEO, which in his mind explains why the CEO does not take advice well and pursues his own interests at the expense of investors' interests, resulting in margin erosion. HF19's characterization of the founder CEO as basically entrenched is consistent with the evidence cited earlier that found that firms led by founder CEOs often underperform on a variety of metrics. Lastly, HF19 emphasizes that his criticism is confined to matters he believes are in his wheelhouse, namely asset valuation – "he's paying prices that are so high" – and is not criticizing things outside of his expertise – "I'm not taking issue with what he's buying."

To sum up, respondents identified several instances of CEOs making blatantly poor capital allocation decisions which they attributed to the general lack of experience corporate insiders actually making such decisions. By contrast, the bread and butter of hedge fund managers and institutional investors generally is expertise in asset valuation, the critical foundation to every capital allocation decision. Some hedge fund respondents, by virtue of prior operational experiences, felt comfortable weighing in on issues separate from capital allocation. Overall, however, very few attested to pursuing strategic, operational, or leadership changes at target firms, while the overwhelming majority focused on "financial stuff." By virtue of their superior knowledge concerning the allocation of capital, hedge fund managers feel justified for engaging companies in order to voice their objections when they are convinced that managements are overpaying to

acquire new assets or failing to monetize undervalued assets already owned through sales or divestitures.

This chapter has tried to answer a number of questions concerning hedge fund activism: Why do some hedge funds bother to resort to activism when, compared to most other institutional investors, they have considerably greater investment flexibility by virtue of the variety of investment tools and techniques at their disposal? Why do hedge fund managers believe they are acting legitimately when engaging in activism and how is this legitimacy constructed? How do hedge fund activist investors cultivate their social influence? And perhaps most importantly, on what basis do activist hedge fund managers believe that they possess superior knowledge than corporate insiders and boards?

Based on interview responses from twenty-nine hedge fund managers, it was found that a number of structural and attitudinal conditions enable the possibility of activism to take place. Hedge funds that invest in equities of public companies, that practice a value style of investing, that are of sufficient size with supportive investors, and with managers who are not averse to conflict are far more likely to engage in hostile activism than are hedge funds without these characteristics. Hedge fund managers engaged in activism believe it is a legitimate mode of action because it is wholly consistent with shareholder value ideology. They legitimate specific instances of activism by identifying violations of shareholder value which effectively includes any corporate actions which are not primarily aimed at increasing the firm's share price. Legitimacy is also garnered by defusing the criticism that hedge fund activists are merely engaging in short-term investing. It is also secured by contesting problems that an activist may believe are obvious and noncontroversial, and also by delegitimizing CEOs and boards of target companies. By virtue of numerous regulatory tripwires, respondents typically exercised social influence not by directly cultivating networks of like-minded investors, but by cultivating their reputations as legitimate, tenacious, and successful activists, and by exploiting the hostile symbolism of Schedule 13D filings. Lastly, hedge fund activists utilize numerous sources of knowledge that are often on par with or superior to corporate insiders, and thus they

believe it is not hubris, but the possession of superior solutions and strategies for improving a target firm's performance that justifies their activism. Most importantly, this knowledge frequently exploits hedge fund managers' unique and superior expertise regarding all matters relating to the allocation of capital. In the minds of institutional investors, this is simply what the very concept of the corporation boils down to – a locus of capital in need of optimal deployment. Given this superior expertise, there is no reason why its exercise and deployment should stop at the corporation's front door.

Chapter 3: *CEOs*

INTRODUCTION

In the modern firm, investor power is articulated in three ways. First, investors can buy or sell shares in companies; greater demand for shares will drive share prices higher, and lesser demand can drive prices lower. A higher share price accords a company certain advantages. Higher share prices increase the total value of a firm's equity, expanding the firm's borrowing capacity and thus the ability to engage in new ventures or projects. Higher share prices also increase the currency value of the firm's shares such that the firm can use its richly valued stock to purchase other firms. A lower share price, by contrast, carries certain disadvantages. As the total value of the firm's equity decreases, its indebtedness, measured by such ratios as debt-to-equity or debt-to-assets, increases and so too does the company's risk profile. A lower share price, therefore, constricts the firm's flexibility to raise capital to invest in projects and also increases a firm's existential threats insofar as a lower share price can make the firm a takeover target. The power that investors can exercise through the equity markets, then, can be very consequential for firms and their managements.

Second, investors can approve or deny major corporate actions which firms are legally required to place before their shareholders. For example, a firm must get shareholder approval for corporate reorganization plans, for the sale of major assets or for the sale of the firm itself, or for any amendments to the firm's articles of incorporation. All such proposals that are put before shareholders, however, are first approved by the firm's Board of Directors. Thus, in addition to the power shareholders can wield by expressing their approval or disapproval of a firm's prospects through the buying and selling of shares, shareholders have this additional avenue of exercising power by voting on significant corporate actions.

The third conduit through which shareholders exercise their power is through the election of directors. And because shareholders elect directors, the board constitutes the formal representation of shareholder interests. For simplicity, these three avenues distill

down to two – the exercise of shareholder power through the equity markets and through the board. Were one unaware of the actual dynamics that exist between firms and investors, one would deduce from the foregoing that, aside from buying and selling shares in the marketplace, the primary point of contact between investors and the firm would be through the board: directors represent the shareholders who elect them and stand in for them to exercise oversight of the firm acting as their agents. It seems paradoxical, then, that the overwhelming number of interactions between investors and firms is not with the board, but with the CEO (and with the CFO and the head of Investor Relations). As recently as 2013, more than half of corporate directors surveyed felt that it was inappropriate for directors to communicate with shareholders on a range of issues including earnings results, risks, strategy, capital expenditures, and other uses of cash ("Shareholder Activism: Who, What, When, and How?" 2015). The corporate governance guidelines which General Motors provides its directors sums up the decades old normative understanding regarding directors' interactions with shareholders: "As a general matter management speaks for GM" (2016).[42]

Against the formal, and false, version of corporate control where boards energetically represent and therefore engage with those who elect them, shareholder activism generally, and hedge fund activism specifically, assumes an air of vigilantism. Of course, such an observation is a naive exercise in making the familiar unfamiliar since, over the past thirty-five years, activism itself has become thoroughly normalized as managerial capitalism has given way to investor capitalism and the ascendance of shareholder value ideology (Davis 2009; Fama and Jensen 1983; Fligstein and Freeland, 1995; Jensen and Meckling 1976; Useem 1990, 1996). Public activism is ubiquitous and occurs hundreds of times annually, and private or quiet activism – undetected by most academic research – likely occurs with even greater frequency. And also contrary to what the formal framework would imply, CEOs often occupy a central position in contests over corporate control and direction launched by hedge fund and other activist investors. By

[42] This paradox of the relationship between boards and shareholders will be further explored in the next chapter.

relying on thirty-four semi-structured interviews of S&P1500 CEOs (an index that includes large, medium, and small publicly traded U.S. companies), this chapter looks at the interactions between CEOs and their institutional investors – mutual funds, pension funds, hedge funds, and other institutional money management firms – and specifically how CEOs view and respond to shareholders' efforts to influence corporate decision making. It begins with a description of the quantitative data teased out of the responses from the CEOs. Following this descriptive segment, I will examine the qualitative data on CEO's attitudes and beliefs regarding their shareholders in order to ascertain why CEOs sometimes ignore, resist, accommodate, or acquiesce to institutional shareholder demands, including those made by hedge funds.

A brief preview of some of the findings will be helpful. Despite recent research which insists that hedge fund activists do not have a short-term orientation, the CEOs in this study beg to differ (Brav et al., 2008, 2013; Bebchuk et al., 2013). Nearly every CEO respondent described hedge fund managers as short-term investors, and since a short-term orientation is a mark of illegitimacy, they therefore view hedge funds with suspicion and greet them with resistance. What was surprising, however, was the extent to which many CEOs were amenable to other shareholders' influence. Approaching this project, I viewed activism not merely as a contest for corporate control and influence, but as contesting the very idea of the separation of ownership and control: an activist event is an effort to bridge this separation. In this sense, activism is about promoting a new paradigm where owners can once again exercise control, an idea that fell by the wayside with the emergence of dispersed share ownership in the early to mid-twentieth century, the period of managerial capitalism, but has since been revived under the new regime of investor capitalism. Judging from the shrill complaints of some activists and from those who believe shareholder democracy represents some still unattained promised land, I suggest that such a new paradigm is more a reality than most suspect, a conclusion reached not simply on the basis of the increased frequency of shareholder activism. Based on what my respondents described, the level of embeddedness of CEOs with their shareholders is substantial, as too is their reliance on what their shareholders think. Of course, much of this may be defensive

in the spirit of keeping one's friends close but one's enemies closer and an exercise in impression management consistent with Westphal's perspective (Westphal and Bednar 2008; Westphal and Clement 2008). Several respondents in fact were dismissive of shareholder input, insisting that they never heard anything from a shareholder that they and their teams had not already thought of or considered. Still, I found that many CEOs emphasized the *value* they saw in the exchange of ideas with legitimate shareholders.

The magnitude and character of this embeddedness revealed by CEO respondents strongly suggests that the so-called separation of ownership and control is increasingly becoming an anachronistic characterization of the relationship between institutional shareholders and managements. While this embeddedness fits the trajectory of investor capitalism described by Useem (1996), it nevertheless is fundamentally different from the worldview of CEOs that he found in the 1990s:

> …company executives have constructed a self-justifying culture, a set of insulating beliefs that serve to protect them from owner interference if not oversight…the culture of management has become consistent, animating, and common enough to constitute a worldview…[that] reaffirms the right of management to resist, and it questions the rights of shareholders to demand (p.78).

Not only is this worldview among many of today's CEOs largely obsolete, it has given way to an interdependent relationship between managements and institutional shareholders evident both in the internalization of common investor expectations as well as in the frequency of friendly and quiet activism that, as observed in the *Introduction*, likely dwarfs the occurrences of hostile activism. This new relationship between managements and institutional investors suggests something very different from a separation of ownership and control with important implications for the nature of agency problems that have long been linked to this separation. While it would be both false and absurd to imply that prominent institutional investors co-manage firms alongside CEOs, the degree to which CEOs today incorporate shareholder input, and the degree to which institutional

shareholders give it, as we saw earlier, is far from trivial and represents a new normative framework for the control of the public corporation. In this context, activist events are not the exceptional instances where investors impinge on managerial prerogatives, where in the absence of such interventions, CEOs are blithely indifferent or even mildly attentive to their shareholders. Rather, activist events are instances where the integral and interdependent relationship between CEO and investor has been upset.

SAMPLE DESCRIPTION

Of the thirty-four CEOs, twenty-four had some interaction with activist investors. As explained in the *Introduction*, my use of the term "activism" is a far more expansive use of the term than is commonly understood. Not only do I include the noisy and hostile variety of activism exemplified by well-known investors such as Carl Icahn or Bill Ackman of Pershing Square, investors who use media outlets to voice their criticisms of and even disdain for company managements and their decisions; I also include the quiet and collaborative variety that is not public (and offers no entertainment value). The logic underlying this more expansive conception of activism is that *any* intervention in the affairs of the firm which attempts to influence and/or change managerial decision-making on firm capital structure, capital allocation, firm strategy, leadership, or firm governance, whether quietly or loudly, whether hostilely or collaboratively, represents an erosion in the separation of ownership and control. If, for example, a firm initiates or increases a share buyback program, whether or not this has occurred by virtue of the pressures from a loud and hostile investor or from a quiet and friendly investor is beside the point: if either investor type succeeds, the outcome is the same – share buybacks.

No doubt, the public variety of activism is by its very nature far more amenable to quantitative analysis than the non-public variety: researchers can, and mostly do, grab 13D filings[43] in combination with media analyses as the grist for their statistical mills. Based on

[43] When an investor acquires 5% or more of a firm's outstanding shares and wishes to remain passive, it must file a 13(g) form; however, if such an investor intends to press some issue, i.e., wishes to be active rather than passive, it must file a 13(d).

what my respondents reported, however, only eight of the twenty-four CEOs experienced activism of the public variety, while eighteen CEOs experienced non-public pressure.

	Public	Non-Public	Total
Hedge Fund	7	5	12
Other	1	13	14
Total	8	18	24*

Table 3.1: Number of CEOs Experiencing Activism
(* Two CEOs experienced both public and non-public activism)

Caution should be exercised in extrapolating from this limited and non-random sample of respondents. As with any qualitative study, generalizability is not among its blessings. That said, given that non-public activism outstrips the public variety by more than two-to-one among the respondents experiencing activism in this study, researchers who rely on the availability of data on public activism also need to exercise caution: it is not that they might only be touching the tip of the iceberg; they may be missing an altogether larger and different iceberg. This is not to trivialize public activism. Indeed, non-public activism may exist and flourish simply by virtue of the power of the example of public activism. Visible action has the potential for wider social consequences; invisible action does not.

Insofar as the emphasis of this study is on hedge fund activism, one limitation of the data gathered from the CEO respondents is the paucity of their interactions with hedge funds. Of the twenty-four CEOs who had interactions with investors pressing recommendations or making demands, only twelve CEOs received such pressure from hedge funds. Of these twelve, six CEOs confronted hedge funds that pressed their demands publicly, four privately, and one both publicly and privately. Interestingly, 87.5% of the CEOs who had to contend with *public* activism did so by interacting with hedge funds,

while only 28% of the CEOs interacted privately with hedge funds.[44] Other institutional investors, by contrast, such as pension funds or mutual funds, interacted publicly with only 12.5% of the CEOs I interviewed, but privately with nearly three-quarters of my respondents.

It would appear, then, that shareholder activism which takes place in the public sphere is a mainly hedge fund phenomenon, while the activism that occurs privately and quietly more typically involves other kinds of institutional investors. A plausible conjecture as to why this is so might be that the short-term nature of dedicated hedge fund activism requires an accelerant in the form of public pressure to more quickly achieve its goals. But even shy of achieving stated goals, simply making demands public often in and of itself redounds immediately to shareholders' benefit in the form of higher stock prices. These two conjectures are not mutually exclusive; in fact, the bump up in share price may serve to increase the likelihood that the activist will succeed in realizing his goals. For example, if Carl Icahn announces on CNBC that he has written a letter to Tim Cook of Apple urging him to launch a large share buyback, the shares of Apple will immediately see a bump in share price as investors, based on Icahn's past successes, anticipate that Mr. Cook will likely oblige Mr. Icahn, at least to some degree. If a CEO fails to oblige, this resistance to Icahn's demand will now come at a cost: the share price, already higher by virtue of Icahn's initial announcement, will decline back to pre-Icahn levels, leaving shareholders who had already enjoyed this initial bump in price disappointed. The very possibility of this cost can serve as an inducement for CEOs to meet the demands of activists, even if partially. This dynamic clearly is not present when activism occurs quietly and out of the public view.

However, before drawing any such conclusions based on *Table 3.1*, it needs to be emphasized that the *n* in *Table 3.1* is the *number of CEOs* experiencing activism and *not the number of activist events*. It is the very nature of public activism that it is quantifiable,

[44] Here I include the two CEOs who experienced *both* public and non-public activism in each of the public/non-public columns, so "public-hedge fund" goes from 5 to 7, and "non-public-hedge fund" goes from 4 to 6 with the Totals adjusted accordingly.

and thus attractive to quantitative researchers: as mentioned above, researchers can count 13D filings and they can count media citations.[45] In the case of non-public activism, we have to rely on the CEO's memory, on his[46] interpretation of my definition of activism, as well as on his filter as to what was noteworthy or not. In greater detail, my question to CEOs regarding their experiences of non-public investor activism was largely as follows:

> Has any investor or investors ever placed a phone call to you, wrote a letter to you, or addressed you in a face-to-face meeting in which (s)he made a demand(s) or recommendation(s) in such a deliberate way as to make clear that a specific response to the demand(s)/recommendation(s) was expected?

To make clear what I was ***not*** interested in, I pointed to the typical earnings conference call on which numerous analysts and investors queue up to ask questions in order to gain greater clarity on the information just released in the firm's earnings announcement and on the future guidance that management has articulated. It is not uncommon for an analyst or investor to say things like: "Have you considered spinning off the "xyz business segment" because it's really depressing your margins?" or "Why wouldn't you do a share buyback given the pace with which cash is building on your balance sheet?" Similar exchanges might also occur at investor conferences where company managements make presentations to the wider investor community. I consider such questions part of the normal give-and-take between firms and investors, lacking the *pressure and urgency* characteristic of activism that more pointed questions made in other contexts might carry. In other words, if an investor wrote a letter to the CEO with the sole purpose of engaging the CEO on the question of share buybacks and asked the same question as the hypothetical analyst on an earnings call, this *would* rise to the level of activism. While the definition of any word or

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[45] Again, the tractability of the data related to public activism does not equate with a greater purchase on reality, especially if it is the case that public activism is dwarfed by non-public (and less tractable) activism.
[46] Despite the 400 letters sent out to a randomized list of companies within the S&P1500, all CEO respondents were male. One explanation for this outcome is that the very small number of female CEOs in itself impairs any effort to preserve confidentiality. One female Director actually requested that I not identify her gender for precisely this reason.

term is never perfectly circumscribed, I believe my respondents understood what I was after.

This conviction that respondents understood my broader, though still limited, conception of non-public activism is supported by two factors. First, the examples my respondents provided would contain references to letters, phone calls, and one-on-one meetings during which recommendations, requests, or demands were made privately to the CEO – precisely the kind of activism I was interested in. Second, respondents described the reasons why they did or did not adopt the recommendations or requests which an investor was privately making, indicating thereby that the shareholder was pressing an issue in such a way as to engage the CEO beyond the normal give-and-take of management-shareholder interactions, and thus indicating that activism in the sense I have defined it was in fact taking place.

Even though respondents understood my broader conception of activism, quantifying the occurrences of activism based on their reports is unavoidably inexact. Because of the reliance on the CEO's memory, interpretation, and filters, reported occurrences lack the verifiability that public filings afford the researcher.[47] While CEOs sometimes reported the occurrence of private activism with precision, others reported occurrences ambiguously with such qualifiers as "several," or "numerous," or "many." Eight of the eighteen CEOs who reported non-public occurrences of activism used such terms even though they also provided specific examples (and the examples were consistent with my broader conception of activism). Thus, a respondent who never received a letter, phone call, or visit where an investor made a request or recommendation was coded with '0'. A CEO who specifically recalled only one (two) occurrence was coded with a '1' ('2'). But if they used the more ambiguous terms, then I coded the number of occurrences with

[47] Although, as detailed in the *Introduction*, quantifying activism on the basis of public filings such as 13Ds is also inexact as some hedge fund managers acknowledged that the use of a 13G – indicating passive, non-hostile investing – rather than a 13D would have been more appropriate as these managers had no intention of "going hostile." Also, as we saw in the preceding chapter, some hedge fund managers acknowledged using the 13D, not because they were going to pursue activism, but in order to draw attention to an overlooked target company, thereby engaging in symbolic management.

a ‘3’. This right censoring, therefore, results in a conservative counting of the number of occurrences of non-public activism.

With the foregoing in mind, accounting for the number of activist events reveals an even greater disparity between public and non-public activism, as seen in the following *Figure 3.1*:

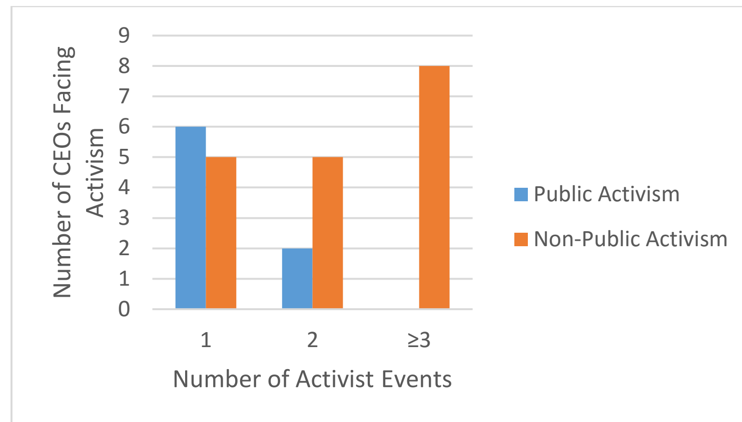

Figure 3.1: Activist Events

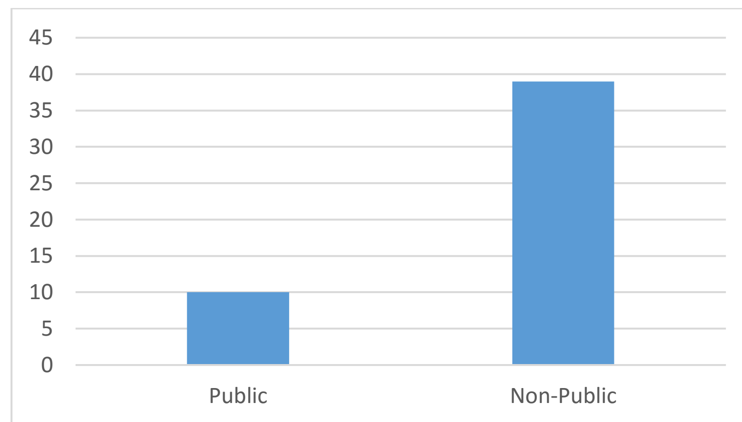

Figure 3.2: Activist Events

In *Figure 3.1*, for example, six CEOs faced one public activist event, but eight CEOs faced three or more non-public activist events. By right-censoring at ‘3’, we can infer from

Figure 3.1 that my respondents experienced 10 activist events – (6x1) + (2x2) – that occurred publicly, but 39 activist events – (5x1) + (5x2) + (8x3) – that occurred privately, again highlighting the likelihood that most activism occurs out of the public view (*Figure 3.2*).

The goals of this activism were varied, but were mainly dominated by returning cash to shareholders through share buybacks and sometimes by increasing dividends, and by governance issues such as majority voting, separation of the CEO and Chairman of the Board positions, and the declassification[48] of boards.

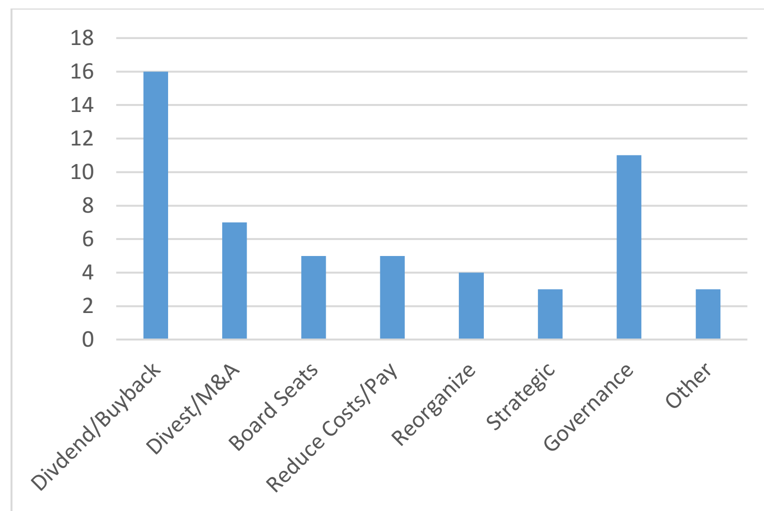

Figure 3.3: Activists' Goals

Another area of investor concern focused on either divesting some part of a firm or recommending some sort of merger or acquisition. Importantly, the push for one or more board seats occurred only in the form of public activism; there was not a single instance of an investor pushing for a board seat quietly, based on CEO responses. Out of the ten public activist events, pressure to make governance changes occurred just twice, one pushed by a labor union and the other by a hedge fund. The remaining eight governance related activist

[48] A classified board is one in which only one-third of directors face election each year making it more difficult for a hostile investor to take control of the board. A declassified board, therefore, eliminates such staggered elections and places all directors up for election each year.

events occurred privately. The number of *goals* shown in *Figure 3.3* (54) total more than the number of *events* shown in *Figure 3.2* (49) because some investors made multiple requests/demands.

What were the outcomes? Partial successes are treated as successes. Perhaps an activist wants two board seats, but gets one, or wants a $4 billion increase in share buybacks, but the firm agrees to just $1billion – these are all considered successes. The justification for this approach is twofold: first, it is not common for an activist to get everything the activist wants; second, and more importantly, partial success still represents a breach in the separation of ownership and control where an investor has altered the decisions and choices that a firm otherwise would not have made.

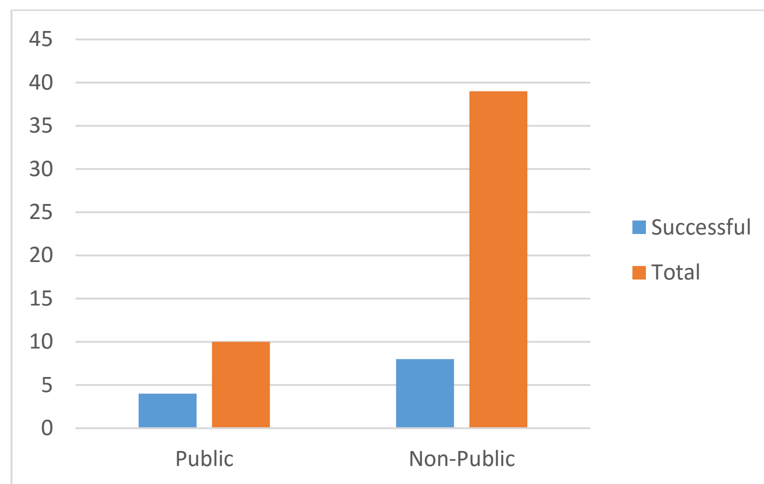

Figure 3.4: Activist Events

Among the ten activist events that occurred publicly, four (40%) were successful, while only eight out of the thirty-nine (21%) non-public events were successful. While more extensive data is necessary to draw robust conclusions, the implications from this limited data – that public activism is more likely to be successful than private activism – is consistent with what we know about the dynamics of each form of activism. Crucially, public activism has the potential to garner the support of other investors which magnifies the pressure on the firm to adopt the activist's demand(s). Unless there is the implicit threat

that quiet activism might become public[49], non-public activists rely on their powers of persuasion. This appears to be true regardless of the type of investor: even though the four public activist events all involved hedge funds, none of the five hedge funds that engaged in quiet, non-public activism enjoyed success.

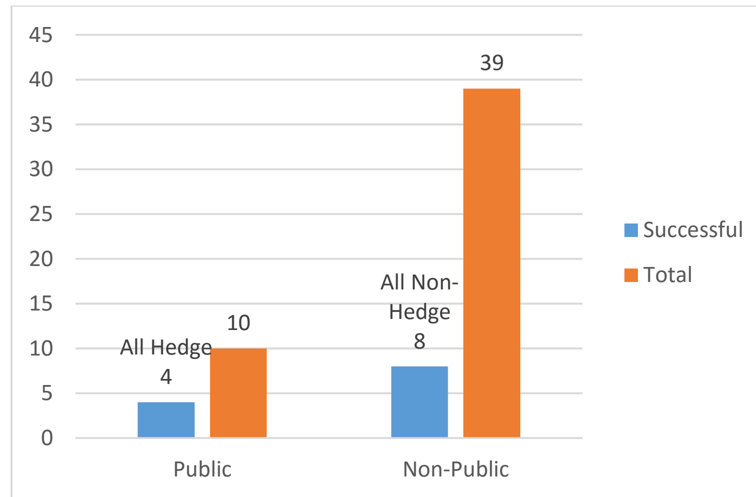

Figure 3.5: Activist Events

Additionally, CEOs seemed quite responsive to shareholder pressure to increase either share buybacks or dividends.[50] This is understandable given that, unlike any other category of investor request/demand, CEOs benefit alongside shareholders since share buybacks typically drive earnings-per-share higher by virtue of reducing share count, and, therefore, stock prices higher as well. By contrast, giving board seats to an investor is most likely done grudgingly as the benefits accrue almost exclusively to the shareholder who potentially gains additional influence on firm decision making.[51] It is noteworthy, then, that only hedge funds pressing their demand publicly gained board seats.

[49] One of the two hedge funds that became active with CEO28, initially did so quietly. After CEO28 rebuffed the activist, the activist went public. I count this as public activism.

[50] Many CEOs want to retain cash for one of three reasons – to invest in the business, to acquire other companies, or to weather economic downturns. Institutional investors, by contrast, are typically suspicious of the first two reasons, and dismissive of the third: they do not trust the wisdom of most CEOs' spending decisions, be it capital spending or acquisitions, and view "rainy day" funds as excessively risk averse.

[51] As I will discuss in the chapter *Directors*, some respondents suggested that giving an activist a board seat(s) was done strategically in order to neutralize the activist who, once a board member, has heightened fiduciary

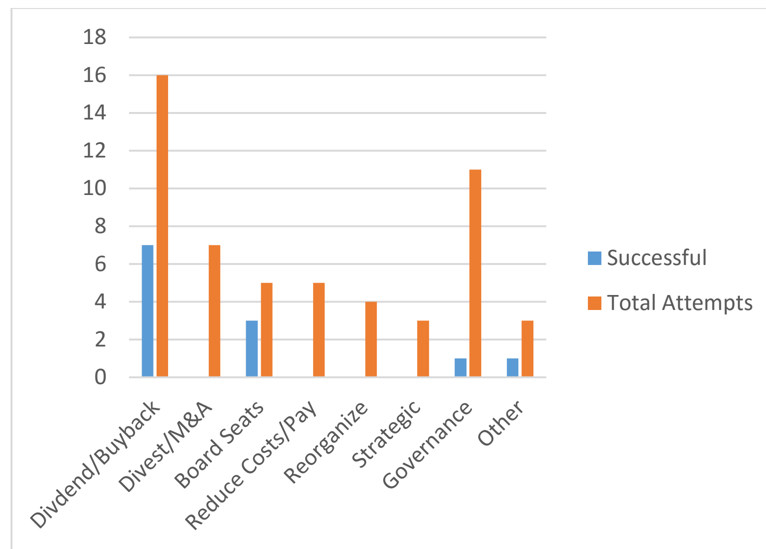

Figure 3.6: Activists' Goals

Summing up the salient points from the foregoing, it is evident that shareholder activism, broadly but not trivially conceived, occurs significantly more often in private than it does in public. Despite the limitations of the data from this study, this finding should at the very least give pause to an overreliance that most academic research places on public activism. Notwithstanding the prevalence of quiet, non-public activism, public activism was "successful" more frequently than was private activism; however, a principal argument I hope to make with the qualitative data is that this less frequent "success" from private activism grossly understates the extent to which quiet activism influences CEOs. Hedge funds, which seem to participate with roughly equal frequency in both public and private activism, appear to dominate public activism since other institutional investors seem to press their concerns publicly far less frequently. That hedge funds enjoyed successful activism only when pursued publicly and never privately suggests a general distrust by

duties owed to the firm. Additionally, the firm is in a position to share confidential information with the newly seated board member that they could not provide while the shareholder was outside the firm, confidential information which can affect and alter an activist's goals. In any event, regardless of the strategic benefits of giving an activist a board seat, the firm would prefer that such strategizing was not necessary to begin with.

CEOs of hedge funds who apparently only succeed by dint of brute force, or the threat thereof.

To further ascertain why CEOs embrace some investors but rebuff others, it will be useful to examine how CEOs understand ownership, what beliefs and attitudes they hold of their investors, how they differentiate their investors, and which investors they view as legitimate. I will also examine how CEOs try to shape their investor base, and will conclude with an examination of the interdependence CEOs have with their investors, an interdependence which demands a new understanding of the concept of the separation of ownership and control.

CEOS' UNDERSTANDING OF OWNERSHIP

It has been over thirty-five years since investor capitalism displaced managerial capitalism as the dominant framework for the control of capital. It was surprising, then, to hear some CEOs speak quite explicitly in opposition to a strong-form version of shareholder primacy and characterize vocal institutional investors as inappropriately impinging on managerial discretion. CEO3 expressed a view not inconsistent with managerial capitalism:

> The capitalist system how I think of it, the great corporate capitalism that's made America so great, you have the right to buy shares in any company you wish and if you don't like what [they're] doing, you have the right to sell those shares. It's really that simple. Guess what, if enough people don't like what you're doing, your share price is going to go down and eventually the Board's going to kick out the management. I mean, it's that simple. (CEO3)

The tenor of these comments has a certain archaic sound in the context of today's shareholder primacy discourse. In the view of CEO3, institutional shareholders should vote with their feet, not with their voice, a viewpoint that would be inhospitable to any form of shareholder activism, public or private. CEO5 echoes this subscription to a hard separation

of ownership and control, a view of corporate control which shareholder primacy explicitly contests:

> Q: What do you think of the balance of power between shareholders today and firms? It seems that over the last 20 years, there's been a lot of regulatory rules, as well as Court rulings that have inched more advantages to the side of investors.
>
> A: I think that's right and I bristle against that because, you know, you're dealing with a consumer market with thousands of public companies and if there's a public company that – where you're in conflict with its mission or its operations – you are allowed to walk on by and go find another company that you like and I think too often companies modify their principles to try to pacify or placate an activist or some loud mouth. (CEO5)

Only these two (or 6%) CEOs, however, expressed such views.[52] Even with these, though, it is perhaps inaccurate to suggest that they outright reject the shareholder value view of the firm. A better characterization is that these two CEOs reject the logic that shareholder primacy entitles shareholders to insinuate themselves into the running of firms; they reject the view that activism is consistent with shareholder primacy. CEO3, for example, implies that his responsibility *is* to drive a higher share price, i.e., to deliver shareholder value, or else he will be out of a job, a consequence he sees as legitimate so long as it occurs through market mechanisms rather than through activism. The respondents who were hostile to activism and to the view of shareholders as owners, then, were not necessarily embracing a 1950s managerial capitalism perspective, but were rather articulating a more narrowly conceived, or "weak-form" version of shareholder primacy.

Thus, the overwhelming majority of CEOs in this study accepted the shareholder value view of the firm and the primacy it accords shareholders. In justifying why they

[52] Five CEOs were coded as having weak-form shareholder value views, but primarily for structural reasons: CEO8 was among the two founders of the firm and founders typically have less shareholder oriented views; similarly, the management team behind CEO11 owns 20% of the firm, and they very reluctantly opened themselves up to public ownership; and CEO18 leads a firm that has only one voting shareholder by virtue of the firm's rather odd articles of incorporation. No such structural explanations existed for the weak-form shareholder views of CEO3 and CEO5.

simply don't ignore their shareholders, five CEOs echoed CEO9's quite simple explanation: "They own the company." Equally succinct was CEO13's observation: "We are in business to serve shareholders." CEO22 was even more emphatic:

> A: Our job is to generate cash and return it to shareholders. That's our job. I mean, that's what we – we get up every day for the company to attract, retain and develop magnificent people who make our product [name of product] available to more people and more places around the world, to have them use it more often and with that we generate a lot of cash which we give back to our shareholders. That's what we get up to do every day.
>
> Q: The nature of the corporation.
>
> A: Exactly. (CEO22)

This, then, is the cultural setting of the contemporary firm which is based on a set of beliefs in the primacy of the shareholder, a set of beliefs which have evolved over forty years, gradually becoming ever more ingrained in the mindset of CEOs. Contrasting the two different regimes of corporate control, that of managerial capitalism and that of shareholder value, CEO10 explained:

> Without a doubt, it's night and day and you can see it in everything, right, from disclosures to engagements to what we've just been talking about. Yeah, you see it just about at every single dimension, compensation, you name it; you name it. It used to be in the old days, gosh, some of the acrimonious, arrogant, dismissive behavior of certain CEOs against shareholders, you know, today there'd be an execution probably if that sort of thing happened. You still see some of that, but you don't see that sort of stuff very often. So, I'd say it's been a sea change. Disclosures – used to be you couldn't read a disclosure and have a clue of what it meant. So, yeah, absolutely. I'd say it's, you know, all been for the better. (CEO10)

CEO13 describes the normative framework of contemporary capitalism: a firm's reason for being is "to serve shareholders." In practical terms, this norm of service is demonstrated through a firm's generation of cash and its return to shareholders. And as an indication of the power of shareholders, CEO10 gives us the image of the shareholder as executioner. In

light of this power, CEOs must display respect towards their shareholders by curtailing any propensity for being "acrimonious, arrogant, [or] dismissive."

Underlying this internalized normative framework which has "absolutely…all been for the better," however, is the *structural reality* of shareholder rights and its relationship to corporate governance and managerial choice, a reality captured by CEO20:

> Q: So, you said that some might describe them as renters versus owners, you prefer not to do that. I can guess why, but I'd like to hear you articulate why you prefer not to see them as renters.
>
> A: Well, because at the end of the day, they have the shares, they own the stock and they have the votes, despite maybe only doing so for six months at a time and that's it put simply. They're the owners today. (CEO20)

Thus, underlying the almost moral commitment to increasing shareholder value articulated by many CEOs is the reality of the power shareholders possess to exercise their will over CEOs, boards, and firms. This transfer of power from firms to shareholders has accelerated in the new millennium. Subsequent to the accounting scandals in the early 2000s, Congress passed the Sarbanes-Oxley Act of 2002 which compelled boards to become more independent of the firms they oversee, and studies have shown that independent directors are more inclined to listen to shareholders' concerns than are directors more closely tied to management (Bhagat and Bolton 2008; Dalton et al. 2007; Fogel and Geier 2007; Gordon 2007). And subsequent to the financial crisis in 2008, Congress passed Dodd-Frank which among its many provisions gave shareholders the ability to voice their (non-binding) opinion on executive compensation packages, what is known as "say-on-pay."

CEOs' Attitudes towards Proxy Advisory Services

Perhaps the single most important factor that has facilitated this shift of power from firms to institutional investors has been the emergence of the proxy advisory firm. Individual retail investors who directly own shares in individual companies will have had the experience of receiving proxy voting materials in their mailboxes prior to a firm's

annual shareholders' meeting. They are asked to vote for a slate of directors, perhaps to reaffirm the appointment of the firm's outside auditors, and possibly on other matters such as a pending merger or one or more shareholder proposals. An individual investor can either vote the proxy or discard it. Institutional investors, by contrast, have no such option and must vote. In 1974, Congress passed the Employee Retirement Income Security Act of 1974 (ERISA) obligating institutional investors to vote proxies for stocks if the stocks are owned in ERISA retirement and pension plans.[53] Fulfilling this obligation probably was not so difficult in the mid-1970s, but ERISA also gave birth to the Individual Retirement Account, or IRA, and soon thereafter, Congress established the 401(k). With these two incentives to save for retirement through investing in stocks and bonds, the mutual fund industry was off and running. As the number of accounts and their equity holdings mushroomed, the number of proxies an investment firm might have to contend with also exploded, and fulfilling the fiduciary obligations imposed by ERISA became unwieldy: virtually no firm had the in-house resources, nor the inclination to shoulder the cost, to thoroughly research the hundreds of proxies it might receive annually which themselves might contain multiple items to be voted on.

In 1985, the firm Institutional Shareholder Services (ISS) was founded and it launched its proxy advisory services the following year. This service provided guidance and opinions to institutional investors on how they should vote for all of these proxies. Also burdensome was actually casting the votes, not just determining what position to take. Large institutional investors might have hundreds if not thousands of clients on whose behalf they would have to vote proxies. So, in 1992, ISS actually began casting votes for clients based on ISS's recommendations.

What was a boon for institutional investors became the bane of corporate America. In the process of bringing an efficient solution to a problem that was a nuisance and distraction for many institutional investors, ISS quickly grew to wield enormous direct and indirect power over boardrooms and managements by advising clients on how they should

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[53] In 2003, the SEC extended this fiduciary obligation to all investment advisers regardless if the assets are retirement assets or not.

vote their proxies. According to ISS's website (www.issgovernance.com), it has over 1600 institutional clients, performs research on over 39,000 companies worldwide, and executes roughly 7.5 million ballots annually.

The radical implications of leveraging this profound influence over corporate governance, corporate strategy pertaining to mergers and acquisitions, executive compensation, and director nominations has not been lost on dedicated activist investors. If a dedicated activist investor who, for example, puts forward his own nominees for one or more board seats in opposition to management's recommended candidates *and wins the endorsement of ISS*[54], the probability that the activist wins such a board contest is high. Not surprisingly, none of my respondents had a kind word to say about ISS. CEO16 best captures a widespread sentiment among my respondents:

> I think ISS and Glass-Lewis I suppose provide a service that would be nice for the widows and the orphans. To me, again, my philosophy is you really got no business being in the market directly yourself trading shares unless you know what you're doing, unless you've educated yourself, and that you're relying on them, woe is you, because their analysis is, in my opinion, is superficial that it's to me virtually meaningless which is astonishing to me that I know a lot of the mutual funds, a lot of the pension funds, a lot of those guys just vote with the recommendation, but I think…that the mutual fund managers – well, not the fund managers themselves, their compliance group who basically does this, vote blindly with Glass Lewis and ISS that I think they're doing their customers a disservice. If you can't do your own homework, don't own the stock and like I said, I think the analysis that ISS and Glass do is just superficial, it's really useless. They can come up with a very negative rating on a stock, or a negative view on a stock, and be completely wrong in my opinion….because it's an inch deep…By the way, having said that, I will tell you that we do we cater to them. We don't have any choice. (CEO16)

[54] In addition to ISS, there are several other proxy advisory firms such as Glass-Lewis, Proxy Governance, and several other smaller firms. I focus on ISS because it is the most well-known, it dominates the space, and it is uncommon for the three large firms to have divergent views on an issue.

Nor does any other CEO have a choice. While there are moves afoot to curtail the enormous power of ISS and Glass-Lewis[55], their role in the transfer of power away from CEOs and boards to shareholders has been unmistakable.

Thus, structural changes in the organization of capital and in the dynamics of corporate governance has resulted in a transfer of power from firms to shareholders. The rise of the institutional investor due to the explosion in retirement assets resulting from newly instituted IRAs and 401(k)s, the emergence of "innovative" financial techniques exploited by the junk bond corporate raiders in the 1980s and by private equity investors in the new millennium, and the birth of the proxy adviser in response to heightened fiduciary duties imposed by Congress onto investment advisers – all of these structural changes ultimately limited the scope of managerial discretion. If many of today's CEOs express a commitment to motherhood, apple pie, and shareholder value and eschew "the acrimonious, arrogant, dismissive behavior of certain CEOs" of the past, it is largely because the structural transformations of the past forty years drove such a cultural transformation. In short, CEO deference to shareholders and the embrace of shareholder value is adaptive behavior.

Attitudes towards Marginal Investors

Sometimes, however, CEOs *are* dismissive. To understand why, it will be more profitable to move beyond CEOs' philosophical conceptions of ownership premised on a homogenous conception of the shareholder almost as an ideal type, and to first understand the beliefs and attitudes these CEOs share regarding the various types of investors they typically confront. If a CEO believes an investor lacks legitimacy to weigh in on corporate decision making, let alone to make demands that a firm pursue a specific course of action,

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[55] Responding to complaints from the corporate community, the SEC has indicated that it will examine the proxy advisory firms more closely. Last year, it also issued Staff Legal Bulletin 20 which essentially admonishes investment advisers to be more engaged with the proxy voting process and with the firms they hire to help with the process, such as ISS. Indeed, large investment firms such as Blackrock have created robust in-house capabilities to directly manage its proxy duties. While engaged institutional investors will still tilt the balance of power to shareholders, this power will be diminished to the extent that shareholders splinter in their views and speak less and less in the monolithic voice of the proxy advisers.

it seems quite unlikely that a CEO so confronted would be the least bit inclined to entertain this investor's opinions or to accommodate his demands. Thus, a CEO who does not ascribe legitimacy to an investor will likely ignore, or at least resist, that investor when the investor urges the firm to pursue a certain course of action. By the same reasoning, we should not be surprised to see a CEO accommodate, acquiesce to, or even embrace an investor engaging in activism whom the CEO sees as legitimate.[56]

What might be the sources of legitimacy? CEOs, even the weak-form shareholder value adherents, recognize that share ownership accords specific legal rights to shareholders and thus, by definition, legitimacy. But legitimacy and illegitimacy, are not binary concepts. The degree of legitimacy that a CEO attributes to an investor can vary. One obvious determinant of this variability is the number of votes an investor has at her disposal, or equivalently, the size of her share ownership. Unlike political democracy where one person gets one vote, shareholder democracy in most cases assigns one vote to one share, endowing a shareholder with 500,000 shares greater legitimacy in the eyes of the CEO as compared to an investor with merely 500 shares. CEO6 put it succinctly: "I think it's fair that shareholders have a way of having meaningful input if they have meaningful holdings." A revealing correlate might be: it is unfair for shareholders with small holdings to have meaningful input.

While the size of share ownership is a very important determinant of shareholder legitimacy, so too is the knowledgeability or the expertise of the investor. An investor with superior skill, insight, and financial acumen relative to other investors, together with a demonstrable thoroughness and thoughtfulness in understanding a firm's business including its strategy, its industry, and its challenges and opportunities, constitutes an expert and knowledgeable investor. Such expertise and knowledgeability enhances the legitimacy of an investor. For example, a minority shareholder with ownership not even remotely approaching a controlling interest can weigh in on corporate affairs with authority

[56] These are not the only conditions under which a CEO might ignore or resist an investor's demands. CEOs often simply disagree with the wisdom or prudence of an investor's recommendations or demands, even if the CEO believes the investor possesses legitimacy.

if they are seen by CEOs and other investors as having especially sharp and compelling insights.

From the perspective of CEOs, then, the ideal, fully legitimate shareholder resembles a shareholder closely fitting the Kang and Sorensen (1999) definition of a powerful shareholder – a long-term shareholder who, through repeated interactions with the firm, obtains expertise and social influence, magnified by her formal authority based on high share ownership. Put more precisely, the fully legitimate shareholder in the eyes of most CEOs resembles a *friendly activist*, a shareholder who is knowledgeable, large, and constructively engaged. The paradox here is that the true friendly activist is highly unlikely to coerce management to take some action they would otherwise resist taking, and thus it is inaccurate to describe management's ideal shareholder as powerful. In fact, in the context of such a relationship, power accrues to management precisely because having a large shareholder as an ally hypothetically enables management to resist coercion deployed by actually powerful hostile hedge fund activists. Knowing what constitutes legitimate shareholders for CEOs, we can now examine the shareholder types to whom they do not assign legitimacy.

Gadflies and Labor Unions

The so-called 'shareholder gadfly' helps to highlight some of these nuances in the ways CEOs differentiate legitimate from illegitimate investors. In 2013, 23% of the 306 shareholder proposals[57] filed on Fortune 250 companies were sponsored by just two individual investors – John Chevedden and Kenneth Steiner (Copland 2014). The SEC has a very low, $2000 threshold in share ownership for permitting an investor to submit a proposal for inclusion on a firm's proxy. From the vantage point of major corporations, Mr. Chevedden seems particularly irksome as evidenced by numerous lawsuits challenging his right, often successfully, to submit proposals for inclusion in companies' proxies.

[57] Chevedden's proposals are mainly corporate governance related, including rules on when shareholders can call special meetings, the declassification of boards, and procedures for removing directors.

Two of my respondents highlighted their personal experiences with Mr. Chevedden in response to my inquiry into the types and frequency of shareholder activism that they had encountered as CEOs. Although Mr. Chevedden was in fact a shareholder, neither of these two CEOs viewed him as legitimate:

A: We have had sort of a nut that's a whole slew of governance issues that he's just – every sort of issue of the day, he's put into our proxy and half of them have gotten approved because he chooses popular issues. The guy's name is John Chevedden. It would be easy for you to look into it if you wanted to…
Q: So this is more of a solo gun individual?
A: Yeah.
Q: Okay, not representing any sort of a major fund or that sort of thing?
A: No…He gets them behind him, but you're right. (CEO1)

CEO1's disparaging attitude towards Mr. Chevedden is clear: he's a "sort of nut." Another CEO also conveyed his vexation with Mr. Chevedden's proposals:

A: We got a proposal this year for written consent. Have you ever heard – you've probably followed this. Have you heard of Mr. Chevedden?
Q: Chevedden? No.
A: He puts proposals into all kinds of companies…He's had more "no action" letters from the SEC than anybody else. So, he put a proposal in for us. You'll love this. He put a proposal in for us for written consent for this year…So they're citing an anonymous report as the source for some of their comments and they were saying things like we have nobody on the board that understands risk management. One of our directors ran [a Fortune 100 insurance company], the major insurance company. He doesn't understand risk management? And that we don't have financial oversight. We've got [name deleted], who's one of the top executives at [large money center bank] – it was just ludicrous…So we went to the SEC for a 'no action' letter for these clearly false and misleading statements and I think it's 403(b) or some bullshit that you can get a no action letter. The SEC will issue no no action letters to anybody right now. Their view is you can correct it in your statement. Clearly the law says if there's false and misleading statements, they

> can't put them in there, but the SEC is refusing to call them on it. So, now we're going to waste some time on this damn thing.
>
> Q: Right.
>
> A: So, that's the kind of activism that's just complete nonsense. (CEO3)

CEO3 clearly sees Chevedden as a gadfly who "puts proposals into all kinds of companies" and questions the legal basis for Chevedden's legitimacy since "he's had more 'no action' letters from the SEC than anybody else." He also impugns Chevedden's legitimacy because he does not believe Chevedden to be knowledgeable by arguing that his claims that the firm's board has no one who understands risk management or that exercises financial oversight are "ludicrous." He concludes by casting the entire proposal as illegitimate: as a "waste [of] time" and "just complete nonsense."

Mr. Chevedden does possess legal authority to submit shareholder proposals which ought to accord him some legitimacy, but this legitimacy is contested. Companies have challenged the legal basis for this legitimacy in the courts as pointed out by *Proxy Monitor*. In the example with CEO3, however, the SEC has in fact affirmed Mr. Chevedden's legal right, and thus his legitimacy, to submit his proposal for inclusion on the company's proxy. In addition to questioning Chevedden's formal authority, these two CEOs also contest Chevedden's knowledgeability and expertise as reflected in their attitudes and beliefs articulated through dismissive, if not demeaning, characterizations of him and his proposals. Paradoxically, despite being viewed as illegitimate, Chevedden and his proposals have enjoyed the endorsement of numerous large, sophisticated investors, as CEO1 attests.

Several CEOs similarly deemed labor unions as illegitimate shareholders. CEO8 complained:

> So, what happened to us is we had a union group send a request to the board to put a ballot item on our proxy about separating the CEO and the chairmanship… They don't really own – they're not a major shareholder, they're a minor shareholder, so that's why I say it's a cottage industry… It's make work. It's a hammer looking for a nail,

> right. So, you know, I think it's bad fundamentally and the reason is that shareholders can vote with their feet by selling the stock. If you don't like what they do, sell it and punish the company by driving their stock price down. You don't have to own them. (CEO8)

The initial attack which CEO8 makes on the labor union is on the legal basis for their legitimacy: they're not "really" owners. Cognizant of this contradictory observation – it is an empirical fact as to whether someone owns a share or not – CEO8 amends his effort to delegitimize the labor union by characterizing it as a "minor shareholder." He further questions the knowledgeability and expertise of the union by disparaging the substance of its demand, characterizing it as "make work" and "a hammer looking for a nail." Implicit here *might* be the belief that an investor who did possess legitimacy would be making demands on the firm that made sense, that addressed real issues, and that actually accomplished something beneficial for the firm and its shareholders. We could be mistaken, however, in making that inference since CEO8, similar to CEOs 3 and 5 earlier, appears to have a rather weak commitment to shareholder primacy and shareholder voice: "shareholders can vote with their feet by selling the stock." It is impossible to determine if the specific presence and actions of the labor union trigger this weak-form shareholder value commitment or if this characterizes CEO8's view towards any shareholder activism.

The attitudes of these CEOs towards gadflies and labor unions sound reasonable enough until one places them in relief against the backdrop of shareholder value ideology. Even including the weak-form shareholder value adherents, one would be hard pressed to find *any* CEO's letter to shareholders or comments on an earnings call, investor conference, or business news program where fealty to shareholders was not on prominent display. Against this backdrop, the dismissal, if not outright vilification, of these vocal shareholders is incongruous with the otherwise ubiquitous embrace of "shareholder value" by CEOs. In fact, differentiating their shareholders is a classificatory act in which CEOs engage with such regularity that it begs the question: For whom are they are creating value?

Short-term vs. Long-term Investors

While gadflies and labor unions elicited an unmistakable derision from some CEOs who saw these investors as lacking legitimacy by virtue of low share ownership and the absence of expertise, other categories of shareholders were also found to elicit negative attitudes from CEOs. CEO5 continued, somewhat derisively:

> A: Well, you tell somebody, you know, you buy a million shares of a company, now you're an owner, so anything that happened before you is unimportant to you and now you have a voice because you bought your way into the party…They're in for the short – for a short hop.
>
> Q: So how do you respond to the retort, "But they [shareholders] own the company?"
>
> A: For how long? Are you a visitor or do you really own the company? If you really own the company then run it. (CEO5)

The short-term orientation of many investors is, for CEO5, reason enough to deny them a legitimate basis for demanding that a firm pursue certain actions. The issue of short-term investors was salient among virtually all of the CEO respondents. Implicit in CEO5's comments is that the short-term nature of share ownership precludes legitimating shareholders with the label of "owners." He further delineates *share* ownership from *actual* ownership of a company, wherein the latter is the only legitimate arrangement, and not shareholding, that would afford someone the right to run a firm. This view resonates with criticisms made by scholars who note that the metaphor of "owners of the firm" is an inaccurate description of shareholders' rights (Blair 2003; Dobbin and Jung, 2010; O'Sullivan 2000; Stout 2007, 2012).

Many respondents indicated their disdain for short-term investors, employing a variety of metaphors. A firm's relationships with short-term investors were like "fleeting romances" (CEO5). In contrast to long-term investors, short-term investors are only "in for a cup of coffee" (CEO11) or "are in it for a pop" (CEO9). Rather than having an interest in the longer term value drivers of a firm, short-term investors "want to know more the buzz" (CEO19). In denigrating short-term investors, these CEOs are questioning the

knowledgeability and expertise of such investors since they contribute nothing to addressing any of the long-term issues that a firm and its CEO confront.

An obvious difficulty in any financial or investment discussion that involves the terms "short-term" and "long-term" is agreeing on a definition that adequately distinguishes the two. A consensus view, let alone a precise definition, is likely unattainable since the distinction heavily depends on one's investment horizon which differs both among investors as well as among firms. The investment horizon of an endowment fund, for example, is perpetual: trustees and managers responsible for university endowments expect, or at least hope, that their institution will still be around in one hundred years and the investment strategies of the fund should reflect this very long-term investment horizon. Similarly, pension funds also have very long investment horizons that reflect the average time until retirement of the fund's participants as well as their life expectancies. It is also widely understood, however, that even such lengthy investment horizons suffer compression due to the pressures resulting from investment managers' performance being graded on substantially shorter time intervals (e.g. quarterly). Even with such compression of the investment horizon, however, what constitutes the long-term for a pension fund manager will likely be very different from what many hedge fund managers deem to be long-term. Many hedge fund strategies, including merger arbitrage, distressed debt investing, event-driven and relative value strategies, and any strategies involving short-selling, will have investment horizons measured in months rather than years.

The difficulty in defining what one means by "short-term" or "long-term" was evident among my CEO respondents. "Obviously more than one year," CEO13 proffered in his attempt to define "long-term." But he quickly added that "we have a lot of people that have held our shares for 10 or 15 years." Implicit in this response is that, while we may not be able to precisely define "long-term," we certainly know it when we see it. This CEO did not say "we have a lot of people that have held our shares for…" more than one year, a response that would have been consistent with "obviously more than one year"; rather, those who have held for 10-15 years register in his mind as long-term shareholders. CEO9 remarked:

> I still kind of chuckle whenever I hear anybody say that they're a long time holder – they're 18 to 36 months – because we have a very, very long business cycle in the insurance industry and sometimes the cycles can be much longer than 18 months to three years. (CEO9)

Several things stand out here. First, CEO9 believes that the "long-term" is greater than three years. Second, and perhaps more implicitly, while investors who hold shares for 18 months to three years might perceive themselves as long-term holders, CEO9 did not share this view, nor likely do most CEOs. And third, investment horizons are fundamentally different for CEOs and investors and this fact strongly influences how one understands the terms "short-term" and "long-term." This last point also was made by CEO10:

> I do think it also depends on what industry you're in and what the value proposition is. In my industry, it's utilities, it's regulated for the most part and so, you know, I define five years as long term, you know, roughly speaking five years. Less than two years – two years or less I would probably say is short term, but my experience with hedge funds in our stock it's been 12 months, give or take. (CEO10)

Again, what one considers to be "long-term" is a function of one's investment horizon, which for CEO10, is about five years. CEO10 astutely recognizes the variability and contingent nature of a definition of "long-term" and "short-term," noting that it very well may differ across industries and even within industries depending on a particular firm's strategy or "value proposition." Rather than define the "short-term," then, as anything less than five years, CEO10 offers that it is two years or less. We might interpret this, especially as the comment immediately precedes his opinion on hedge funds' investment holding periods, as an acknowledgement by CEO10 that *investors have different investment horizons than do firms*. As CEO15 put it:

> I think at the end of the day, the shareholders are motivated by making money. I mean, that's the name of the tune and I think that

> their focus is probably – not probably – I'd say almost exclusively, shorter-term than management's. (CEO15)

Thus, while conceptions of "short-term" and "long-term" will vary across firms to greater or lesser degrees, we can be nearly certain that these conceptions generally will be in fundamental tension between investors and CEOs. The source of this tension lay in their different investment horizons which are tied to the nature of their respective endeavors:

> …we are similarly motivated to increase the company's value. I say similarly motivated, not identically. There's a difference. We're trying to build the value of a company. They're trying to receive or realize value from a stock and there are some inherent differences in that…That's where you get to short versus long term. A business – a company has value in my mind to the extent it has more defensible advantages, higher margins through the long term and the ability to grow. A stock has more value to the extent it goes up *now.* (CEO20)

CEOs are building, preserving, and fortifying organizations in competitive industries with investments in human and physical capital which vary across these organizations and industries. Investors are placing bets on these investment decisions made by CEOs. While each investment decision – the one made by a CEO and the one made by an investor – is predicated on an expected return, the payoffs to each differ fundamentally. Payoffs to the firm result from the physical realization of an investment: products or services are first imagined, then created, produced, distributed, and finally sold, a sometimes lengthy process which generates revenues or concrete promises of revenues only at the end of that process. This *physicality* of the firm's investments, a physicality grounded in time, differs from the non-physical and atemporal nature of the investments which investors make. The investments investors make depend on an accurate *anticipation* of a firm's future revenues and profits. While a CEO is hostage to time, an investor operates to a certain extent outside of time through the wizardry of the discounting function in finance: expected future streams of cash flows are discounted to the present whereby a value is placed *today* on these cash flows, cash flows that hopefully arrive sometime in the future. A biotech firm, for example,

may see its stock price jump 20% on the day it releases news of a favorable outcome from Phase II trials of some drug the firm is developing, even though the drug still faces Phase III trials and may yet be several years away from generating revenues and profits. Investors in the biotech company enjoy a partial payoff today; the firm's payoff may still be some time off. A fundamental tension between CEOs and investors, then, pivots on each's relationship to time.

CEO's attitudes towards their short-term investors appear to be reflected in the character of their shareholder engagement. Characteristic of the age of investor capitalism is the extensive interactions CEOs have with their investors. Nearly every CEO whom I interviewed engaged in substantial face-time with their investors at various venues, ranging from investor conferences where multiple firms make presentations followed by so-called "one-on-ones" where individual CEOs and their accompanying staffs meet with several investors in smaller conference rooms, to investor days in which firms invite investors to corporate headquarters or to a flagship manufacturing site, and to road shows where a firm's investment banker schedules investor meetings in major cities. While a CEO, CFO, head of investor relations, or a firm's banker cannot always and everywhere control with whom they interact, they do have ample opportunities to choose their audience. Nearly every CEO, for example, spoke of the importance of regularly meeting with their top ten shareholders, those with substantial formal authority. This level of attention, however, was not typically extended to short-term holders:

> I don't want to work with investors that are more focused on short term results at the expense of the long term interest because I think that's where the value was for this company and for this industry. (CEO19)
>
> We tend not to get the faster in and out funds. They're just – you know, I don't really want to spend time on them. They're not a good match for us. (CEO31)
>
> We'll certainly spend time with the longer term investors. I won't spend a lot of time with hedge fund type people. We prefer not to

> have people that just want to come in and trade and be out of the stock, so I don't go visit hedge fund people as an example. (CEO33)

Each of these CEOs exercises discretion over how and to whom they allocate their valuable time for shareholder engagement, and short-term holders are near the bottom of the list. Of course, there are obvious structural reasons why a CEO would choose not to spend time with short-term holders. Short-term holders are unlikely to be terribly interested in the longer-term drivers of the firm's value, precisely those things a CEO typically wants to communicate. Also, to the extent that CEOs develop relationships with their investors, relationship-building takes time which is unavailable with short-term investors. Relatedly, to the extent that shareholder engagement is an investment in goodwill and in cultivating positive views of the firm, that investment is squandered on an investor who may no longer hold shares next month. Indeed, implicit in these CEO's statements of negative preferences (i.e., "I don't want…," "We prefer not…," etc.) are indications of what sort of investor they actually desire to have, a preference nicely articulated by CEO14:

> From a CEO and management team perspective, ideally you'd want, you know, engaged patient investors who aren't going to trade in and out of your stock based on quarterly earnings because *that's not how we run the company*. We're not trying to optimize Q2, 2014, we're trying to build a company that delivers a set of outcomes across time and so *investors who take the same timelines that management* does are very valuable. (CEO14, emphasis added)

Ironically, the watchword in the age of investor capitalism is 'alignment' which typically means that CEOs, management teams, and directors are incented to pursue those things which investors want them to pursue: alignment solves the principal-agent riddle. And yet, here we have CEOs expressing a desire for a different kind of alignment, one in which *investors* are aligned with management's long-term focus and who share management's investment horizons, a desire that matches up with the characteristics of friendly activists. Later in this chapter I will examine the capacity of and constraints on CEOs and firms for shaping their shareholder bases according to such preferences.

Activists Generally and Hedge Fund Activists Specifically

CEOs attitudes towards activism in general were mixed, due in large part because of the variety of activism that investors direct towards companies. While I made clear to my respondents that I was not investigating social activism where investors object to a firm's practices which adversely impact the environment, communities, employees, and minorities, some nonetheless expressed their antipathy to this kind of activism. Also objectionable, though less so, was activism directed at a firm's corporate governance structures, such as the separation of the CEO from also serving as the Chairman of the Board. Many saw this activism as a cottage industry, with individuals working from lists, encouraged by proxy advisor firms, knowingly or unknowingly enriching lawyers, and generally creating additional expenses and distractions for firms.

Numerous CEOs, on the other hand, did not object to investor activism that targeted underperforming firms. My sample of self-selected and thoughtful CEOs had little patience for their fellow CEO targets of hostile activism and believed such activists were engaged in important and necessary work:

> When you're not performing well and someone comes in and tells you you're not, it's tough to defend it and so…I'd say, you know what, even though we're supposed to stick together, I'd say you know what, they're right, the bank isn't performing up to where it should be and, you know, they should listen a little bit more and not defend. (CEO2)

CEO2's perspective, echoed by many CEOs as we shall see in the upcoming section on opinions of investors' expertise, ideas, and recommendations, is that a CEO and her management team faces limitations on their ability to understand and interpret their world and thus does not have a monopoly on good ideas. Cognizant of such limitations, CEOs should be open to investors' input. But also implicit in his remarks is that resisting such input in the context of underperformance is not smart relationship management. Even less sympathetic towards underperforming CEOs was CEO22:

> I should be thinking like the activists all the time and a lot of companies who, I believe, who draw in the attention of activists absolutely deserve it because they're doing a crappy job leading their business…I'd say that the…that most companies who get serious activism, they deserve it…the activist comes in and forces leaders who were either weak-kneed or asleep at the switch to do things that they probably should have done anyhow…if they're [activists] causing trouble you deserve it because you either haven't communicated, you've been ignorant, you've displayed a huge amount of hubris, or you're doing a crappy job. (CEO22)

Aside from his unsympathetic view of struggling CEOs and firms, this CEO has such a favorable opinion of investor activism that he advocates internalizing their mindset – "I should be thinking like the activists…." Interestingly, this CEO has enjoyed a tenure at his firm exceeding fifteen years, well beyond the average six year tenure, suggesting that CEO longevity might very much depend on a wholehearted embrace of shareholder value ideology. Other CEOs were similarly supportive of activism:

> In many cases things that these activists are asking for make a hell of lot of sense and, you know, you think about prudent business decisions, I mean, we should be making prudent business decisions and if we're not and an activist comes in and makes us aware that we're not making prudent business decisions, they ought to have some influence on you…When you see an activist that comes in and looks at underperforming parts of the business and seeks to have companies, you know, sell or do something with underperforming parts of the business, I always scratch my head and wonder, "Why did you need an activist to tell you that?" (CEO26)

> I support actions taken by certain activists because they have created value – they have forced leadership teams and management to make decisions because there are a lot of people in our space that have done a lot of stupid things and they've been well compensated for it and they've not – they've not had to, you know, not had to feel the wrath of their poor decisions. But as I mentioned earlier…the best defense for that is: don't do that; create value. (CEO32)

Implicit in the foregoing favorable views of public activism is that when CEOs (or boards) act imprudently or stupidly, they are forfeiting their authority over the firm to prudent and smart institutional investors who step in to make the right decisions and "create value": such public activists, in the view of the preceding four CEOs, are acting legitimately.

Fascinating in all of these comments is the extent to which they resemble what institutional investors themselves say: activists are simply stepping in to fix firms that have gone awry (i.e., "underperforming") due to the shortcomings of leadership (i.e., who are doing "crappy jobs," not making "prudent decisions," and who are simply doing "stupid things"). As discussed in the *Introduction*, much of the literature on activism highlights underperforming and struggling firms as likely targets, and my respondents tend to agree. But the recent literature also notes that hedge funds target healthy firms too, companies with admittedly poor stock performance and subpar growth opportunities, but also with strong operating characteristics such as high return on assets and strong cash flows (Boyson and Mooradian, 2011; Brav et al., 2008; Clifford 2008). Also, it is reasonable to presume that each of the above quoted CEOs has had to endure challenging periods that might have had nothing to do with doing "stupid things" but with changing competitive landscapes, with inevitable fluctuations in interest rates or currency exchange rates, or with the ebb and flow of business cycles. While it might empirically be the case that each instance of public activism which the quoted CEOs had in mind did in fact involve poor management decision making, it was nonetheless surprising that CEOs – of all actors weighing in on these matters – articulated greater solidarity with the activists than with their fellow CEOs. I will return to this paradox later in the chapter when I discuss CEOs' interactions with their investors in greater depth.

Such solidarity – or 'alignment' in the investor's lingua – is the product of forty years of investor capitalism, of discipline and punishment meted out to CEOs and directors who cling to an increasingly archaic notion of the separation of ownership and control. Alignment is perhaps an insufficiently strong characterization of this new landscape of diminished separation between institutional shareholders and CEOs. Indeed, "thinking like the activists" suggests an evisceration of any barriers, a culmination of investor capitalism

where many CEOs have internalized the norms and values of institutional shareholders, particularly the activist ones. While CEO22 perhaps best articulates an archetypal principal-agent universe that engenders no agency conflicts, several other respondents, such as CEO26 and CEO32 quoted above, also articulated views that closely approximate this archetype. Furthermore, "thinking like the activists," "making prudent business decisions" that would comport with an activist's expectations, or "creating value" in ways that activists do, would all seem to preclude engaging in symbolic management to secure space for managerial discretion: CEOs' internalization of activists' expectations represents a posture quite apart from one of resistance. CEOs do *disagree*, as we will discuss later, with their institutional shareholders including activists, but such disagreement is quite different from the hoodwinking character implicit in symbolic management.

This favorable view of activism stood in contrast to the negative view CEOs adopted when assessing activism initiated specifically by hedge funds. This negative view, moreover, seemed often linked with their negative view of short-term investors generally:

> I think with hedge funds I think there's just this I'll call it a bravado that says, you know, I'm a hedge fund and I want this, this and this and they're not looking at the long term shareholder value. (CEO2)
>
> The challenge you have with most hedge funds is, "What have you done for me right now? What can you do for me in the next 90 days?" How can I get in your stock, do something to create value and then, you know, get out of your stock? (CEO8)
>
> Frankly, we listen a lot more closely and intently to a long holder versus a hedge fund holder because hedge fund interests typically ask us about short term movements, volatility…My experience with hedge funds in our stock it's been 12 months, give or take…They'll take a position, get out, take a position, get out, take a position, get out. (CEO10)
>
> There are hedge funds and traders who are really just renting our stock and looking for the up and the down to get in and out. (CEO22)
>
> Hedge funds are always looking for that, you know, bit of minutia that would cause them to develop a trading thesis. (CEO26)

> All they're doing is looking at a cash flow stream and saying, "I want more of that," when they don't really understand what it takes to run these different businesses that we own. They're not, for the most part, willing to or the slightest bit interested in learning about your business. They don't care about that. (CEO32)
>
> Hedge funds are, you know, notorious for in and out. They create huge volatility and swings in stock and that's not – that's not something we believe is good for our shareholder. (CEO33)
>
> So, I mean, we're not very – we're not very, you know, hedge funds is not like our favorite – favorite category because they're just buying and selling all the time and trading on, you know, the moment as you would expect. (CEO34)

To the extent that CEOs view hedge fund activists as "renters" rather than "owners," and to the extent that hedge fund activists do not weigh in on the firm's long-term challenges but try to find a "trading thesis," these CEOs do not view hedge fund activists as speaking with any legitimacy.[58] These rather jaundiced assessments of hedge fund activists, while consistent with the popular view of hedge funds, are at odds not only with recent research which asserts that activist hedge funds are long-term oriented (Brav et al., 2008, 2010, 2013), but more importantly with the two-thirds of hedge fund respondents who self-described as value investors, an investment approach that typically adopts a long-term orientation. Before trying to disentangle this contradiction, we should assess the reliability of these contradictory reports.

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[58] While it could be argued that many hedge fund managers are very knowledgeable and demonstrate remarkable expertise in matters of investing, it is the point of view of CEOs that is relevant here – do *they* view the hedge fund manager as knowledgeable and expert? To the extent that a hedge fund manager is short-term focused, whatever knowledge and expertise they possess is of little to no value for a CEO focused on longer-term issues, and therefore the CEO would not view him as knowledgeable or expert. Of course, in the case of public activism, the opinion of the CEO is not the only one that matters as other investors may come to view the activist hedge fund manager as legitimate by virtue of both his ownership levels *and* his knowledgeability and expertise. This, however, raises larger policy issues regarding the possibility that the majority of investors are short-term oriented: is their different assessment of the hedge fund manager's knowledgeability and expertise due to concluding that the hedge fund manager's prescriptions are indeed long-term focused, thereby disagreeing with the CEO's opinion, or is the different assessment a fig leaf for opportunism?

While we cannot rule out the possibility that the above CEOs are parroting popular stereotypes of hedge fund managers, we must bear in mind that CEOs are unlikely ill-informed: with the help of their investor relations people, CEOs report that they typically pay very close attention to their shareholder rosters – who's buying, who's selling, and what the share turnover looks like. With regards to Brav and his peers, they estimate that the median activist's holding period is a mere twenty months (2008). While this is considerably longer than that of traders or quant investors, or even of most mutual fund managers for that matter, it nevertheless is damning with faint praise when compared with investors who hold positions for three years or longer. Finally, while the hedge fund respondents may simply be reflecting the desire to not be stigmatized with the 'short-term' label, most hedge fund respondents in this study, as just mentioned, identified as being a value manager[59], an investment style highly consistent with long-term investing, lending credence to their self-descriptions.

The contradictory reports may arise from the heterogeneity of hedge fund activism as discussed in the previous chapter. There I distinguish between hedge funds who pursue activism either *always*, *often*, or *occasionally*. Hostile activism is mostly either practiced *always* or just *occasionally*. A hedge fund activist who *always* pursues activist situations, i.e., a dedicated hostile activist, is extremely likely to be short-term oriented: they invest with the sole purpose for making a specific demand, and since activism is costly, the quicker the demand is met, the better. Negotiated settlements can lead to quick exits, while a proxy contest will take more time but typically will conclude within a year given the annual cyclicality of proxy voting. If a hostile activist wins a board seat, this may result in multi-year holding periods given the requirements for directors to hold some minimum number of shares, although respondents stated that an activist will typically hold a board seat for only about two years. These longer holding periods can be avoided, however, if it is not the activist who actually sits on the board but someone she nominates. In any event, it would be accurate to characterize *dedicated* activists as short-term investors since their

[59] Value managers typically invest in companies that are cheap on some valuation metric, are thus generally out of favor, and thus require ample time for the given investment thesis to come to fruition.

demands – share buybacks, divestitures, removing a director(s), etc. – can be met in the short-term.

By contrast, a hedge fund manager who only *occasionally* pursues hostile activism rather than as a primary investment strategy, is highly likely to be a long-term holder: the occasional nature derives from the fact that such an investor typically has been holding shares for some period of time, has lost patience, and now seeks changes. Also, all hedge fund managers who pursue friendly, rather than hostile, activism are very likely to be long-term investors: the friendly nature of the activism is part and parcel of relationship building between the institutional investor and the target firm, and thus inherently long-term in nature. Thus, CEOs were likely crafting their responses in which they characterized hedge fund activists as fundamentally short-term with *dedicated* hostile activists in mind, precisely that category of hedge fund activist that necessarily has a short-term investment horizon. Indeed, only one of the five dedicated hostile activists in my sample self-described as *long-term*. By contrast, six of the nine *non-dedicated* hostile activists (those who pursued hostile activism either often or occasionally) and seven of the eight *friendly* activists self-described as *long-term*. The Brav dataset, with its 20 month median holding period, likely displays such a medium term holding period because it mixes the three types of hostile activists such that the longer holding periods of the *non-dedicated* hostile activists counterbalance the shot-term holding periods of the *dedicated* hostile activists. The 20 month median holding period could also partially result from the difficulty of some hostile activists getting what they want quickly.

Short Sellers

In addition to CEOs' antipathy towards hedge funds as short-term investors, some CEOs were also quite guarded vis-à-vis hedge funds who engage in short-selling. The ability to "sell short" is a distinguishing feature of hedge funds and most hedge funds with a focus on public equity markets will engage in short-selling. In a short-sale, the investor borrows shares and then sells them, *hoping for a decline in share price*, at which point the investor buys back the shares at a lower price and returns them to the lender of the shares.

Short sellers make money when share prices decline. It is generally considered a riskier technique since time can often work against the short seller: stock prices move up over time more frequently than they move down. Also, when prices rise, short-sellers must post more collateral. Theoretically, if a share price moves up for the investor who has shorted the stock, their losses are infinite. Thus, short selling is typically a short-term investment strategy with greater risks than traditional long-only investing.

Given the riskiness of short-selling and the fact that time is not on the side of the short-seller, the incentive exists for disseminating bad news on a company being shorted which can be a catalyst for driving its share price lower. Several CEOs expressed the view that hedge funds, the most likely type of investor to engage in "going short," engage in market manipulation by spreading false rumors:

> For instance, a company that I'm familiar with here in Houston, they attracted the attention of an activist [who] went to Barron's, got Barron's to write an article that there may be accounting irregularities, which caused the stock price to move down and then they continued to hammer on these points that, you know, which I'm sure <inaudible 6:47> hedge fund, they came up with a strategy to short the stock…You know, and they can do that. I'm certain that there are other cases where you have hedge funds in particular industries where you've got analysts within those funds that collaborate in order to create some skepticism about market which causes stocks to drop and once again, which they are able to profit on by shorting the stocks. Those types of things happen and those, in my mind, are those types of – I mean, they're imprudent, they're despicable, frankly, things that activists will do in certain cases and generally don't drive change in the company, but companies go through and often cases, years, in order to clear their image because of bad information. Personally, I don't view those as activists. Those are enemies. Those are people that are not working for your shareholders, they're working against your shareholders (CEO26).

> I would just say this much, I mean, when I'm talking to investors, I'm certainly – I may take a different sort of approach and again everybody gets the same information and same access – but I might be a little more on heightened alert if I'm talking with a hedge fund or a notorious short- seller whom I know not only is trying to short

> our company, but is also trying to disseminate damaging information about our company and in many instances, fabricate information if they need to (CEO27).

CEO26 and CEO27 have a visceral dislike, if not a mortal fear, of short-sellers. While this is an understandable sentiment given that a substantial portion of a CEO's compensation depends on the firm's share price moving up rather than down, it is also true that reputational damage can jeopardize a firm's relationships with suppliers, customers, employees, and investors. Although such market manipulation no doubt occurs through the dissemination of false or misleading information by short-sellers, it is important to remember that short-selling contributes to market efficiency by permitting an outlet for contrary views on securities, thereby facilitating more "accurate" valuations; equally importantly, short-selling also acts as a lid on so-called "animal spirits"[60] (Zuckerman 2012).

The point of examining these various subsets of marginal investors – gadflies, labor unions, short-term investors, hedge funds, and short-sellers – is to highlight the conditionality of CEOs' embrace of shareholder value ideology. Not every shareholder counts. The ideas of serving shareholders, of creating value for shareholders, of recognizing shareholder primacy become murky concepts upon recognition of the inherent heterogeneity of shareholders who vary in their relative legitimacy. CEOs will likely ignore, or be dismissive of, investors who own few shares and lack knowledgeability of the firm's business, such as the gadflies, and will more likely willingly engage those with expert knowledge but low share ownership, often the quiet, non-public activist. Conflicts will likely arise between CEOs and investors with significant ownership but low expert knowledge, a profile that respondents believe often fits hedge funds and other short-term

[60] First coined by Keynes (1936), 'animal spirits' refers to the heightened emotions that investors can experience during periods of rising securities prices, and are thus purportedly the basis for financial bubbles. Federal Reserve Chairman Alan Greenspan coined the now famous phrase 'irrational exuberance' back in 1996, warning Congress of the animal spirits taking hold in the stock market which would ultimately fuel the stock market bubble of 1999-2000.

investors.[61] In such cases, CEOs will often malign the activist as being self-serving and not acting in the interest of all shareholders, an argument that may or may not be true but is nonetheless curious given the heterogeneity of shareholders and given that self-interested behavior is purportedly the very animating force of capitalism. A taxonomy of investor legitimacy along the dimensions of share ownership and expert knowledge is shown in *Figure 3.7*.

		Share Ownership	
		Low	High
Expert Knowledge	Low	Gadflies Hedge Funds Labor Unions	Hedge Funds Pension Funds
	High	Friendly Activists Occasional Activists	Pension Funds Friendly Activists Occasional Activists Dedicated Activists

Figure 3.7: Investor Legitimacy (CEO's Perspective)

Shareholder power, coincident with shareholder legitimacy, increases as we move from the upper left quadrant to the lower right quadrant, illustrating that power – within certain ranges – is not simply a function of formal authority as represented by share ownership percentages. Shy of having a controlling interest, a large shareholder still needs the support of other shareholders to enact changes in a target firm through the proxy voting process, and thus needs to have some level of knowledgeability and expertise regarding the

[61] As the record of accounting scandals, managerial misdeeds, and gross underperformance relative to peers reveals, incompetent and sometimes felonious individuals can occupy the C-suite. Conflicts will arise here too, but in these cases between investors with either low or high legitimacy (i.e., low or high share ownership) but with high expert knowledge.

firm and its industry to be perceived as fully legitimate. Lastly, based on respondents' comments, CEOs (who are not consistently underperforming, thereby inviting the occasional or dedicated hostile activist) place the greatest value on large *and* knowledgeable institutional investors, those with both formal authority and expertise.

CEOS' ASSESSMENT OF INVESTORS' EXPERTISE

Marginal investors described above are seen as illegitimate by CEOs because they are not large shareholders and do not possess expert knowledge, thus having deficient formal authority and expertise. Hedge funds, when they command significant ownership positions in a company, will be perceived as legitimate, but this view will be tempered by a perceived lack of expert knowledge from the CEO's point of view. The most critical element supporting an investor's authority is their knowledgeability and expertise. I asked my respondents to offer their general opinions of the expertise of the investors they have had interactions with. It should be noted that most investors do not directly interact with managements, and of those that do, the purpose most often is to obtain and/or clarify information in order to develop or refine an investment thesis on a firm, rather than to advance specific recommendations or demands. Thus, institutional investors making recommendations and/or demands, i.e., those who fall under my more expansive definition of activism, represent a small subset of all shareholders – the vocal ones.[62]

Responses were rated from 0 to 2, with '0' being a low (sometimes disparaging) opinion of vocal shareholders' ideas and expertise, '1' a moderate opinion, and '2' a strongly favorable opinion. Out of thirty-four respondents, twenty-nine commented on their sense of the *expertise* of their investors who have made demands and/or advanced recommendations. CEOs had a surprisingly high opinion of their vocal shareholders, rating their *expertise* on average at 1.5. Only four CEOs expressed low opinions of their vocal investors' expertise. As one such example of a low opinion of shareholder expertise, CEO18 commented:

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[62] Thus, "vocal" is not to be confused with hostile; it can be either quiet or loud, private or public.

> They don't really understand the business…And it's okay because, you know, it's taken me years to understand the business because it seems like a simple business, but it's quite complicated, so I can't point to a specific example where we left a shareholder meeting and said, "Man, we should really go think about that." (CEO18)

Complexity of a business is one factor that can impede investors from attaining a level of expertise which a CEO might find noteworthy.[63] Another is the experience of the CEO. In an era of six year average CEO tenures, CEOs with ten, fifteen, or more years at the helm have demonstrated unusual survival skills, the product of some combination of luck, skill, and political shrewdness. Such lengthy experience can lead a CEO to be unimpressed with their vocal shareholders' knowledgeability:

> After a certain amount of time doing this work – I've been the CEO now for 11 years – it becomes extremely rare when somebody comes up with a new idea …When I first joined, understanding the company myself and understanding the investor base, there's a lot of good inputs that were digested and really helped me understand…their perspectives on the business…But very quickly it gets to the point where that whole process is just very, very repetitive – certainly I wouldn't say they had breakthrough ideas. (CEO19)

This CEO found investors' knowledgeability quite valuable early in his tenure as CEO, but with time, his knowledge and expertise exceeded (presumably) that of his investors. Of course, one could easily imagine shareholders having a different take, namely that such a CEO has grown stale in his outlook, unable to take a fresh look at his business or at his likely changing competitive landscape. Another long-tenured CEO had a competing view to that offered by CEO19:

[63] While I do not demonstrate statistical significance, it is anecdotally interesting that this CEO, and his Chairman, were subsequently removed by an activist shareholder group. It is at best suggestive that CEO18's dismissive view of his shareholders' expertise might have been a factor triggering the activism.

> Q: I had an interesting conversation the other day – because it's not every day I speak to a CEO that has your sort of tenure – but, in terms of, you know, I asked the question, do you ever get any great ideas from your investors and he said, "Well, initially, but then with my experience over the years it's really, really rare for me to hear something I haven't seen, experienced, thought of."
>
> A: That's a very knowledgeable person.
>
> Q: Well, I think you're being modest with your [>15] years of being CEO.
>
> A: Well, yeah, but you know…I've had a lot of learning moments, but today's world is different from tomorrow's world, so, you know, I certainly believe I know a reasonable amount about a lot of things within the company, but the environment that we operate in is completely different, you know, if you look at the way the world has changed, so as I've said, I'm consciously incompetent. I don't know what I don't know…Again, if you had an overall mindset that you don't know – you're not very smart – then you'll listen to a lot of people and you'll learn a lot of stuff and I think that's a healthy environment. (CEO22)

CEO22 elsewhere repeatedly spoke about his efforts to remain "consciously incompetent," as he did in this exchange, acknowledging the inherent limitations of his own knowledge. In contrast to CEO19, he disputed the idea that a lengthy tenure ameliorates the cognitive challenges which derive from a universe that is not static. His "conscious incompetence," furthermore, enables him to acknowledge that some shareholders do bring knowledgeability and expertise such that he can "learn a lot of stuff."

Most CEOs expressed a far greater willingness to recognize that some of their vocal investors were thoughtful, knowledgeable, and possessed expertise. One vocal institutional investor approached the following CEO to discuss increasing the firm's share buybacks:

> I'm an IT guy, not a finance guy and so I had never really listened. I had never heard those kinds of arguments before and I sort of said, "Okay, let's hear this guy's [the shareholder] opinion and let's bring the finance guys in."…We…had the education from them [the institutional shareholder] because they brought some pretty good case studies with them to the meeting. (CEO12)

Like CEO22, CEO12 understood the limitations of his own knowledge – "I'm an IT guy, not a finance guy" – which perhaps inclined him to be more open to the possibility that shareholders might know things he does not. CEO12's investor is clearly expert, bringing in case studies and persuading management by the strength of his arguments.

CEO14, whom we have already met in the previous chapter, had strongly favorable opinions of his vocal shareholders' knowledgeability and expertise and articulated how legitimacy, jointly comprised of significant share ownership and expert knowledge, compel him to listen to his shareholders' input:

> These guys, you know, they're smarter than the average bear. They get up…they had high test scores at every level of their education, they get up every morning and they look at dozens of companies, including many in your sector and many all around and they're like bees. They're going flower to flower and they're learning stuff and I'd be a fool not to – they're spending time – I'm looking at my customers, they're looking at my competitors and they have ideas and they notice things and they have perspectives and but, boy, you'd be foolish not to – you know, at its best, sometimes investors are often offering what is just plain, good, free advice. And so for two reasons – number one, from a fiduciary responsibility perspective, you know, they own the company. From a practical, you know, I'm not all knowing, all seeing and these guys can round out my understanding of markets and systems and what other people are doing and what demand patterns are affecting other people and things other people have done that have raised or lowered their stock price or, you know, I'd be foolish not to take…to at least to listen to free advice as offered. (CEO14)

CEO14 listens to his vocal shareholders because they possess legitimacy through their formal authority: "they own the company." But he also listens to them because this legitimacy is buttressed by their expert knowledge which he believes stems from their inherent acumen and from their immersion in the competitive landscape in which this firm operates: "they're like bees…going flower to flower."

In contrast to marginal investors who possessed little legitimacy because of either low share ownership and/or inadequate expert knowledge, valuable investors in the eyes

of many CEOs were those who displayed high levels of expert knowledge. CEOs generally welcomed the input from investors who demonstrated knowledgeability of and expertise with the firm and its industry independent of their ownership levels. Referring back to *Exhibit 3.7*, we see that quiet friendly activists and occasional hostile activists typify investors with perceived expert knowledge. Quiet activists are willing to work with management in a collaborative fashion and often base their investment decisions on whether or not management is amenable to such collaboration; where it is welcome, such investors can sometimes build sizeable positions, further cementing their legitimacy in the eyes of the CEO. Occasional activists are a form of patient capital grown impatient with a firm's underperformance; CEOs may or may not attribute high levels of expert knowledge to them, but other investors typically will: that activism is not their stock-in-trade lends credibility to their actions when they do opt to become active. Pension funds, by virtue of the sizeable assets they command, possess legitimacy because of their investment resources and expertise, but CEOs will sometimes be skeptical of their expert knowledge when they believe that the pension fund is applying a "one size fits all" approach to governance matters and in so doing, ignoring the specific circumstances of a given firm. For example, one common goal of many good governance experts is declassified boards on the grounds that shareholders should have the right to remove an entire board and replace it with their own slate of directors if they can muster the votes. Staggering the elections of one-third of a board's directors, the definition of a classified board, is perceived as being shareholder unfriendly by impeding such changes of control. Some executives and directors, however, argue that small or newer firms require the stability that classified boards provide in order to create the space to grow into more defensible and stable firms.

CEO RESPONSES TO ACTIVISM

Based on the taxonomy of *Figure 3.7*, we can construct a taxonomy of probable CEO responses to the different kinds of investors a CEO might confront.

Expert Knowledge		Share Ownership: Low	Share Ownership: High
	Low	Ignore	Resist/Placate
	High	Accept/Reject Acquiesce	Accept/Reject Acquiesce

Figure 3.8: Probable CEO Responses

CEOs can easily ignore marginal investors because they lack legitimacy due to negligible share ownership and, from the CEO's perspective, little expert knowledge (upper left quadrant). When a marginal investor acquires sufficient shares and thus some legitimacy, but lacks expert knowledge in the eyes of the CEO (upper right quadrant), the CEO and management may resist the demands made by the investor (upper right quadrant). However, as resistance is often not free of charge, CEOs and boards may opt for placating the activist by engaging in symbolic management or by making the most minimal concessions. Resistance also can be costly and disruptive, sometimes extremely so as described by CEO29:

> Well, you know, they do everything. I mean, they sue you, they…make your life miserable. I mean, it was miserable. It still is. You know, they cause you to be in a bunker, they cause your whole board, I mean…have two sets of lawyers at a compensation committee meeting. I mean…the whole of your environment gets acculturated to this kind of nonsense and you spend more time thinking about that…than you do about business…I would say we went from an environment in which our legal fees were…something like $10 million a year to where they're now $50 million a year and hasn't stopped…You know, morale of the…organization, loss of credibility amongst customers…as much as it is, you know, lost

> opportunities…I've seen companies going to a bunker mentality for years on end…a single lawsuit that these activists put out could take you two, three, four years to adjudicate. (CEO29)

Even in less extreme cases, resistance can be costly, disruptive, and ultimately futile: CEO3's nine month proxy fight with two activist investors ultimately failed with the activists winning four board seats. CEO3 highlighted the distractions:

> What I did is I took me, my CFO and my Chief Legal Officer and maybe two or three other internal people and some very expensive outside advisors and we're the ones that focused on the proxy contest. I told my other executives and the rest of the company, "You focus on running the company continuing to produce the great results we are, which is the best defense we have…" (CEO3)

Although CEO3 went on to emphasize that the firm generated another year of great results, one can't help but be skeptical of the benign effects from the distractions of the proxy contest that preoccupied the very core of the firm's leadership for nearly an entire year. In light of the substantial disruption that might result from resisting, acquiescing – or placating – can quickly seem a very reasonable course of action:

> I also knew the Icahn's pretty well and my sense was once they're inside the tent, they're reasonably productive, usually, but if you fight with them and they're outside the tent, you could have a very ugly battle and at that time I didn't think that would be a good thing for our company. (CEO17)

The difference between acquiescing as compared to placating depends on one's perspective. As we shall later see in the chapter *Directors*, a board seat may be perceived by an activist and other outsiders as a significant concession by the firm, while the firm may view it as an effective means of quieting, if not neutralizing, what could have been a major distraction.

By contrast, CEOs who engage with friendly, quiet activism in a spirit of collaboration have the freedom to disagree with their vocal investor who possesses expert

knowledge and may or may not have substantial ownership (the bottom half of *Figures 3.7* and *3.8*). This sort of engagement is based on constructive dialogue which permits room for disagreement, as both parties exchange and entertain ideas with the best long-term interests of the firm in mind. In these cases, then, CEOs may either accept or reject an investor's demands/recommendations. In the case of the occasional hostile activist who, again, may or may not have substantial ownership, the CEO and board often do not have room to disagree as the firm's underperformance likely compromises the credibility of the CEO's ideas and vision. CEOs confronting an occasional hostile activist with expert knowledge but low share ownership (lower left quadrant) may succeed in resisting any demands made by the investor, but the more widely recognized is the expertise of the investor, even one without substantial holdings, the more likely that the CEO acquiesces since the investor's reputation for expert knowledge will likely win the support of other investors creating the equivalent effect of high share ownership (bottom right quadrant).

Importantly, *Figure 3.7* and *Figure 3.8* represent the CEO's perspective. The types of CEO responses just described will prove appropriate so long as the CEO's perspective is in sync with that of the majority of shareholders. Significant problems can arise, however, when CEOs misjudge their activist interloper, particularly when dismissing the knowledgeability of high ownership shareholders or when misconstruing their disagreement for inexpertise. In such cases, a CEO places an activist in the upper right quadrant while the majority of shareholders place the activist in the lower right quadrant, assigning greater legitimacy to the activist than management does. In such instances of misjudgment, the dismissive character of upper right quadrant responses of resisting and/or placating through symbolic management will likely meet with widespread shareholder disapproval and worsen the situation for management. As highlighted in the chapter *Hedge Funds*, hedge fund respondents were far more receptive to CEOs' reasoned disagreement through dialogue than they were to dismissive behavior.

CULTIVATING THE SHAREHOLDER BASE

While the core idea of shareholder value ideology is that the business of CEOs is to serve shareholders, an idea which all CEOs embrace with varying levels of enthusiasm, we have seen that CEOs in fact do not try to serve *all* shareholders. In part this is due to the unavoidable reality that shareholders are not a homogenous group. We have already seen how shareholders differ according to their legitimacy, resulting from differences in either share ownership levels and/or perceived expertise. We have also seen that shareholders differ by their investment horizons, relationships to time that depend in part on their clients' financial requirements but also on how they are compensated. They further differ along idiosyncratic dimensions, such as their varying appetites for risk or whether they are more growth oriented versus value oriented. CEOs cannot fully satisfy the demands from such diverse constituents simultaneously. For example, a growth oriented investor would prefer to see profits reinvested in the firm rather than distributed through dividends or stock buybacks. A value investor who typically has a longer-term investment horizon would prefer to see profits distributed through a steadily growing stream of dividends. Short-term oriented investors often eschew dividends in favor of faster profit growth that can drive stock prices higher sooner rather than later. Admittedly, something akin to assortative mating takes place in the marketplace whereby value investors tend to invest in dividend paying stocks while growth investors are partial to non-dividend paying stocks, and thus it is commonplace to hear of some stocks referred to as "growth stocks" and others as "value stocks." But it would be a mistake to conclude that the share rosters of most companies are solely comprised of a single type of investor.

Thus, although there are structural and idiosyncratic reasons precluding CEOs from fully satisfying the interests of all of their investors simultaneously, a reality that strains the meaningfulness of shareholder value ideology, we have also seen that CEOs favor some investors over others to the extent that they see the investor as being legitimate. CEOs view gadflies and labor union shareholders with suspicion and sometimes engage in active attempts to marginalize them. Short-term investors are tolerated, but not embraced. Nearly

all CEOs expressed a preference for patient capital, investors whose investment horizons matched up with, or at least approximated, that of the firm's.

If wishes were horses, every CEO would have a shareholder stable comprised solely of patient capital. A cynical, though not entirely misplaced, view of this preference might be that patient capital translates into managerial job security. But it is no doubt also true that long range planning, the translation of vision into salable products, and the investment in people, ideas, and things takes time to bear fruit. Moreover, the greater the proportion of patient capital in the shareholder base, and assuming their patience is not strained by gross managerial missteps, the less room there is for unfriendly activism. Should activism occur which is not welcomed by management, it is less likely to gain momentum if there is a critical mass of patient capital. Thus, cultivating the ideal shareholder base can prove very beneficial for any CEO.

But shaping the shareholder roster is difficult. Indeed, some CEOs felt doing so was a fruitless exercise:

> First of all, there's nothing I can do about it. You know, I mean, you can't – you can't choose who your investors are…I would be less happy if all we had were hedge fund investors. (CEO34)

Others, however, believed they could indirectly exert an influence by clearly explaining the firm's strategy and goals and then delivering on these expectations:

> Do we wish we had a stable base of 30% or 40% of our shareholders that have been with us five years? Of course we do. We try to address some of that with our capital allocation and dividend policy and try to make it really clear what they should expect in a given business environment and then make the footsteps match the words. (CEO20)
>
> I'm a firm believer that over time if you generate, you know, strong operating results, financial results, that the market valuation will follow and an appropriate shareholder mix will follow. (CEO27)

Cognizant of the limitations of crafting an ideal shareholder roster, CEO20 and CEO27 both believe, nevertheless, that they can have some effect on the complexion of their investor bases, though it is likely a long-term project. An interesting, if somewhat extreme, example of garnering "an appropriate shareholder mix" by delivering on a stated strategy was given by CEO24. In this case, however, the "stated strategy" was a new one. The firm's shareholder base was populated by many so-called value investors who were enjoying a rising share price driven in part by the firm's commitment to a significant stock buyback program. Management and the board decided to shift gears by pursuing a more growth oriented strategy by executing a sizeable acquisition. As this strategic change depleted the firm's excess cash, the firm suspended its stock buyback program. Disappointed, and probably irate, value investors dumped the stock, but growth investors, excited by the change in strategy, bought into the shares at the depressed price. And this is precisely what management had hoped for:

> We achieved something of what we wanted to achieve which was that we grew the type of investor that we have in our base. We broadened that sort of footprint, if you like…if we were going to do another deal at some point in the future, it would probably be easier to do that deal with the investor base that we have rather than the investor base that we started off with and our stock price probably wouldn't be hit as badly if we did another deal. (CEO24)

What CEO24, his board and management team "wanted to achieve" was a shareholder base of a certain complexion – growth oriented investors. Once it had cultivated this new investor base, the firm could more easily pursue its newly instituted strategy.[64]

CEO14 also discussed an active approach to shaping his shareholder roster, again despite the hurdles:

[64] Interestingly, they accomplished this at the expense of its previous shareholder base, again highlighting the heterogeneity of shareholders as well as the inherent tension in the concept of "delivering shareholder value."

> We don't sit around saying, "Gee, I wonder who will buy our stock today." We spend time actively on the road seeing investors who we think will be interested in our story. You know, we spend time with – we target people who are successful investors who owned companies with profiles like ours who – sometimes it isn't totally passive…So, we have some…certainly we don't have control over who buys the stock, but we certainly have influence over who we can get interested in the stock and how we spend our time to tell the world the story. (CEO14)

CEO14 describes a rather robust effort, akin to a marketing campaign, of targeting likely buyers and then visiting them to pitch his firm's story. On the road, face-to-face time was also important to CEO19:

> Well, we have a preference and we steer towards that preference and so we will prioritize our time towards the shareholder base that we prefer…I guess the mechanics of the way it works in reality is we've got our tier one set, our tier two set and our tier three set with tier one being the most attractive investor for us, tier two kind of being in the mix of two and three. So, we allocated X amount of time for investor relations and we started filling up that time with tier one. Whatever time we had left we fill up with tier two and tier three may not make it into the mix and the way that works out is, you know, what happens is we typically always over-subscribed for one-on-one meetings and so rarely do tier three people get into a one-on-one meeting because we're trying to respond to tier one and tier two and then when people call into the company, we've got a director of investor relations, we have the CFO, we have the CEO and it's kind of the same thing, right?. A tier three investor will call in and we'll answer all their questions and give all the information, but it will be handled by the director of investor relations. For tier one, they will quickly elevate and get their answers from either me or the CFO. (CEO19)

Like many other respondents, CEO19 and his team try to cultivate the ideal shareholder base, the "shareholder base that we prefer." They implement these efforts by stratifying their existing and prospective shareholders. Unaddressed, however, is the extent to which these efforts yield the desired benefits – a core of stable, patient investors.

The flipside of actively encouraging potential and existing shareholders to buy or to continue to own shares is deliberately not encouraging potential shareholders that are deemed undesirable. Recall the earlier discussion regarding CEO's attitudes towards short-term investors and hedge fund activists. CEOs did not place great value on these categories of investors and this attitude resulted in shareholder avoidance as a technique for shaping shareholder rosters:

> We emphasize repeatedly kind of a long term, sometimes contrarian approach. We tend not to get the faster in and out funds. They're just – you know, I don't really want to spend time on them. They're not a good match for us. (CEO31)

While preventing any investor from buying shares is an impossibility, CEO31 will certainly avoid encouraging, persuading, or otherwise actively inducing undesirable investors from becoming shareholders of the firm. Ignoring shareholders that are not desirable, however, extends beyond the kinds of marginal investors discussed earlier:

> Our investor relations person does have, you know, kind of a short list of people it is safe to say I would not go call on to try to encourage them to buy my stock. I mean, BlackRock would be one of them. They own a part of us. I've never heard from them, but they can, you know, be a thorn in some people's sides at times. There's a couple of other ones I can't even list the name, but our IR person would say, "Eh, I kind of keep my eyes on these other two to see if they're building a position or reducing a position," and again, she would not recommend that we go visit them…(CEO23)

Interestingly, CEO23 describes both the effort to shape the shareholder roster and the futility of such efforts. CEO23 deliberately avoids making visits to BlackRock, the largest institutional asset management firm in the world, since the firm can "be a thorn in some people's side;" yet, despite not encouraging them to invest, BlackRock nevertheless owns a position in the firm's shares. But CEO23 also engaged in proactive behavior:

> Our IR [investor relations] people go to a lot of IR conferences and they talk a lot. They say this so and so is really a terrific investor, they're engaged, they know the business, they're long term holders, you should go talk to them…So, they do pick up a few things like that, that this investor said they were a little underweight on financials and are looking to build that up and they understand your business and you should talk to them. So, we put those people on the list too. (CEO23)

A difficulty in analyzing all of the foregoing comments provided by respondents is distinguishing between efforts aimed at cultivating the ideal shareholder base of patient capital and efforts to simply create demand for the stock of the company. As with CEO14, numerous CEOs likened the purchase of a company's stock to the purchase of any other consumer good: "To me buying a company in the stock market is no different than where I buy my coffee or where I have my car serviced" (CEO5). Here is a sampling of what other CEOs had to say:

> …you are interested in picking up what seems to excite them [investors], what seems to intrigue them, what seems to please them and, of course, likewise, what seems to be irritating to them, doesn't resonate with them…(CEO7)

> We're in business to make shareholders want to own our shares. (CEO13)

> If we've had a long term shareholder that we see – and had a substantial holding – and we see them exiting, eventually I would like to have an exit interview. And find out, "Why don't you love us anymore?" (CEO22)

No other respondent, however, put it as clearly as did CEO26:

> I think – here's the way a guy in my shoes needs to view these shareholders, they're like customers. So, if you think about, you know, a mentality, a retailer's mentality or even a business-to-business mentality, I mean, you like to please your customers, you like to do things that you know you're customers are going to like

> because it’s going to cause them to buy your product, your service, perhaps, before they buy someone else’s. I think about investors the same way. I’m competing with everybody else in my space for investment dollars; I want to do things that are going to be attractive to them because they’re likely to buy my stock if I’m doing things that are attractive to them, maybe more so than they’ll buy someone else’s, and we’re all competing for the same pool of dollars. So, in that sense, it’s smart to try and do things that you know investors are going to like. That drives your stock price. That drives your multiple, you know, so the two economic variables - you know this better than I do – that drive the stock price, are earnings and return. The third is multiple. So, we’ll do things in the business to try to improve earnings. We’ll do things in the business to try to improve return, but I don’t have to do anything to improve the business if I get a multiple expansion. You get multiple expansion by winning the popularity contest with investors.[65] (CEO26)

In this rather blunt if not cynical view of the role of the CEO, CEO26 explains that stocks are essentially consumer products, and the job of the CEO, like any retailer, is to generate interest in and demand for the firm’s consumer product *par excellence*, its stock. And like so many boxes of cereal products along a grocery aisle competing for shoppers’ attention and dollars, a firm’s stock competes for the attention and dollars of investors.

While it is conceivable that a CEO’s focus on generating excitement and demand for her company’s stock as if it were a consumer product might result in a shareholder base comprised of the ideal patient shareholder, it is easy to see how just the opposite might occur. Indeed, the language of excitement, popularity, and of fleeting love resonates more loudly with short-term romances than long-term bliss, suggesting a tension between stock-as-consumer-product and stock-as-long-term-investment. As CEO26 explained above, he doesn’t “have to do anything to improve the business if I get a multiple expansion,” hardly the recipe for cultivating a base of patient capital in search of healthy, growing businesses. That said, CEO26 pursues the popularity contest as but one part of a larger repertoire of

[65] The price-to-earnings ratio (P/E) is based on stock price divided by earnings per share. This is often simply referred to as the “multiple.” Put another way, the “multiple” reflects how much investors are willing to pay for a given level of profitability. Two firms with an identical level of profits may trade at different multiples. Typically, investors will pay a higher multiple for firms growing their profits more rapidly and/or with greater stability.

strategies that also requires a focus on long-term drivers of profitability.[66] Indeed, most CEOs practiced a shareholder engagement which struck a balance among the competing interests of heterogeneous investors, as captured by CEO3: "I've got to be playing a good enough short term game…to play the long term game for the business." Numerous CEOs spoke of rewarding longer-term shareholders through their dividend policy and shorter-term investors through share buybacks, and balancing these two avenues for returning cash to shareholders with that of reinvesting in the business.

Despite the challenges of walking the capital allocation tightrope, it nevertheless remains true that patient capital is most prized among CEOs and boards. And this preference for the long-term shareholder explains why CEOs and boards initiate and then increase share buybacks usually only at the behest of investors. Many CEOs see share buybacks as rewarding impatient rather than patient capital: cash reinvested in the business is essential for securing the long-term growth prospects of any firm. A paradox of shareholder value ideology, however, is that many CEOs have been converted into impatient capitalists themselves through compensation structures heavily skewed towards stock and stock options, the key mechanisms behind so-called shareholder alignment. But "shareholder alignment" is every bit an amorphous concept as is "shareholder value." Value for which shareholders? Alignment with which shareholders? Given CEOs' views on share buybacks, but also given the fact that CEOs regularly sell their own personally held shares in the name of diversification, it would appear that so-called "shareholder alignment" has simply aligned CEOs with short-term shareholders: share buybacks push stock prices higher in the near-term to the benefit of short-term shareholders *and* to the benefit of CEOs regularly unloading their own shares. One CEO spoke candidly and colorfully of the risk from buying back shares:

> So, that's one that for a long time I rejected. I eventually embraced it [share buybacks] because I thought it made sense, and of course

[66] CEO26 perhaps short changes the sources of multiple expansion: investors will drive multiple expansion if they are convinced of the durability of improving prospects for profitability, which is to say, if they like not just the short-term excitement surrounding a firm's story, but also its long-term prospects.

> they [the shareholders] thought that was wonderful. You could immediately have voted for it. I mean, it's heroin. You know, you can get addicted to it and when you stop…I mean, the withdrawals are bad[67], but you get immediately rewarded, right, the shareholders love it.… (CEO15).

CEO15's comments underscore the short-term effects of share buybacks – "you get immediately rewarded." More interesting is the notion that share buybacks are addictive: they yield an immediate "high" in the form of higher share prices, a CEO can bask in the love from shareholders, and not least importantly, the CEO can quickly feel the "high" in his elevated stock-based compensation. By reducing share count, share buybacks essentially give a tailwind to earnings-per-share growth; when share buybacks end, therefore, this tailwind disappears, earnings growth slows, and investors will punish the share price: thus, "the withdrawals are bad."

Lest we conclude that CEOs undermine their own efforts at cultivating the ideal shareholder base of patient capital by indulging the demands of short-term shareholders as well as their own hedonic needs, we should recall CEO20's observation quoted earlier that even short-term shareholders "have the votes…they're the owners today." Thus, CEOs do not have the option of completely ignoring the potential power of short-term shareholders if their high levels of share ownership render them partially legitimate. A more reasonable conclusion, then, is very simply that the heterogeneity of shareholders militates against efforts to cultivate the ideal shareholder base. Put even more simply, "you can't choose who your investors are," as CEO34 insisted at the beginning of this section. And even though CEO20 flexed the levers at his disposal – capital allocation and dividend policy – to try and attract more long-term investors, he pointed to additional structural impediments to shaping the shareholder base:

[67] To understand why the "withdrawals are bad," it is important to understand the profit effects from buybacks. While absolute, dollar profitability is unaffected, earnings-per-share (EPS) does get a boost because share count is reduced, creating a tailwind: with a significant buyback program, EPS may increase at 12%, for example, rather than merely at 10% and the firm's share price is likely rewarded for this faster EPS growth. To stop or curtail the share buyback program now suddenly looks extremely unappetizing because EPS growth will revert to the slower pace and investors will invariably penalize the firm's share price.

> I do believe that there are very few truly long term investors in this space [petroleum/refining] and it's only through observation of seeing the share registers turn over. Our visibility to earnings is poor and for that reason people tend to trade the stock maybe more actively than other sectors. (CEO20)

From CEO20's point of view, the capacity to shape the shareholder roster varies across sectors. A given sector will be conducive to either a stable earnings environment or to a less stable one. For example, companies within the so-called consumer staples sector, which sell products such as toothpaste, shampoo, and tissue paper, all enjoy similarly stable revenue and profit growth patterns. Because of this stability, "visibility" to earnings is generally good. In the petroleum/refining sector, by contrast, revenue and profit growth patterns can be erratic and unpredictable, resulting in poor earnings "visibility." It is CEO20's contention – a contention that could be empirically investigated – that poor earnings visibility results in high share turnover, meaning that the share roster will be dominated by short-term investors rather than long-term investors.

The mechanism by which this higher share turnover likely occurs is price volatility: poor earnings visibility likely results in greater volatility in share prices reflecting frequent adjustments to the pricing of forecasted earnings streams, and this price volatility is what in turn causes higher turnover in share ownership. This process is captured in the following vignette provided by CEO3 in which the catalyst of share price volatility and subsequent share turnover is not poor earnings visibility, but a public activist event. After rebuffing the initial demand by two hedge funds to take on debt in order to fund a massive stock buyback, CEO3 and his board engaged in a protracted nine month proxy contest with the two hedge funds who were now demanding five seats on the firm's board. Over the course of these nine months, turnover in the shareholder base increased substantially such that:

> A: By the time we got to the election, we were owned about 41% or 42% by hedges. So, you know you're going to lose.
>
> Q: And clearly a lot of your shareholders sold to the hedge funds?

> A: Yeah, because it's – you always get a run up when you're under attack. So, some of them said, "Hey, great, I'm going to take my profit."…they lock it in and go somewhere else for a while. (CEO3)

Volatility in share prices begets volatility in the shareholder base as many will exploit a spike up in price "to take my profit." And, as CEO3 rightly observes, a visible and public campaign by an activist typically generates just such a spike up in the target firm's share price as investors anticipate any of various actions that can result in share appreciation – share buybacks, dividend increases, spinoffs and divestitures, etc. Indeed, limiting share price volatility is one reason many CEOs engage in "income smoothing" where profits in excess of Wall Street expectations are often deferred into future periods by means of accounting manipulation.[68]

High share turnover is anathema to a stable shareholder base, and although every CEO desires and even strives for the latter, the former invariably upsets such efforts. Like virtually every CEO I spoke with, CEO3 spent ample time in front of existing and potential investors in order to cultivate a stable shareholder base, efforts that ultimately were for naught by virtue of the kerfuffle with the two activists. Even though CEOs might prefer to deal only with their ideal patient shareholders and to have them dominate their shareholder rosters, investor heterogeneity, share price volatility stemming from the normal vicissitudes of firm performance, and regular turnover in the share base driven by such share price volatility – all of these realities preclude CEOs from being with the ones they love and compel them to love the ones they're with.

EMBEDDED WITH SHAREHOLDERS

Each occurrence of public activism leaves one with the impression that a firm's fortress wall is about to be breached and that the separation of ownership and control is under threat. The idea of the separation of ownership and control, however, has become

[68] The difference between fraudulent accounting manipulations and acceptable ones is socially constructed because accounting rules allow certain latitude for managerial discretion and because the interpretation of accounting rules is often contested by various parties with competing interests. Donald MacKenzie makes these points in his brilliant discussion of the WorldCom accounting scandal (MacKenzie, 2009).

somewhat of an anachronism judging from the responses from CEOs in this study. As was highlighted early in this chapter, quiet, non-public activism occurred an estimated four times as frequently as did public activism: CEOs are routinely engaging with institutional shareholders who have ideas of their own for improving the prospects of firms they are invested in. And as we also saw, CEOs generally have a reasonably high opinion of their vocal investors' expertise. One might be tempted to think that any CEO would prefer a return to the days of managerial capitalism, or at least a return to a more quiet and deferential shareholder base that gave wide berth to managerial prerogatives, but many of the CEOs in this study recognized that vocal but non-hostile shareholders can be a tremendous resource for the CEO. Rather than alienate shareholders by monopolizing control of the firm, CEOs have learned to incorporate institutional shareholders with expert knowledge and non-trivial share ownership, i.e., fully legitimate shareholders, into their decision making processes. While it would be difficult to disentangle symbolic management of shareholders from honest listening to and evaluation of shareholder ideas and input, CEOs are very cognizant of shareholder power and most are intent on building trust and credibility with shareholders, and further understand that "blowing smoke" at an astute investor can rapidly undermine such efforts.

CEOs articulated multiple motivations for engaging with shareholders including building trust and goodwill, gathering business intelligence on their industry and competitors, and ensuring that the investment community clearly understands the firm's goals, strategies, challenges, and opportunities. Even though the interactions with investors based on these kinds of motivations often do not directly influence managerial decision making, they still represent avenues and opportunities for utilizing shareholder expertise as a resource for the firm.

CEO7 used his experiences during the California energy crisis to emphasize the importance of building trust and goodwill with investors (and creditors):

> You know, if you're going through a tough time, you need to be visible and you need to be there, not necessarily to, as they say, market yourself, spin the facts in a way that just pushes your point of view, but I think it's human to be present, to be visible, it makes

> a big difference…When you have a bad loan and the news headline comes across and says you're – you know, something has gone terribly wrong…you better have some answers and we have a lot of people who own us…and they're going to need to have answers…It's not to market it, it's not to spin it, it's to try to provide real time information to these people…I have to admit, I thought that was going to go on for about five or six weeks and it ended up going on for a better part of a year because we did these every Tuesday and Friday, but I came away from that experience groaning a little bit of how much time and effort it took, but I think it was – we never did declare bankruptcy. We never sought bankruptcy protection and we asked people to bear with us…Any three creditors with a total liability of $11 billion could have thrown us into bankruptcy and nobody ever did. I think it really taught me that when you're in tough times…and even if you're delivering bad news or you don't really have a lot of developments, but you are present, you are visible and they hear your voice or they see you, it has an interesting, soothing effect and, it's just, I think it's just human nature. You just somehow feel a little bit better about it if this person can talk about it on a civil, level-headed way and just explain what's going on and there were many times where I did that. I got asked questions and I couldn't really answer them. I didn't really have an answer or in some cases, it would have been foolish for us to answer that question at that time. Just say that:. "I think you can understand it really wouldn't be wise for me to speculate on that at this point in time, so I'm sorry, but I'm not going to take that question on. Next question please," you know. It was odd, but it really makes a big difference. (CEO7)

While involving creditors rather than shareholders, this story nonetheless demonstrates the benefits from CEOs who work hard at building trust and credibility with stakeholders. CEO7 attributes the fact that none of his three creditors declared his firm in default of its bond covenants to these very trust building efforts. Not every firm faces a crisis similar in proportion to what CEO7 faced during the California energy crisis, but every CEO will at some point hit a rough patch when the firm falls short of investor expectations. Most CEOs agreed, similar to CEO7, that the establishment of trust and credibility with shareholders can pay dividends during periods when results fall short of the mark. Investors can react mercilessly if they feel they have been misled, but can exercise patience if they believe a CEO has been forthright. It should also be obvious that investors will not bid up shares if

they do not believe the story, strategy, and vision that the CEO is trying to convey. The importance of trust, credibility, and reputation was highlighted earlier in CEOs' antipathy towards short-sellers who sometimes promulgate negative stories to catalyze a sell-off in a firm's shares and who thereby threaten a firm's reputation. Turnaround situations also serve as good examples where not only is firm performance being repaired, but so too is its reputation:

> When I took over the company four years ago, it was – it was really a turnaround situation and one of the – one of the things we clearly set out to do was to establish a very high degree of credibility and respect and trust with investors…because the opinion or reputation of the company prior to that wasn't where it needed to be. So, as a result of that, we interact with investors considerably during the year and we do that primarily three ways. One, in the energy space, there are about 12 to 14 conferences that – and we attend almost all of those…Now, sometimes those may be a 30 minute meeting or a two hour meeting, but over the course of a year, and we've done this for four years, I would say that myself or one of the other two people, we would probably come across and sometimes the same investor multiple times, but we would probably have 600/700 investor interactions over a 12 month period of time. So, we have a lot, a lot of activity. The second thing is we have a fair number of investors that call and come in to talk to us…and we'll usually give them a minimum of an hour…and then the third thing is that we target really kind of regionally areas that we want to go out and usually include one of the banks, ask them to support a marketing trip of the company. (CEO30)

Establishing trust and credibility with investors is so highly prized by CEOs that once they have been compromised, rebuilding them becomes the CEO's top priority. Every CEO devotes considerable time and energy making presentations at investor conferences, holding "one-on-ones" at these conferences, fielding investor phone calls, and even hosting investor days at their firms. Compared, however, to the 10%-25% of time respondents reported that they spend interacting with investors, CEO30's efforts, by his estimate about 50% of his time, are extraordinary. His efforts reveal not only the importance of trust and

credibility, but also the tremendous effort required to repair them once damaged. CEO10 articulated a similar experience:

> [Our] particular company had performance issues and disappointed shareholders – I think that's what's driven our really aggressive engagement. (CEO10)

Like CEO30, CEO10 pursued "aggressive engagement" in order to reclaim trust and credibility with his institutional shareholders.

In addition to building, repairing, or maintaining trust and credibility with investors, CEOs devote time to investor interactions in order to gain business intelligence. Recall CEO14's "bee" metaphor:

> …they look at dozens of companies, including many in your sector and many all around and they're like bees. They're going flower to flower and they're learning stuff and I'd be a fool not to – they're spending time – I'm looking at my customers, they're looking at my competitors and they have ideas and they notice things and they have perspectives…(CEO14)
>
> You're listening to what they're saying and what they're asking. So, you know, it's intelligence, it's data...It might be their questions that are based on just having a meeting with a competitor or somebody else in our space… It might be a discussion that they have had with credit rating agency representatives. It can run the gamut. (CEO10)

This rich resource of information and data, essentially stemming from a network of weak ties, cannot be had by the CEO who, at best, does not hold shareholder input in high regard, or at worst, insulates himself from his shareholders.

Lastly, CEOs engage with their shareholders, perhaps predominantly, to explain the firm's story, what its goals are and how and when the CEO expects to achieve them. This is crucial information for investors to digest in order to properly set expectations for the firms they invest in; these expectations get reflected in earnings estimates for the firm made by either analysts or institutional investors themselves. And the more complex a firm's

business, the greater the effort required of CEOs to insure that shareholders understand the model:

> I mean, for example right now, the deep water floating drilling rig market is – is viewed somewhat negatively because there's a lot of units being delivered and there seems to be a bit of a pause in demand on the oil company side right now and so there's a lot of negative speculation about what this means and *even though we are not directly connected with the deep water drillers*, I mean, we do have ROV's on, you know, 60% of the deep – of the floating drilling rigs fleet in the world, but we – *they're not our customer and as long as they're working, even if their day rates are going down, that doesn't really affect us, but we get painted with that brush and – and so our stock does suffer a little bit as a result of that* and so those are the kinds of things that they'll – they'll try to hone in on, you know, "What do you think about that? Well, why do you think that doesn't affect you?" and so you explain in more detail what your business model is and why you don't think that is going to impact you and that's the kind of stuff they ask. (CEO34, emphasis added)

If shareholders or analysts misunderstand or do not fully grasp the intricacies of a complex business model, they risk misinterpreting performance results which can send share prices lower. Similarly, to avoid having shareholders set improper expectations, CEO28 felt it was his job to:

> …make sure they have good buy/sell decisions…so that they're not buying you and expecting something that you don't intend to deliver. (CEO28)

CEO22 engaged with shareholders in part "to hear what they've got to say before their thought turns into something that isn't real." Driving this point home, CEO22 appealed to C. Northcote Parkinson: "The void created by the failure to communicate is soon filled with poison, dribble and misrepresentation." Misunderstanding, or incompletely understanding, by shareholders can result in a "valuation gap" according to CEO27:

> If our story is misunderstood where we think there is a disconnect between the value of the company and the perceived value of the company, then it's our job to fill in that information. That's your opportunity to "move the dial." If there's not that kind of a gap, then, you know, there's really no need to be going out there…For the last couple of, I'd say five years at least, a couple of those years we thought, "Well, there's a gap in valuation here. We need to be out there explaining it. They don't understand, or what have you, but the short voice [short sellers] might be stronger than our voice, or whatever, and we need to get out there and inform and make sure people understand the value." That's our job, right. The task of increasing shareholder value, part of that is making sure people understand the story and can see clearly the value of the company. When I say "move the dial," it's like: inform; educate; make sure people understand. (CEO27)

Thus, while some CEOs will market their firm's shares like a consumer product to stimulate demand for the shares (as described earlier), all CEOs engage with their shareholders simply to promote a sound understanding of the firm so that investors can set realistic expectations and make sound investment decisions. In short, most CEO respondents were keenly aware of the risks of failing to do what they had said they were going to do, and thus engaging in symbolic management, such as announcing a share buyback but not following through on the promise, was for these respondents an invitation for shareholder wrath.

CEOs, then, engage with their shareholders for multiple reasons, including cultivating an ideal shareholder base, trust building, intelligence gathering, and educating. And this engagement occurs remarkably often:

> I can honestly tell you that we probably have between 150 calls and meetings a year with our shareholders. We do that voluntarily, by the way. So, every quarter, we try to take about two weeks. (CEO11)

> I'll spend two days a month talking to investors on average. I'll go out on road shows, have people in here, you know, do quarterly reporting, talk to our investors and you know, it's *a perpetual dialogue*. (CEO14, emphasis added)

> I do investor relations *almost constantly*. So, at least once a week I'm on the phone and many cases I'm on the road meeting with investors or prospective investors. (CEO16, emphasis added)

> I just got back last night from Toronto and Montreal where I had 16 meetings in two days with either current or potential investors. (CEO22)

> I'm out there – that's probably 20% of my time. It's not a small number. (CEO28)

> I've probably spent 25% of my time in front of investors and employees. I didn't probably, I *did*. Depending on the situation, sometimes more. (CEO32)

This level of embeddedness with shareholders is perhaps the most tangible manifestation of how so-called shareholder value ideology and shareholder primacy translate into the behavior and practices of CEOs. While much of these interactions is dominated by CEOs engaged in trust building, in intelligence gathering, in educating, in wooing prospective shareholders, and in retaining the ideal ones, *every interaction is also an opportunity for shareholders to weigh in on the firm's direction and strategic options*:

> I've got like 15 guys that are sort of major owners in the company and <inaudible 15:52>, let's just say there's five of them that I talk to quite frequently. I can almost count on a call from them. Maybe I'm at the point where I know what time, what day following the earnings release they're going to schedule a call and I would say for those people, it would be rare if I didn't have a conversation during that regular quarterly call where they didn't recommend something or suggest something. (CEO27)

Not only are shareholders communicating their ideas and making suggestions and recommendations, but many CEOs welcome this input, particularly from fully legitimate shareholders who have sizeable share ownership and who possess expert knowledge:

> If they have size, they're large and they really, really get it, yeah, you're gonna communicate with them even more. (CEO10)

In addition to asking my respondents to offer their opinions on investor *expertise*,[69] I also asked them to evaluate the specific ideas, recommendations, or demands made by these investors. Generally, investors who provide input to a CEO do so with respect to capital allocation. Those investors who advance ideas and/or make demands frequently are urging the firm to distribute more cash to shareholders, either through increasing the dividend payout, or more commonly, through initiating or accelerating share buybacks. Such investors will make these recommendations and/or demands to firms that either have, in the opinion of the shareholder, cash which exceeds investable opportunities, or insufficient levels of debt, in which case the investor will urge the firm to take on more debt, and to use such borrowed cash to repurchase shares. CEO32 summed it up thusly:

> They don't have that tacit knowledge about the business and the business is what generates the dollars and then you get to decide how you distribute, pay down debt, increase dividend, buy back shares, invest, blah, blah, blah, blah, blah, blah. So, most of your engagement with all investors is on the choices made after you make the money. (CEO32)

Less frequently, vocal shareholders will focus on other issues that also involve capital allocation, such as whether a firm should buy another firm, perhaps sell itself, or sell some piece of itself. Even far less frequently will an investor weigh in on the actual business of the firm, which is to say, how the business might be run better, more profitably, more efficiently, or even to argue that the firm requires new leadership.[70] While institutional investors certainly can and have made more intrusive demands or suggestions beyond mere capital allocation, CEO32's observation is consistent with the findings in this study (see *Figure 3.3*).

[69] See the earlier section "CEOs' Assessment of Investors' Expertise" above.

[70] As an indication of the non-randomness of my sample, no CEO reported any occurrence of an investor pushing for their removal.

Just like questions regarding investor expertise, responses to my inquiries regarding investors' *ideas and recommendations* were rated from 0 to 2, with '0' being a low opinion, '1' a moderate opinion, and '2' a strongly favorable opinion. Out of thirty-four respondents, thirty offered their opinion of the *ideas and recommendations* made by their vocal investors, rating them at 1.2 on average. This was slightly lower than the 1.5 rating of investor *expertise* discussed earlier. This discrepancy is understandable since it is one thing for a CEO to say of an investor that she is smart, knowledgeable, has done her homework, knows the industry, has clearly read all the financials, and asks intelligent questions (read: that are not a waste of our time); it is another to say that the investor has an insight that actually might alter, if even in some minor way, the firm's strategy, how the CEO runs the business, or how it allocates capital. CEOs who held high opinions of their vocal shareholders' expertise yet found their actual input of lesser value attributed this differential to information asymmetry: investors simply did not have all of the necessary information, or obtained information with a time lag, to make thoroughly relevant recommendations.

Consistent with the moderately strong opinion of shareholders' ideas and recommendations, many CEOs expressed a strong desire to understand what their investors want. In so doing, they are not simply demonstrating their listening skills, no doubt critical to relationship building, but are also striving to be responsive to these wants:

> If we weren't asked, I would ask the question. As a shareholder, how do you think about dividends versus share repurchases? How do you think about share repurchases versus contributions back down into the operating company because I wanted to know what they were thinking.… (CEO9)

> How we think about capital investments, how we think about dividend growth, how we think about organic growth versus M&A driven growth, sure, sure…We listen to them and we want to understand what their investment – growth, return – objectives are. So, yeah, we take it in and *we'll calibrate when we think it's compelling*. (CEO10, emphasis added)

> Now, if I met with any of our large shareholders and they would say to me something like, "Your cap ex budgets, cap ex plans are way, way out of line," well, I'd be on the phone right after that phone call, right after that meeting, with the Chairman of the board and probably the Chairman of the Finance Committee. (CEO10)
>
> I would say investor perspective is really core input into the decision making process of a CEO and a management team and a board. (CEO14)
>
> We're also trying to be responsive to what we think shareholder interest is…Make a dialogue out of that as opposed to just decide. (CEO20)

Unilateral decision making, characteristic of managerial capitalism, was eschewed by CEO respondents in favor of engagement with investors. To be sure, the incorporation of investor input may not always reflect an internalized belief in shareholder primacy; it may reflect the simple reality of increased shareholder power:

> I think we want to hear what's on their minds. You know, we want to hear what the issues are that are important to them…especially in this day of transparency and better corporate governance and, you know, shareholder votes on executive compensation, it's really important that we have outreach where we can explain our strategy, our story, our results, but more particularly hear what they're thinking and quite frankly there are times we ask them questions about what do you think about this or what do you think about that? So, it's really kind of a two-way exchange, not necessarily just a monologue. (CEO13)

The subtext of CEO13's comments is that of a CEO very concerned with receiving too many "no" votes in his firm's annual say-on-pay vote. Still, CEO13, like others just quoted, places a priority on maintaining a dialogue with his shareholders for the simple fact that what shareholders think is important.

Barring the exceptional cases of activists dictating dramatic changes in firms' structure and strategic direction usually through winning multiple seats on boards through proxy contests, several respondents explicitly acknowledged utilizing investor input:

> If I get somebody that calls me for the very first time, I've never talked to them before, I don't know anything about them and they call, they're going to get access, right, so everybody gets equal access, and we're going to talk and as I'm talking to them and they're asking me very rudimentary questions, they don't understand the sector and then they start making suggestions, I'm probably going to take a little less…a less influential call than I would with somebody who I've talked to a 100 times, who I know studies the sector, knows it extremely well, has offered other suggestions *that have benefited the organization* – that's just a different conversation. (CEO27, emphasis added)

Highlighting how he discriminates based on investor expertise, CEO27 acknowledges that he *has* utilized input from knowledgeable investors to the benefit of the firm. Another CEO made similar remarks:

> Now, I've had a number of shareholders who have had huge positions who were not considered activists. And one in particular…they have shared lots of ideas. Some of them I rejected, some of them I accepted. Quite frankly, I really respect these guys and I have found most of their suggestions incredibly thoughtful and quite frankly I've incorporated a number of them. Sometimes I didn't. (CEO15)

Again, based on the investor's legitimacy which stems from their expert knowledge ("incredibly thoughtful") and large share ownership (they "had huge positions"), CEO15 pays particular attention to this investor and has actually utilized some of their proffered ideas. CEO15 also highlights a critical element in CEO engagement with shareholders, namely the retention of managerial discretion: sometimes they incorporate an idea or recommendation, sometimes they do not.

The importance of maintaining managerial discretion was implicit in several CEOs' reluctance to acknowledge any explicit adoption of an investor's suggestion, even though they drew a direct line between investor input and the acceleration or amplification of some course of action. Recall CEO12, the "IT guy," who was being asked to increase share

buybacks by an investor who brought in case studies to demonstrate to the CEO and his management team the positive effect such a move would have on profitability and share price:

> We didn't tell him [the shareholder] we were going to do anything. We just decided over the next three to six months to use our cash in that way and we probably would have not been as aggressive doing it had we not, you know, had the education from them because they brought some pretty good case studies with them to the meeting. (CEO12)

CEO12 implies that the firm would have pursued share buybacks regardless of investor input, and that the influence of the investor was reflected in how "aggressive" they executed the share buybacks. Despite the clear acknowledgement by CEO12 that this investor strongly influenced managerial decision making, he deemed communicating such an acknowledgement directly to the investor as inappropriate and out of bounds:

> Q: Was there a reaching out to this investor and saying, "Hey, we just wanted to let you know, we thought you had good arguments and by virtue of that, we're increasing our buyback?"
>
> A: No, we never did that. We knew that they would see it and we didn't think it was necessary to call them. We also didn't want them to think it was because of them, although they probably figured it out. Frankly I think it would have felt inappropriate to call them and tell them that. I think they would have thought it was inappropriate as well. I mean, maybe not, but that was just my gut feel.
>
> Q: Right…Do you want to add any color to the appropriate…
>
> A: I would say that it would have felt like we felt responsible to them in a report back and that would be an improper communication between a stockholder and the management of a company. (CEO12)

CEOs, as I am attempting to argue, are embedded with their fully legitimate shareholders who can speak authoritatively to CEOs because of their knowledgeability and expertise, and they are thus frequently influenced by them to greater or lesser degrees through "perpetual dialogue." Indeed, such responsiveness to shareholder interests is entirely

consistent with shareholder value ideology. Setting aside the inherent tension within shareholder value ideology arising from the heterogeneity of investors, the fiduciary duty to act in the best interests (of some idealized conception) of shareholders rests squarely with CEOs and boards, and so CEO12 is reluctant to explicitly attribute the increase in share buybacks to this particular investor, even though he has conceded as much and even though the investor will have "probably figured it out." CEO27, from whom we've heard earlier, also is sensitive as to how to characterize shareholder input and influence:

> I've been doing this for seven years or so and I was CFO for the previous five, so I've been talking to these guys for like 12 years. I have relationships with some who have been in and out of the stock and you just get to know them and you have pretty casual conversations with them. When I'm hearing <inaudible 9:15> on them, "Hey, have you guys ever thought about this?" I might say, "No we really haven't. That's kind of interesting. Let me do a little research on it," or I'll say, yeah, we have, here's what we've done before." *And so you don't want to suggest that it's sort of consultative*, but there are aspects of these conversations that are – it happens almost on every call and like I said, probably 15% of the time it at least shapes the conversation and shapes our thought…at least gives us something to think about... and I say this, I don't mean it the wrong way, but *if they've earned the right to be a trusted advisor* in addition to their role as an investor…they call me. (CEO27, emphasis added)

It would appear that CEO27 doth protest too much that his engagement with certain legitimate shareholders is not "consultative" given that they have "earned the right to be a trusted advisor." In any case, the reluctance to characterize engagement with shareholders as "consultative" might be ascribed to the perceived risk of eroding the very notion of managerial discretion, or to use the words of CEO12, having a "consultative" relationship "would have felt like [he] felt responsible to them." The further intimation behind these concerns made by both CEO12 and CEO27 is that responding to just one shareholder or even several shareholders risks breaching their fiduciary duty of loyalty to all shareholders.

Despite these reservations and scruples, the fact remains that each CEO was in fact decidedly influenced by shareholders they viewed as having legitimacy.

What we glean from CEO12 and CEO27, and others, is that they recognize the value of engaged shareholders and leverage them as a resource for managerial decision making while simultaneously insisting on managerial prerogative. Indeed, the predominant theme from most respondents was that shareholder input simply "goes into the mix." Some CEOs who could not recall ever adopting a shareholder idea or recommendation, still insisted on the importance of listening to their shareholders:

> They're bright people, they have a number of holdings, so they hear a lot of things, they see a lot of things and I want to know what their opinion is. Doesn't mean we have to follow it. It doesn't mean we have to agree with it. I do want to know what they think. (CEO9)

Cognizant of the informational benefits deriving from weak ties, CEO9 values the perspective of large and knowledgeable shareholders, and though he insists on managerial discretion, he clearly does not foreclose on the possibility that a shareholder may present an idea worth adopting. Many CEOs were also aware of the possibility of shareholder input influencing them in more tacit and subtle ways:

> So, there are certain institutions and there are certain people, portfolio managers and/or analysts that you know are particularly knowledgeable, thoughtful, get what you're trying to do so you'll take that into account in probably some subconscious way as well. (CEO7)

> I would be very arrogant if none of that free advice ever affected me in any way. (CEO14)

> It absolutely forces you to think on your feet and sometimes think out of the box a little bit or think of things that I had not otherwise thought of. I very much appreciate shareholders who are thoughtful, right, or thoughtful and constructive, even if it's a criticism. If it's thoughtful and constructive, I take it – you know, I deliberate on it definitely. I take it very seriously. (CEO16)

Given the substantial time CEOs spend with their shareholders, such tacit, subtle, even subconscious effects are entirely plausible and should not be dismissed. The input from fully legitimate shareholders need not rise to the level of "trusted advisor" in order to influence managerial decision making.

This is the current landscape of the separation of ownership and control: CEOs, together with their boards, see themselves as the final arbiters in the decision making process, thereby retaining substantial control over the firm; but shareholders are now an integral part of that decision making process as many CEOs listen to, consider, sometimes adopt, and in many cases actively solicit the input from fully legitimate shareholders who have significant holdings *and* are knowledgeable and thoughtful. Rarely do we see CEOs encamped behind fortress walls. The raiders of the 1980s burnt those walls down, and subsequent legislative, regulatory, and institutional changes have drained the surrounding moats dry. If today's CEOs are not out amongst the citizenry, they are assuredly out amongst their shareholders building trust, gathering free information on competitors and industry trends, and explaining their business models. To be sure, they focus these efforts on shareholders they see as fully legitimate, those with significant holdings and who demonstrate knowledgeability of the firm; with marginal investors – gadflies, labor unions, and most hedge fund managers and other short-term investors – CEOs expend minimal energy, sometimes shunning or even actively delegitimizing them. Crucially, legitimate shareholders are participating energetically, frequently making suggestions and giving advice. There are undoubtedly occurrences of so-called entrenched CEOs who mistakenly believe they remain protected by fortress walls until an occurrence of public and hostile activism shatters the illusion. But the vast majority of instances of activism are not cases of barbarians at the gates as there are no walls or gates: these CEOs are already thoroughly embedded with investors, particularly with the ones they value. Much of the activism taking place occurs in this context of embeddedness in which legitimate and valued

investors sometimes pursue alignment with the interests of the firm rather than the oft spoken CEO alignment with the interests of shareholders.

Chapter 4: *Directors*

INTRODUCTION

As I observed at the onset of the preceding chapter, there exists a tension between the formal structure of corporate control – the “formal framework” – and the actual practice of corporate control – the “normative framework” (*Figure 4.1*). CEOs formally report to their respective boards whose most important task is to select, monitor, evaluate, and often to dismiss them, or more simply, to hire and fire them. Shareholders, in turn, elect members of the board to represent them as their agents in order to oversee and advise management. Despite these lines of authority and responsibility – directors to shareholders and CEOs to directors – directors paradoxically interact minimally with shareholders while CEOs, as the preceding chapter highlighted, interact extensively with shareholders. It is true that CEOs are far better positioned than are directors for communicating the details of company results, for providing explanations for out- or under-performance, and for providing guidance for future performance. But as was earlier revealed, CEOs’ interactions with their large and/or knowledgeable shareholders encompass far more than the mere unidirectional dissemination of information; these interactions also afford many CEOs the opportunity to receive frequent and valuable input that at a minimum serves as a sound-check for their strategies, but that can also influence, shape, and alter managerial decision making. Indeed, as CEO27 articulated, some even “earn the right to be a trusted advisor.” As we shall see, directors have no such relationship with the very investors who have elected them and to whom they are accountable.

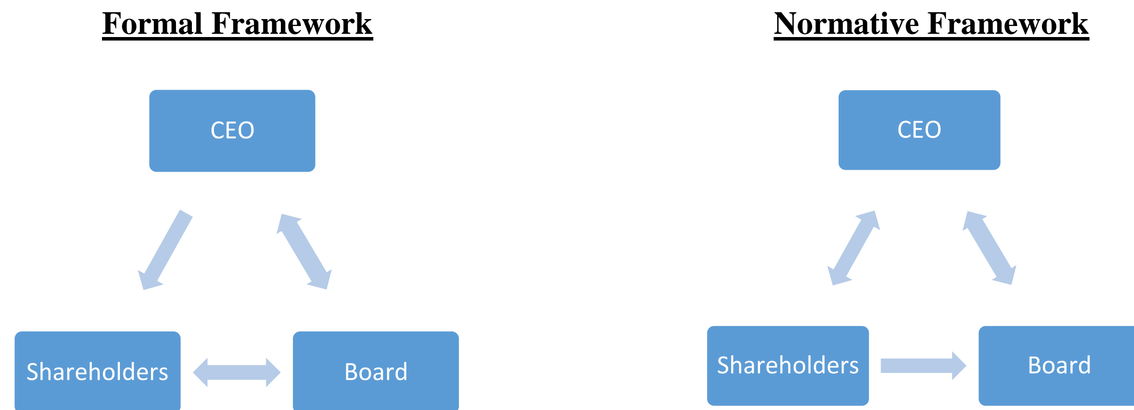

Figure 4.1: Governance Frameworks

By relying on thirty-five semi-structured interviews of S&P1500 board directors[71], this chapter will continue fleshing out this paradox of corporate governance, and will attempt to leverage any insights so gained to further shed light on how firms respond to hedge fund activism and to activism generally. While thirty-five respondents are, admittedly, a small sample, a drawback compounded by the non-random nature of the sample, these shortcomings are attenuated by the fact that respondents had substantial experience serving as directors on multiple corporate boards. In total, respondents occupied 180 distinct board seats throughout their careers, 115 of which were on public company boards and 65 on private ones.[72] As shown in *Table 4.1*, the median number of career board seats per director was 4, consisting of 3 public board seats per director and 1 private board seat.[73] Non-CEO directors had twice as much board experience than as CEOs, a distinction I will later return to.

[71] Unlike the sample of CEOs which had no female respondents, the sample of director respondents included nine female respondents or 25% of the sample. As two female directors requested that I mask their gender – due to the low representation of females on public corporate boards, they believed disclosing their gender would compromise their anonymity – I have chosen to not identify the gender of any respondent in the director sample.
[72] In tabulating board seats, I did not include board seats of subsidiaries. Also, if we exclude three outlier directors with 12, 16, and 18 total board seats across their careers, total career board seats decline to 134, public board seats to 95, and private board seats to 39.
[73] Because of the three outlier directors referenced in the immediately preceding footnote, use of the median rather than the mean is the more appropriate measure of central tendency.

Respondents	(median)			
	Public	Private	Total	Concurrent
All	3	1	4	2
CEOs	2	0	3	2
Non-CEOs	4	2	6	3

Table 4.1: Number of Board Seats per Director over Career

Seventeen of the thirty-five directors reported having experienced some sort of shareholder activism during their careers as directors (*Table 4.2*). Several directors reported having experienced more than one activist event resulting in an estimated twenty-nine *distinct* activist events reported by respondents. Thus, while half of the respondents experienced *any* activism (17/35), *discreet* activist events as a percentage of total public board seats for these directors was only 25% (29/115). Out of these twenty-nine distinct activist events, boards acquiesced to shareholder demands roughly two-thirds of the time (18/29).

	Activism	No Activism	Total
No. of Respondents	17	18	35
No. of Public Board Seats	29 (25%)	86	115
Activism Success	18 (62%)		

Table 4.2: Directors' Experience of Activism

In contrast to the CEO respondents in the previous chapter, directors experienced substantially less activism – 25% – as compared to 71% for CEOs.[74] While the same expansive definition of activism was applied to both CEOs and directors, directors were simply far less likely to field the more routine and often collaborative input which CEOs

[74] The 25% of the total board seats that experienced activism is remarkably similar to survey results conducted by PricewaterhouseCoopers in 2014 that found that 29% of directors reported direct interactions with activists.

enjoyed. Obviously, if a shareholder has the attention – and trust – of the CEO and engages collaboratively with the CEO, there is no need to engage the board. Put differently, a shareholder engages the board either when engagement with the CEO breaks down or when the CEO is the very issue of concern to the shareholder. Thus, it seems reasonable to assert that shareholder engagements with boards represent a very different tenor than do typical engagements with CEOs.

While directors experienced substantially less activism than did CEOs, they acquiesced far more frequently – 62% – as compared to 25% for CEOs.[75] Again, this differential is consistent with the reality that directors, once a shareholder elevates their demand(s) to the board, confront actors who are far more insistent than those who are either satisfied with their interactions with the CEO, or if dissatisfied, do not present similar urgency and determination (i.e., they walk away). However, the thirty-five interviews with directors reveal that other factors may also be at work in shaping board responses to activist shareholders other than the sheer force of activists' wills. Specifically, I draw several inferences from director responses. First, the paucity of director interactions with shareholders leaves directors ill-prepared when circumstances demand that they actually dialogue with a shareholder or group of shareholders: CEOs are embedded with shareholders; directors are insulated from them. Second, stemming from these interactional deficits, directors lack sufficient knowledge of the firm that otherwise might enable them to more adeptly deflect activist complaints and criticisms. These knowledge deficits, however, principally stem from the normative requirement that *directors do not manage*, a norm that looks askance upon a director learning the details of a firm's operations, processes, and other facts that are distant from higher level strategies and goals.[76] These

[75] Again, the 62% of directors who reported acquiescing to shareholder demands is similar to the 63% (2013) and 73% (2014) success rates of shareholders launching proxy fights according to FactSet (as reported in the *WSJ* 1/1/15).

[76] There is no hard and fast distinction between what counts as an 'operational' matter and what counts as a 'strategic' one, though the former often involves matters of optimization and efficiency, such as sourcing the lowest cost inputs or optimizing headcount levels, while the latter will tend to focus on sustainable ways to achieve higher profitability. More abstractly, strategic goals typically reflect management's longer term objectives while operational issues address the optimal day-to-day matters necessary to meet the longer term goals. Still, there can be overlap. A restaurant's menu represents a firm's major strategic choices: the

knowledge deficits, however, are not only the consequence of interactional deficits and normative prohibitions; they are also the product of having too many commitments. Just as a standing CEO who also sits as a director on the board of an outside firm does not have the bandwidth to become totally immersed in all the details of the outside firm's processes and practices, neither does a director who concurrently sits on multiple boards. Third, the institutional culture of boards valorizes collegiality, deliberation, and consensus; these cultural values ill equip directors in confrontations with activists who often adopt no-holds-barred techniques. Lastly, and perhaps by virtue of the sum total effects from the foregoing, numerous directors cited the costs and distractions of resisting activists when explaining their acquiescence to activist demands.

Thus, while power differentials no doubt play an important role in explaining why activist investors "win" with such high frequency, I contend that directors' interactional deficits, knowledge deficits, overcommitment, and style of discourse are also critically important in understanding why boards acquiesce to activists so frequently. Of course, boards do not always acquiesce; however, when they resist, they do so at great cost with no guarantee of success. Directors' awareness of these costs likely reinforces the already accommodative dispositions of boards.

DIRECTOR INTERACTIONS WITH SHAREHOLDERS

In order to understand how directors experience and ultimately respond to activism, it will be helpful to give a fuller description of the normative framework which shapes the relationship between directors and shareholders. As a starting point, a look back at one

impression it is trying to imprint on customers through its the style and format, the niche it wants to dominate as reflected in its cuisine and food selections, etc. The menu can also reflect operational choices: breakfast cutoff at 10:30 is more optimal than at 11:00, or that fettuccini alfredo should be promoted on Tuesday evenings. At the board level, directors likely understand operational matters only at the most summary levels: they may understand the multiple products that result from 'cracking' ethylene, but likely do not understand the operational ramifications nor the optimization expertise in targeting a specific array of outputs using the least volume of inputs. Such operational issues, however, will be subordinate to strategic decisions, such as the goal of taking market share in PVC plastics at the expense of polyethylene products. As an example of higher level strategic decision making, by contrast, it will be the board's exclusive purview to decide, in the case of a multidivisional energy company, whether to even remain in the chemical business.

CEO respondent will help contrast the formal and the normative frameworks for corporate control. This CEO's company has an unorthodox governance structure: despite broad institutional ownership, there is only one voting shareholder, the founder. According to this firm's CEO, management and the board are sensitive to the risks of a single controlling shareholder trampling on the rights of minority shareholders, particularly shareholders with no voting rights. To offset these risks, management and the board pay particular attention to following widely sanctioned governance practices that reflect an adherence to the lines of authority and responsibility characteristic of the formal framework of corporate control:

> But you know, does he [the one voting shareholder] give direction? No. Does he – sometimes he will cross over and say something like that and I'll say, "Did you just direct me?" <inaudible 17:21> and it's true. I joke about it, but I work for the independent directors of the board. I don't work for him. In the end, all he can do is hire and fire directors, which is still a significant thing he can do, but he generally hasn't. Generally the board has managed that functionality pretty well on their own. (CEO18)

But as we saw in the previous chapter, no CEO (in a firm with more normal ownership structures where all shareholders have voting powers) would so blatantly discourage a powerful shareholder from providing input to management that might improve the prospects of the firm. And no director interviewed for this project would abide a CEO for adopting such an off-putting posture towards any legitimate shareholder. On the contrary, directors uniformly expected the CEO and the CEO's team to manage shareholder interactions and found the idea of director interaction with shareholders to be anathema:

> Q: To what extent do board members reach out to the larger investors?
>
> A: I'm the Lead Director at [a healthcare company], so there it does happen from time to time, but other than, you know, a person who's a Non-Executive Chair or Lead Director, the answer to that question should be never. It would be very inappropriate and as a CEO, I would actually never stand for that. (D14)

Despite the fact that directors are elected by and are accountable to shareholders, this director asserts that a regular director, i.e., one who is neither the Chair nor the Lead, should never interact with shareholders. This director's comments also suggest that boards still have some ways to go before attaining the strength and ascendancy advocated by corporate governance experts: "as a CEO, I would actually never stand for that" is curious language for a CEO to adopt towards those charged with monitoring, retaining, or possibly discharging him or her. And yet other directors echoed this deference to the CEO: "I think in most cases, if you have a CEO you trust to run the company, you're largely going to take his direction" (D23).

To a certain extent, this deference to the CEO specifically, and the persistence of the normative framework generally, seem to be vestiges of mid-century institutional arrangements whereby boards were literally handpicked by the CEO. For the typical boardroom in 1950, a mere 22% of directors were independent while corporate insiders represented 49% and directors with close ties to the firm represented another 26% (Gordon, 2007). In addition to the powerlessness of dispersed shareholders during these decades, this dependence of directors on the CEO was an equally critical component of "managerial capitalism." While much has changed over the past twenty years by virtue of the push for "good governance" reforms – in 2014, 84% of directors at S&P500 firms were independent, and at 58% of boards the CEO was the *sole* insider to sit on the board – the power of the CEO over many boards was still evident in the responses from interviewees ("Spencer Stuart Board Index" 2014). Perhaps the single most telling indicator of the persistence of CEO power, albeit in diminished form, is the ongoing presence of CEO duality whereby the CEO also holds the title of Chairman of the Board. In 2014, 53% of S&P500 boards had chairmen who were also the CEO, but as recently as 2004, this number was as high as 74%.

What is perhaps most interesting is that D14, in addition to extensive experience over a career on a dozen boards, brings a background of institutional money management,

has engaged in activism, and has been associated with a well-known activist.[77] To the extent that activists generally believe that boards need to be *better* in tune with their shareholders, D14's embrace of the normative framework (rather than the formal framework) which holds that shareholder engagement is *not* the bailiwick of the board seems contradictory and highlights the durability and inertia of this normative framework. D14 continued, this time from the vantage point of a director:

> I do not talk to the press on behalf of any board and neither do I talk to any investors on behalf of, you know, the company and if somebody on my board did and they know that I expressly prohibit that, it's part of our rules of conduct for an independent director, I'd be quite upset. (D14)

Again, D14 emphasizes that board interaction with shareholders is wholly unacceptable, but D14 further notes that it also violates the firm's "rules of conduct" highlighting the institutional character of this normative framework. There is, no doubt, a commonsense element to this prohibition – the CEO actually runs the business, is therefore most familiar with the operational and strategic details of the business, and is thus best positioned to communicate to the investment community how the business is faring. Still, despite the practicalities of this arrangement, the tone of D14's comments as well as that from other respondents belie a managerialist attitude that subordinates the board to CEO prerogatives.

Other directors confirmed D14's assertion that director interactions with shareholders, when they do occur, happen infrequently and only involve either the Chair or the Lead Director, and possibly the Chair of one of the board subcommittees, which these days is likely to be the Compensation Committee. Regular directors, those who neither hold the Chair, the Lead, nor any committee chairs, rarely have any interactions with investors:

> Q: How often, if at all, have you have had engagements with investors

[77] Six of the thirty-five respondents had investment backgrounds in endowment fund management and in private equity.

> in your capacity as a board member at the various firms you've been involved with.
>
> A: Really never…And several of the companies I've been involved with, the lead director has had some interaction with institutional investors but just as a, you know, journeyman director, I have not. (D1)

But even with respect to the Chair or Lead Director, shareholder engagement can be minimal: "Very rarely would a lead director interact with an institutional investor," according to D2. Another director with both investment management experience and extensive board experience – six public boards and one private board over this person's career, with experiences as Chair, Lead, and the Chair of subcommittees – similarly maintained that:

> I would find it odd that an institutional investor who made a demand would solicit a response or would get a response from a chairman or a lead director on the board. I would find that unusual. And I've been on both sides…I had a money management firm myself for eighteen years. (D3)

Another director who held the dual positions of CEO and Chairperson of the Board, but also served as Chair of another firm's Compensation Committee, similarly observed that:

> I think in normal circumstances the lead director is not talking to institutional investors. I think that only happens when you get into a troubled situation. So, for example none of my board members at [company name] have ever met any of our institutional investors, however, the CFO and I are both known by name and face to our top ten shareholders who own over half the company. (D4)

D4's observation is consistent with what we learned about extensive CEO engagement from the previous chapter and also with what other directors have observed about director engagement with shareholders. But even in a so-called "troubled situation," the board may still choose not to engage, as another director with a career experience of nine boards including being the Chair of one firm's Nominating and Governance Committee explains:

> You're quite right that when there is quote engagement, it's usually the Chair or the maybe the Lead Director, if you will. But even then I've got boards that I serve on now and that I have served on where there's been no engagement with activist investors by any member of the board other than the CEO. So that is a pretty uncommon thing to have the board engaging with an act… with any investor, including an activist investor. (D7)

Not mentioned by D7 is that, while the board may not directly engage, it most likely, as we learned in the previous chapter, instructs the CEO as to what message to deliver to an activist under these circumstances. Regardless, that a board would choose to not directly engage even with an activist making their presence felt indicates just how averse many boards, including Chairs and Lead Directors, are to shareholder engagement.

Given what we *do* know of CEO interactions with their shareholders from the earlier chapter, we know what is *not* occurring between directors and shareholders by virtue of the absence of director-shareholder interactions. CEOs are not merely disseminating and clarifying information for their shareholders; they are also receiving substantial input which, if coming from knowledgeable and legitimate shareholders, can inform, influence, shape, modify or change managerial decisions. Because of the frequency of CEO-shareholder interactions, there is a level of trust that emerges between many CEOs and their large and knowledgeable shareholders that affords room for disagreement, for give-and-take, and for clarification. When activists do eventually confront directors and a firm's shareholders have to decide which side to take, directors have not laid the groundwork for trust through ongoing interactions with their large and knowledgeable shareholders on whose votes they may have to count. Perhaps the greatest benefit from CEO engagement with shareholders beyond the trust that emerges from such dialogue is "to hear what they've got to say before their thought turns into something that isn't real" (CEO22). In the absence of regular shareholder interactions, directors foreclose on such opportunities to disabuse shareholders of ideas that may be off the mark. And lastly, by having little to no shareholder engagement, directors deny themselves the informative discourse that CEOs

enjoy, a denial which results in knowledge deficits which conceivably hobble their ability to more adeptly rebut or deflect activist complaints and demands. In short, directors enjoy little if any social influence with their institutional shareholders, closing off an important source of power.

KNOWLEDGE DEFICITS

The assertion that directors suffer knowledge deficits would most likely be greeted as an affront by any director, and yet hardly any director would dispute the fact that a director's knowledge and understanding of the firm is limited and incomplete as compared to the CEO's thoroughgoing understanding of the firm. I describe this more limited knowledgeability as 'knowledge deficits' because, as I hope to argue, this more limited knowledgeability is not benign: 'knowledge deficits' place directors in a questionable position of dependency vis-à-vis CEOs; they reinforce the normative prohibition on routine director-shareholder interactions; and they disadvantage directors when they have no choice but to interact with sometimes more knowledgeable activist shareholders placing demands.

D14, the very experienced director with investment management experience, opined that:

> …it would be really weird if the Independent Director really understood everything that's going on in the business. That's the CEO's responsibility, to control information flow. (D14)

The normal expectation for directors is not that they should thoroughly understand the company they are overseeing; in fact, it would be abnormal and "weird". Boards hire CEOs to manage firms and look to the CEO to "really [understand] everything that's going on." And by virtue of the CEO's thoroughgoing knowledge of the firm, it stands to reason that they should be similarly charged with managing shareholder engagement, i.e., "to control the information flow." The tacit presumption which D14 makes, however, is that the only purpose of shareholder engagement is to disseminate information, but as we just recalled, CEOs thrive on what investors have to say and contribute. Thus, while a director may not

be in the optimal position to *disseminate* information like a CEO, a director could surely benefit, just like a CEO, from *listening* to what shareholders have to say.

In point of fact, directors *are* interested in what investors are thinking and have to say, but the existing normative framework, which discourages, if not precludes, director interactions with shareholders, relegates directors to the awkward position of depending upon management to mediate between shareholders and directors:

> Yes, and you know, it's kind of management's responsibility to keep us abreast of you know what is current discussion in and among you know our peer companies vis-à-vis investors, and to make us aware of that. You know, because directors are always you know very interested in, well what's the competition doing, what are your peers doing, and it would spill into, what are they hearing from investors. (D2)
>
> You know, if—if it's a huge amount of activity in the stock, I'd want to know that. If one of the largest say 10 shareholders was either buying a lot or selling a lot over a quarter, I'd want to know that. I'd want to know if management was, you know, trying to find out why. I am very interested in listening to the CFO and the CEO talk to me about how – what kind of questions or push back they're fielding on the analysts calls. It's more the flavor of when you are interacting directly with people who are following your stock. What's the sense you get? Are they happy? Are they not happy? (D16)

Both D2 and D16 express significant interest in shareholder sentiment, in what investors are saying, and in what sort of questions they are raising, but they depend on management to relay this information rather than obtaining it directly. Ironically, D16 appreciates the value of *direct* interaction with shareholders, but D16 is alluding to direct interaction between *management* and shareholders, not direct interaction between *directors* and shareholders. It is true that every CEO interviewed exercised an abundance of caution ensuring that they communicated any shareholder concerns to their board. Recall the CEO from the earlier chapter, who said:

> Now, if I met with any of our large shareholders and they would say to me something like, "Your cap ex budgets, cap ex plans are way, way out of line," well, I'd be on the phone right after that phone call, right after that meeting, with the Chairman of the board and probably the Chairman of the Finance Committee. (CEO10)

Similar comments were made by many CEOs as to keeping the board apprised of shareholder feedback. Nevertheless, this structural arrangement whereby the CEO acts as intermediary between the board and shareholders seems particularly fraught with hazards. Even in the benign case where management conveys thoroughly and truthfully what they hear from shareholders, everyone interprets the universe from their own vantage point and employs filters and heuristic devices to process the data they take in. Thus, the processed data that directors hear from their CEOs and CFOs may differ from the unprocessed data that they could obtain directly from shareholders. In less benign cases, CEOs have much at stake which might encourage them to more actively manage their board precisely through "control[ling] the information flow" (D14 quoted above). At the very least, depending for such critical information upon the very individuals whom they are tasked to monitor and evaluate seems a suboptimal arrangement for boards to effectively fulfill their duties of oversight.

At the root of directors' knowledge deficits is the fundamental principle of corporate governance: *directors do not manage*; CEOs do. This maxim does not necessarily preclude a director from gaining an in-depth, thorough, and detailed understanding of the firm he or she oversees. Within, however, the normative regime which holds sway over corporate governance and the delineations this regime makes between managerial and director duties and responsibilities, such a level of knowledge would be viewed suspiciously: "it would be really weird" as D14 observed earlier. Another director similarly believed that deep familiarity with the firm would be highly unusual. Relaying an experience with three newly seated directors who represented an activist investor, this director recounted an exchange with one of the three:

A: …one of the unusual comments made by one of those three board members is that "Surely we went to [name of consumer discretionary company] a hundred times a year." Well, I'm thinking, that's every three days [laughter]. So the answer is "No we don't." … But I mean, it was a little, it was a little "out there" comment. ... I don't go into a [name of industry] factory a hundred times a year. I don't go into a [name of company] store a hundred times a year. [laughter] That's all I'm trying to say, so…

Q: Was the implication that the board wasn't engaged with the firm? Where's your loyalty?

A: Yeah, not just loyalty, but I mean: how can you know what's going on if you don't go there a hundred times a year? So it was a little "out there" as a comment, and again, it was meant to…I gotcha…you know, what do you call it, a gotcha moment. Well, they got us, if you will. But it really showed more about one of them, one of the three who had come on our board as how much they didn't understand, number one, the responsibilities of board members, but number two, just what it takes to be engaged fully as a board member at [name of consumer discretionary company]. (D7)

While it is possible that the new director might have been speaking facetiously or exaggerating for effect, this was not D7's read on what the new director was suggesting; rather, D7 took in literal fashion the new director's comment on visiting the company's retail outlets "a hundred times a year." If we too take the new director's comment literally, then we might justifiably characterize the new director as arguing in favor of the principle that a director ought to be much more familiar with the firm they oversee than they in fact are. And indeed, this is how D7 interprets what the new director is saying – "how can you know what's going on if you don't go there a hundred times a year?" To D7, this is more than a novel idea from the fresh perspective of a new board member representing an activist shareholder; it's a bizarre idea – it's an ""out there" comment." D7 further underscores the discord between the new director's understanding of the role of a director and the normative view of a director's role which D7 embraces and defends by arguing that the new director understands neither the responsibilities of being a director nor what constitutes full engagement. The degree to which D7 views this outside perspective as

bizarre is a measure of how deeply entrenched is the normative view of board duties which limits directors' knowledgeability of the firms they oversee.

By delimiting what directors need to know, the normative construction of the maxim that *directors do not manage* sanctions directors for strictly focusing on higher level issues – CEO succession, appointments of auditors, divestitures, and the like – and thereby absolves them of any duty to delve deeper into the mechanics and processes of the firm. Aside from the normative prohibition of director-shareholder interactions, construed as encroaching on managerial duties and responsibilities, the normative prohibition on acquiring in-depth and detailed knowledge of firms can create a knowledge asymmetry between directors and highly informed shareholders. On the board of a different company in the telecommunications sector rather than the consumer discretionary sector, D7 had another encounter with an activist who had won a seat on their board:

> …he had a lot of ideas as to how the company could sort of rationalize the business as well as grow the top line…he came in with a lot of I'll call it 'alternative data' [laughter] to the data that we were made available to us. So he had his own people I guess scrub the data and without the benefit – presumably – without the benefit of our, the data provided to the board, or any kind of inside track, because, again, as a board member, he really wasn't able to share that with his staff. They came up with their own analysis of sort of where we are at this moment in time and where we should be going. *So he had mountains of data the rest of us did not have.* Now, I'm not saying his data was good, but I will say that it was 'alternative' [laughter]. I'll use that term. (D7, emphasis added)

D7 is bemused by the data the new activist director has brought to board meetings, and questions its legitimacy by calling it "alternative," by suggesting that it is not recognizable insofar as it is different with the data the board normally sees, and by pointedly not describing the data as "good." While we have no way of independently assessing the quality of the activist's data, it can be noted that the activist is both well-known and highly regarded, the co-founder of a firm the *Wall Street Journal* described as "one of the oldest and most successful activist-investment firms," making it unlikely that some crank has

generated bogus or otherwise illegitimate data about the firm and its competitive environment (10/1/14). What emerges, instead, is the sense of a knowledge asymmetry between a director – and most likely the entire board – and the activist who "had mountains of data," data which was not familiar to D7. Again, D7 observes:

> Sometimes I thought, well my goodness, he's got so much more data in front of him than we do, *it puts us at a disadvantage*, but I'm not altogether sure that the data he had was accurate, if you will, it was merely 'alternative'. (D7, emphasis added)

D7 acknowledges the information asymmetry between the board and the activist. While D7 again hedges on an estimation of the quality of the activist's data – "it was merely 'alternative'" – what is further noteworthy is the inability of the board to provide a deeper and more robust characterization of the data the activist was relying upon to push his agenda.[78] Were the metrics the activist was using wrong? Was the activist wrong in his assessment of market opportunities? To agree or disagree with the activist or to accept some perspectives but to reject others would all seem like reasonable responses to a major activist that has arrived on the board, but to remain agnostic – "…not altogether sure…",; "…merely 'alternative'"… – seems particularly incongruous in the context of an activist pushing for changes, although not altogether incongruous with institutional boardroom norms which sanction higher level strategic thinking and absolve directors of digging deep into the details of the workings of the firm.

The otherness of the activist's data also highlights boards' dependence on management for the data to which they actually have access. Boards can make requests to management for any information they deem necessary for fulfilling their duties to oversee and advise, but management ultimately has control over how information is generated,

[78] I make a leap in taking D7's comments and attributing them to the entire board here under the assumption that, had other directors expressed a higher opinion of and level of confidence in the activist's data, these views would have been voiced and that D7's comments would have reflected these assessments. There are, of course, reasons why this might not be the case, including less group solidarity than what D7 led me to believe existed on this board in which case other directors might *not* have publicly articulated, for whatever reasons, their more favorable views of the activist's data.

processed, and reported. Of course management is constrained by generally accepted accounting principles (GAAP), but GAAP does not perfectly circumscribe every accounting choice, affording management with varying degrees of discretion and latitude in reporting information to interested constituencies, including their boards (MacKenzie, 2009). The degree to which accounting choices are negotiated should not be overstated, however, especially after the enactment in 2002 of Sarbanes-Oxley which transferred the authority to hire and supervise outside auditor engagements from management to the board.[79]

Such asymmetric knowledge, moreover, makes routine director-shareholder interactions highly unlikely to occur in the first place in addition to the normative proscription of them occurring. This could explain why D14, described earlier, was so adamant that directors not speak to shareholders:

> …it can be very dicey to let directors start speaking because that means everyone's going to be pawing the records…To try and, you know, get another piece of information here and confirm, "Is that really what management meant? Is that really what's going on?" It's a very dangerous course. (D14)

D14 is not only concerned about the dissemination of "another piece of information," but is also concerned with the quality of the information insofar as it might differ from what management is communicating. While D14 may merely be making the cynical observation that directors, inexperienced as they are with shareholder communications, are not adept at spinning, filtering, and good storytelling, this director also is likely questioning whether

[79] A personal anecdote might prove illuminating here. As a financial analyst working at a manufacturing facility, I frequently received directives to "book additional accruals" during month-end reporting to Financial Planning and Analysis (FP&A) headquarters. This meant that I was to charge additional expenses because FP&A wanted to offset revenues that were coming in above plan. Such "smoothing" is ubiquitous, with General Electric the model of such behavior for many years. Importantly, senior finance people at FP&A all had spent tours of duty as controllers at one or more manufacturing facilities and thus were capable of discerning reasonable from unreasonable accruals from the field, such as from my own facility. The knowledge that FP&A possessed this expertise constrained the extent to which manufacturing sites would unilaterally engage in such behavior. This symmetrical knowledge relationship between FP&A and the field, and the power that therefore accrues to FP&A over the field, stands in contrast to the asymmetrical knowledge relationship between boards and management with obvious power implications.

directors know "really what's going on." In fact the latter is entirely consistent with what D14 said at the opening of this section –"it would be really weird if the Independent Director really understood everything that's going on in the business." And if a director does *not* understand everything, then it truly would be "dicey" for directors to routinely engage with shareholders. Most importantly and most relevant for the present analysis, if directors do not understand everything about the business, it would seem difficult to argue that such deficits would not be a serious disadvantage when they have no choice but to engage with an activist making demands or that such deficits play no role in the frequency with which boards concede to activist demands.

COMPOUNDING DIRECTORS' KNOWLEDGE DEFICITS

Not only might the maxim that *directors do not manage* absolve directors of the need to thoroughly understand the firms they oversee, giving them permission to cordon off the weightier, longer-term matters of concern, but this very arrangement has made it possible for directors to serve on multiple boards. In so doing, director knowledge deficits are reinforced:

> I've been on that board for 10 years. I don't know that company intimately; I can't. I mean, I have another job. You know, I know it enough to do the things I just discussed with you. I mean, I was one of the major pushers – we've got to get ourselves focused because I think focused companies do better than ones that have multiple interests. But, you know, the details of the [company's industrial] process, shit, I'm never going to know that, Bob. I don't need to. So, even diligent directors aren't going to know all the intimate details of a company. (D23)

This director was also included in the CEO sample of respondents and thus we know his[80] other "job" is CEO of another firm in the transportation sector. Despite the diligence, commitment, and conscientiousness of all the directors who participated in this study, there

[80] From the fact that this director was part of the group of CEO respondents, all of whom I have pointed out were male, we therefore already know that this director was male.

is no avoiding the part-time nature of holding a seat on a corporate board, as D23 himself points out: "most board members are showing up for board meetings, depending on the company, five to eight times a year." Given the "24x7" nature of most CEO positions, it is a wonder that a CEO's "day job" would permit *any* room at all for the additional time and energy, no matter how occasional, required for holding a board seat at another company. Indeed, most CEOs will not take on the commitment. Decomposing all respondents into those who were CEOs at the time of the interview and into those who were not reveals an interesting though not surprising difference between the two types of directors: current CEOs held half as many total board seats during their leadership careers as did directors who were not currently a CEO (*Table 4.1*). However, this more than likely still exaggerates the board activity of CEOs generally. Of the 19 directors from the sample of director respondents who were also a current CEO, 14 of these were culled from the sample of CEO respondents upon which the preceding chapter was based.[81] Looking at *that* sample of 34 CEOs from the previous chapter, 60% of them – the remaining 20 out of 34 – reported occupying *no* board seats outside of their own firm during their tenure as CEO. This is consistent with survey data from Spencer Stuart (2014) that found 54% of sitting CEOs of S&P500 companies did not hold any outside board positions. It would be reasonable to conclude, therefore, that the difference in the level of board activity between CEOs and non-CEOs is greater than the difference displayed earlier in *Table 4.1*.

Thus, D23 admits that he cannot "intimately" know the company on whose board he sits by virtue of how much his primary job as CEO of his other firm demands of him. Despite these constraints, D23 nevertheless feels he knows "enough" to justify his push to get the company to divest what he believes to be non-core assets, giving the rather anodyne justification that "focused companies do better than ones that have multiple interests."[82] It

[81] These 14 CEOs from the earlier chapter were not simply members of their own board – as every CEO is – but actually occupied a board seat on an unrelated firm.

[82] As it happens, the author spent four years in the chemical business. At the particular company I hired on with as a financial analyst, new recruits were placed at manufacturing facilities (aka, chemical plants) to learn what products were made by which processes. This "intimate" knowledge was considered critical for the analyst's future responsibilities in strategic decision-making. Admittedly, the precise content of D23's knowledge base is unknown, but it would seem that, in order to make decisions regarding the disposition of assets, "intimate" knowledge is precisely what would be required in an industry as complex as chemicals,

is an epistemological question beyond the scope of this work as to what one would actually need to know in order to make such weighty, impactful, strategic decisions. How "intimately" should a director – or an activist shareholder, for that matter – know a company before playing musical chairs with a firm's assets, both physical and human, that will have significant organizational, not to mention social and economic, consequences? The answer to this question given by neoliberal capitalism seems to be: not very. "Independence" is prized over "intimacy" which is increasingly reflected in thoroughly independent boards and a growing preference for new CEOs to be hired from outside the firm, since expert managerial skills are, presumably, also highly portable and can be deftly applied unhampered by "intimate" differences from one firm to the next (Huson, Parrino, and Starks 2001; Murphy and Zabojnik 2007).

D14 and D23 were not confining their views on limited director knowledgeability only to directors who had "day jobs" as CEOs, but to all independent directors. While non-CEO directors are, most likely, not as taxed on their time as are sitting CEOs, they do sit concurrently on 50% more boards than do CEOs. The demands from these additional boards can quickly add up to substantial time commitments which can impede deep familiarity with the companies they oversee. Given "the new demands for board work…I think it would be difficult to serve on more than two [boards]," D12 hypothesized. But *Figure 4.2* suggests a greater burden as the median concurrent board seats held by the 16 *non*-CEOs was 3.

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where a raw input such as ethylene, for example, can be "cracked" into a plethora of products for use in multiple end markets. The same skepticism might be voiced of Nelson Peltz of Trian, who, despite the fact that his expertise lay with retail and fast food, felt knowledgeable "enough" to pressure the chemical company DuPont to divest assets. We can further add that "downsize and distribute" is a classic example of isomorphic behavior promulgated by investment bankers always in need of deal-making opportunities and who therefore command the riverheads of business fads. Further, and most crucially, it is the essence of isomorphic behavior that alleviates actors of the burden of obtaining "intimate" knowledge.

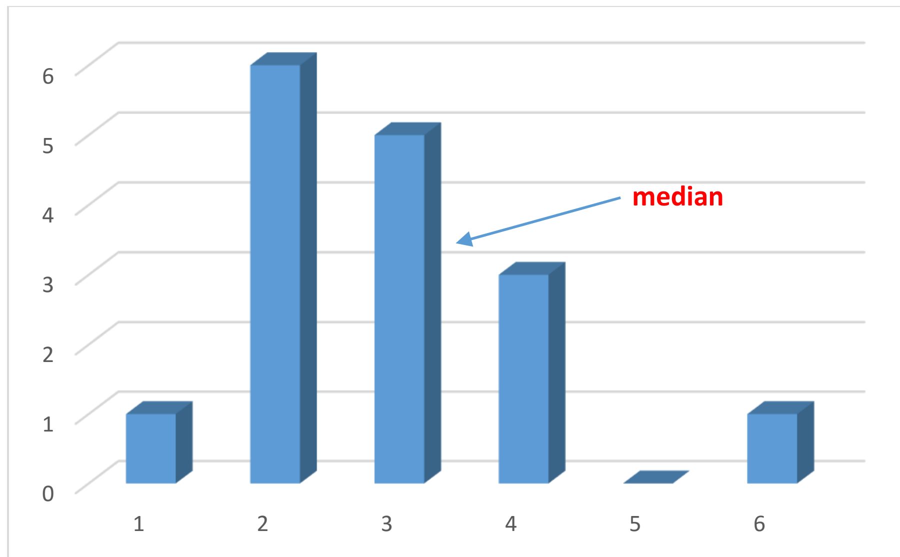

Figure 4.2: Concurrent Board Seats (Non-CEOs)

Despite the non-random sampling of director respondents and the small sample size, the characteristics of my sample of directors from the S&P1500 are remarkably close to those of S&P 500 directors as reported by the executive search firm Spencer Stuart in its *Spencer Stuart Board Index* (2014, *Table 4.3*). The *SSBI* reports that the average number of board seats held by a director is 2.1 which is spot on with the aggregate number reported in *Table 4.1* (i.e., for both *CEOs* and *non-CEOs* listed under *All*). This number from the *SSBI*, however, appears to include outside board seats held by CEOs as well as by non-CEOs. But, the *SSBI* also shows that the average number of outside board seats held by CEOs is only 0.6 and that 54% of CEOs held no outside board seats. Thus, the average number of board seats held only by *non-CEOs*, i.e., plain vanilla independent directors, if you will, must be considerably higher than the 2.1 number reported by Spencer Stuart and likely closer to, if not higher than, the median of 3 found in this study (*Figure 4.2*). While 3 concurrent board seats is significantly lower than the number of board seats held by directors ten or twenty years ago, the workload, expectations, and scrutiny of directors has increased substantially since Sarbanes-Oxley (2005) and Dodd-Frank (2008). It is very likely that, just like D23 and other CEO directors, diligent non-CEO directors cannot "intimately" know their companies because they remain overcommitted.

Median number of board meetings	7.0
Shareholder Interaction	11%-14%
Avg. number of board seats	2.1
Avg. number of other board seats for the CEO	0.6 (1.6 in 1999)
% of CEOs holding no outside board seats	54%

Table 4.3: S&P 500 Directors (*2014 Spencer Stuart Board Index)*

A director's overcommitment is particularly strained if one of the boards the director sits on is actually engaged in a proxy fight with an activist. One director confirmed the toll from entanglement with several hedge fund activists who, in one instance lobbied for board seats, and in a second were contesting management's compensation packages as the firm was emerging from bankruptcy:

> And, you know, if everybody [sic] ever told you that it's easy to be a board member, I can tell you in those specific cases in both these companies, you know, I ended up doing 40 meetings in two months, as we were in crisis. (D17)

As opposed to the median of seven meetings that a typical director will attend during the course of the year, D17 was compelled to devote nearly six-fold as much time across only two months, essentially exploding a part-time commitment into a full-time one. During the first confrontation, this director was sitting on two other boards, on one other board at the time of the second kerfuffle, and at the time of the interview, on four boards which implies approximately thirty meetings per year along with the necessary time for preparation. Can a director concurrently sitting on multiple boards have the bandwidth necessary for dealing with an activist sponsored proxy fight? Conversely, can a director engaged in a full blown proxy fight at a firm he/she oversees continue to provide an appropriate level of oversight

at the director's other boards? At the very least, it seems reasonable to surmise that a director enmeshed in an activist event and who is, consequently, that much more distracted from staying on top of the activities of the other firms on whose boards they sit, will suffer additional knowledge deficits. Moreover, it also seems likely that directors with multiple commitments will have a structural propensity to settle quickly with any activist making demands to avoid any breach of fiduciary duty at their other boards.

To summarize, directors have less knowledgeability of the firms they oversee relative to their CEOs and even to some shareholders. I have termed this 'knowledge deficits' in recognition of the potentially deleterious effects on directors reflected in CEO dependency and knowledge asymmetries with powerful shareholders. These knowledge deficits stem from the absence of any routine director-shareholder interactions and from the prohibition of directors engaging in any managerial related activities, which informs a normative prohibition on directors gaining deep and "intimate" knowledge of the firms they oversee. These deficits are compounded by directors' multiple commitments. CEO directors, i.e., CEOs who also sit on outside boards, suffer additional knowledge deficits by virtue of the demands associated with being the CEO of their primary company. Non-CEO directors see their knowledge deficits compounded too by virtue of being overextended in their board commitments. Ultimately, the knowledge asymmetries resulting from these knowledge deficits between directors and knowledgeable and insistent shareholder activists disadvantage directors when they must engage with such activists, and possibly contribute to the frequency with which boards make concessions to these activists.

INSTITUTIONAL CULTURE OF THE BOARD

The very culture of boards may also predispose directors towards reaching agreement with activists. While CEOs live in the rough and tumble environment of competition and parry with institutional investors and analysts who infrequently pull their punches, directors, in stark contrast, inhabit a world predicated on collegiality. Despite this

rather quaint, if not trite characterization of boards, one director described the difference between management and boards incisively:

> Everybody at the board is equal and so the question is: how do you get them to move in their beliefs? And I do – and I've always been a belief you don't treat every Director the same. You – it's based on that individual Director's makeup and so forth. I mean, you have to – you manage your Directors just like you would an executive team except as a CEO you have a lot more authority than you do as a Chairman of a board. As a CEO, you tell people what do to. As a – but when you're leading a board you – you really have to be a good listener. You have to provide a modicum of guidance, but I mean, you do have to be a good listener. (D8)

According to D8, CEOs have the advantage of being able to "tell people what do to." The CEO is the boss, the actor with no equal within the confines of the firm, the top of a hierarchy. This director is not saying that the CEO has more authority *over* the board; rather, D8 is observing that the level of authority a CEO commands *within* the management team is far greater than the level of authority a chairperson wields *within* the board. Ironically, over 40% of board members within S&P500 firms are either active or retired senior executives, as was D8; in addition, being an active or retired senior executive is the most common background of those who hold committee chairs (Spencer Stuart*,* 2014). Thus, despite the prevalence on boards of what we might call "Type A" personalities, that is, precisely those who bring substantial experience in "tell[ing] people what to do," these temperaments are subordinated to the institutional norm of collegiality that prevails in the boardroom.

One reason for this emphasis on equality (even if D8 is exaggerating the egalitarian character of boards) is the imperative for consensus on most boards. For example, if a board decides that it is time to remove a poorly performing CEO, a 7-to-5 vote on a twelve person board simply won't do. Regarding the dismissal of a CEO, D19, who has sat on five public boards and one private board and has held the positions of Chairperson of the Board, and has chaired several committees, remarked: "obviously the majority of the board believed

it appropriate and generally, you know, the board votes unanimously." Indeed, the most important task of any board is management succession, and most chairs will insist on a unanimous decision when removing a CEO, when selecting a new CEO, or for that matter, most any other critically important decision:

> I think typically you have on a board, you have some people that are more vocal and some people that are more sort of generally aggressive than others and I think typically the sort of the impetus to saying "we need a change" comes from one or two or three you know people, a subset of the board, and they voice that view to the whole board or sometimes to smaller groups and eventually to the whole board and usually there are a few people who are sort of comfortable with the status quo or they don't particularly like conflict or whatever it is and it takes a little while to sort of get them you know over the top, but eventually you reach a consensus and then *everybody* buys in at that point. That's sort of the pattern I've typically seen. (D1, emphasis added)

Despite the fact that some directors "are more sort of generally aggressive than others," D1, who has had four separate board experiences and has chaired a committee, observes that boards generally won't execute substantive decisions unless those in favor of a course of action can convince those unsure or reluctant to change their minds; the board only moves once "everybody" agrees with the decision. As group solidarity is prioritized over action, this consensus building can take time:

> A: I mean, I was involved in forcing a CEO change not long ago.
> Q: And what were those circumstances like?
> A: Those circumstances were reluctance on the part of certain board members to make a change that the other board members saw was extraordinarily obvious. The results of the company had been declining, the management had put forth plans that were, that were pitiful and expected to be incented to achieve poorer results actually.
> Q: How long did this situation persist?
> A: More than two years.
> Q: So what did it take to bring the other board members to your point of view?

> A: It took a couple of things. One is introducing them to a candidate to replace the existing CEO that was just so obvious to them that they were getting the short end of the stick on the guy now, that they relented. You know, it's very complicated. Sometimes you can lead a horse to water but you can't make him drink. (D5)

Even in a situation where a firm is suffering, the chair, or even a minority of directors, simply cannot act unilaterally in forcing change, but must build a consensus first, even if it takes two years, according to D5 who has sat on six boards, with experience as a COB, the chair of several committees, and also as a CEO. The length of time and the importance of consensus, which can go hand-in-hand, was echoed by D8 who had nearly identical past experiences as D5:

> Sometimes it takes a couple of years for a board to coalesce around an action on a CEO. I tend to believe that you don't – you don't make CEO decisions based on a vote. You wanna reach a position where all your Directors agree. You'll take a vote for legal purposes, but in reality, I tend to be of the belief that a board, on important decisions, should have consensus. Obviously, some people would be less enthusiastic than others because we're all bright people and they're all individuals, but they all realize that at the end of the day you got to come together and make a decision and sometimes it takes a little while to get to that point. (D8)

"To coalesce" and "to come together" capture the institutional character of boards: collegiality provides the foundation upon which boards make decisions and take action. It is obvious, however, that the timeframes implied by this normative framework which values deliberation and patience can be at fundamental odds with the timeframes of hedge fund activists and other impatient shareholders. More importantly, when boards do have to engage with activists making demands, they engage them in a manner consistent with the institutional dispositions displayed by boards: while directors may not necessarily feel collegial towards out-of-group actors making demands, they nevertheless interact non-combatively with the goal of reaching agreement, a posture consistent with the 60%-70% of activist events in which activists attained all or some of their goals.

The enactment of these norms of collegiality and consensus building are visible on boards that have either invited, or have been forced to accept, an activist onto the board, a situation already previewed by D7 above. Normally, new board members arrive as the result of a process that begins internally with potential candidate names generated by existing board members and shepherded by a board's Nominating and Governance Committee. It is a process that historically has sustained group solidarity. Introducing new members to boards who are or represent activist shareholders – who by definition have adopted a highly critical posture towards the firm and its board – can understandably threaten this institutionally critical group solidarity. Sometimes this group solidarity is preserved, sometimes it isn't:

> This investor had a – has been involved on a significant number of transactions over the years in different – in a group of companies that are all consumer businesses and now was venturing into a different type of company, not a consumer company, and especially early on used to bring up in our board meetings examples of why certain actions could be taken based on how they – how successful they were in his historical group of companies, right, that are really not necessarily even apples and oranges, but maybe like apples and bacon, you know, really different. And – and – and to some extent, at the beginning, that was a hindrance. But what I would say is he definitely made it his – made it a priority to, over time, it's been about over about a year now, to learn the business of the company, you know, attends every board meeting, always has read the materials, asks very – actively involved, asks a lot of questions – and I would say a year later has come to have some real respect for the management team for the initiatives that were in place before he joined the board and is – and he makes more thoughtful comments…and although he can sometimes get a little disruptive in the meetings, and by that I mean say things or ask for things that it's difficult to understand how they're – how that's adding value. But in general, I would say again, you know, he's kind of gotten socialized, if I can use that word, and it's not that anybody particularly loves him, but, you know, he's made it his business to learn quite a bit about the company and to make some thoughtful comments that are quite positively taken. That being said, one continues to know that his primary mission has been this break-up

> of the company that would cause, you know, the stock price to rise. (D15)

From the perspective of D15, the activist was initially perceived as a "hindrance" to the proper functioning of the board in that none of his input resonated for D15 as sound ideas. Whether or not this perception is an accurate representation of the poor quality of the activist's input, reflects an in-group's resistance to an interloper's novel but high quality ideas, or some combination of the two, is impossible to know. With time, the activist demonstrates his commitment to the group though his diligence, hard work, and display of "real respect" towards management, and the board reciprocates the activist's trust building efforts by recognizing the activist's "thoughtful comments that are quite positively taken." Nevertheless, group solidarity has not been fully restored because the activist is still viewed as an interloper by virtue of his ongoing commitment to the "break-up of the company." Perhaps more damning is that D15 perceives the activist as short-term oriented, only interested in getting "the stock price to rise."

D17 described a similar experience with an activist coming onto the board. In this case, rather than an addition to the board as occurred with D15, this director relates a surprising defeat of a fellow board member and the subsequent onboarding of the replacement:

> …so we had to go into the meeting the next day and guess what? The one member got voted off, the new guy got voted on and talk about like weird and then we all had to go and introduce ourselves to the new member. He then joined our board meeting. It was – and by the way, he ended up being, I thought, a pretty good guy and he worked his tail off over the next year to learn how to be a good board member. I actually think his intentions were decent. (D17)

The disruption of group solidarity here is palpable – "talk about weird." But again, similar to the activist which D15 experienced, this activist too gains acceptance – "he ended up being…a pretty good guy" – by the display of hard work – "he worked his tail off." Unfortunately, things later headed south at this board when a widely recognized, high

profile activist succeeded in placing his representative on the board. D17 was appalled at the conduct of the new board member:

> He would filibuster until you did it his way, or, until you were at a minimum exhausted… It was shocking to me. His just total lack of caring about the business, [customers][83]. (D17)

D17 attested to the enormous "responsibility of meeting your commitment to your [customer]," to the importance of sound policies and practices, and to what it took to be a market leader; however:

> You can be all of these things and tell that to the hedge fund guy and he'll laugh in your face. (D17)

To say that the new board member eschewed collegiality would be a gross understatement. This person would not seek consensus and, from the perspective of D17, demonstrated little respect not only for the company, but for the business in which the firm competed. With the group solidarity fraying beyond repair, D17 resigned. Shortly thereafter, five more board members resigned.

Thus, activists on boards throw into sharp relief the institutional importance of collegiality and consensus building, lubricants that sustain group solidarity which is essential for making board decisions and for taking board actions. Most directors serve lengthy terms which further underscores the necessity of group solidarity and collegiality.[84] As interlopers, activists are foreign bodies disturbing the homeostasis of the boardroom environment. By enacting collegiality through trust building and displays of mutual respect, original board members can try to restore group solidarity. But, while collegiality

[83] To be more specific here by using the words of the respondent rather than "customers" would risk disclosing the identity of the respondent.

[84] Examining S&P500 boards, the executive search firm Spencer Stuart observes that the average tenure is 8.4 years, and only 18% of boards have an average tenure of less than 5 years. This makes sense given that the most important task of the board is to hire and fire the CEO, and given that average CEO tenure is about 6 years, the tenure of directors ought to exceed that of CEOs if directors are to adequately fulfill this duty.

is the governing dynamic among directors, we see hints that this behavioral norm, perfectly suited to a group of like-minded, in-network, and long-tenured actors, may be maladaptive in the context of directors' interactions with activists on the board who typically serve for only two years (Gow, Shin, and Srinivasan 2014). Even in the example relayed by D15 in which the original directors and the activist gradually developed a modicum of mutual respect, the apparent triumph of collegiality is illusory as the activist remains intent on pushing his demand for a break-up of the company. The high-profile activist in the case of D17 does not even attempt any pretense of collegiality, openly flouting the norm through "filibustering" his fellow directors who, given their collegial dispositions, choose exit over confrontation. While impossible to quantify, it nevertheless seems plausible to suggest that the institutional culture of boards, which privileges collegiality, plays an important role in boards' propensity to acquiesce to demanding shareholders, rather than to confront and challenge them.

To sum up, I have acknowledged, in attempting to explain why boards acquiesce to activist demands roughly two-thirds of the time, that this frequency may reflect a combination of selection and survivorship biases: those shareholders who have either been satisfied with responses from the CEO or, if dissatisfied, have chosen to walk away, are not represented among the shareholders choosing to engage the board.[85] But I have also argued that other factors may be at play. Given the nearly total absence of any routine interactions between directors and shareholders, directors may simply not know *how* to interact with them; in contrast, CEOs regularly interact with their shareholders and have much practice in listening, explaining, considering, disagreeing, rebuffing, and sometimes agreeing. One critical byproduct of the routinized interactions between CEOs and shareholders is trust which proves critical when a firm inevitably hits rough patches: shareholders exhibit more patience when the CEO has been candid (in addition to competent). No such dynamics exist between an angry and frustrated shareholder and the

[85] Some shareholders who petition boards bypass management from the start. Such a tactic, however, can reasonably be construed as another form of demonstrating a heightened level of insistence and determination.

board, likely resulting in activists being even more insistent and in directors being severely constrained in their capacity to dialogue, persuade, and deflect, dynamics entirely consistent with activists gaining concessions from boards.

One explanation for the paucity of director-shareholder interactions is the fundamental law of the boardroom which proscribes directors from engaging in the management of the firm. While this "law" might unarguably prohibit directors from engaging in the budget process or in personnel matters or other patently managerial functions, engaging with shareholders would not seem to fall so unambiguously under the purview of the CEO and her team. And yet, even activist shareholders, the very actors who clamor for more board accountability, for more engagement with the firm, and for greater attentiveness to shareholders, see no ambiguity – once they hold board seats – in delegating shareholder interaction to the CEO. More than any other piece of evidence, the responses from such boardroom activists attest to the inertial force of this norm prohibiting routine director-shareholder interactions.

Another consequence of the dictum that *directors do not manage* is that directors' understanding and knowledge of the firms they oversee is compromised. I highlighted three avenues along which this dictum fosters directors' knowledge deficits. First, to dig deeply into how the firm functions and competes – not to manage, but to understand – would give the appearance of a director encroaching on management's sphere of responsibilities, or more simply, would seem "weird" as one director put it. Second, by having no routine interactions with shareholders, since shareholder communication is conceived of as a managerial function, directors miss out on the learning opportunities that CEOs enjoy from engaging in frequent dialogue with shareholders who offer CEOs a multitude of perspectives and points of view. The flipside of this opportunity cost from no shareholder engagement is the exposure to a single perspective and a single point of view – that of the CEO. Even when the CEO is relaying to the board what she "is hearing from investors," what directors are receiving – or not receiving – is information that has been already filtered and processed. Third, by occupying a median number of three board seats concurrently, a workload made possible, in part, because directors are not taxed by managerial

encumbrances, non-CEO directors – and CEO directors to be sure – have little bandwidth to dig deeply into the firms they oversee: "shit, I'm never going to know that, Bob!" The ultimate outcome arising from the proscription of directors from meddling in managerial spheres of responsibility is that directors might very well be disadvantaged when having to confront an activist shareholder from not having acquired "intimate" knowledge of how their firms are run, and being thusly disadvantaged, might have no other recourse than to acquiesce rather than push back.

The last factor I proposed to explain why boards acquiesce to activists with such frequency is the institutional culture of the boardroom which privileges collegiality. Unlike the power structure of a management team in which power is concentrated in the CEO, power is more dispersed in the boardroom with consensus prized over unilateral force. But this institutional disposition is ill-suited for confrontations with aggressive shareholders, evident not only when we see an activist assume a board seat, but also in the very frequency of board acquiescence to demanding shareholders: to compromise or concede is far more consistent with a collegial disposition than it is to reject or otherwise resist.

RESISTANCE IS FUTILE

Because of the hermetically sealed environment of the boardroom in which air is breathed only after having been filtered through the CEO, interactions between directors and shareholders that actually do occur are often not harbingers of happy times. As longtime corporate governance observer Nell Minow stated in an earlier *SSBI* report:

> When a company is having significant trouble, making a change on the board is going to be the first item on the shareholder wish list. They are not going to focus on secondary items, but will go right to where the money is, which is who is on the board and who gets to decide who is on the board. (*Spencer Stuart Board Index,* 2004)

This type of activism is the variety familiar to readers – the public and often hostile kind of activism. On those occasions when boards actually do resist, the consequences can be

onerous, regardless of the outcome. Recall some of the observations reported by CEO respondents from the earlier chapter who were also Chairmen of the Board:

> Well, you know, they do everything. I mean, they sue you, they…make your life miserable. I mean, it was miserable. It still is. You know, they cause you to be in a bunker, they cause your whole board, I mean…have two sets of lawyers at a compensation committee meeting. I mean…the whole of your environment gets acculturated to this kind of nonsense and you spend more time thinking about that…than you do about business…I would say we went from an environment in which our legal fees were…something like $10 million a year to where they're now $50 million a year and hasn't stopped…You know, morale of the…organization, loss of credibility amongst customers…as much as it is, you know, lost opportunities…I've seen companies going to a bunker mentality for years on end…a single lawsuit that these activists put out could take you two, three, four years to adjudicate. (CEO29)
>
> What I did is I took me, my CFO and my Chief Legal Officer and maybe two or three other internal people and some very expensive outside advisors and we're the ones that focused on the proxy contest. I told my other executives and the rest of the company, "You focus on running the company continuing to produce the great results we are, which is the best defense we have…" (CEO3/D23)

While these reports are coming from CEOs, both CEOs chair their boards and the actions they are implementing would not occur without board vetting and approval. What both CEOs highlight is that resistance to an activist can be extraordinarily time consuming, expensive, and demoralizing – in short, costly. In the case of CEO3/D23, the company still lost the proxy contest which monopolized the attention and energies of the senior management team for nine months.

While some directors related activist incidents in which the activist actually did walk away, this seemed to happen only when the stock price rose. Far more often, boards do not have the luxury of ignoring an activist:

> Well, you know, it's hard to tell them to go away. They don't typically go away. (D16)

> Honestly, I know Einhorn does a ton of work, but I mean, the truth is if you get caught in one of these nets as a company for whatever reason, it can be just so destructive. (D11)

The metaphor of the net is powerful and illuminating. It conveys the inextricability of a board's engagement with an activist, a board's lack of maneuverability, and the almost inevitable outcome of an activist achieving their goals. Additionally, the metaphor paints a picture of boards as helpless and powerless once entangled with an activist. Lastly, the metaphor suggests two rather obvious courses of action in dealing with activists. First, firms must avoid at all cost becoming the target of an activist and the best way to accomplish this is, in the words of CEO22 from the previous chapter: "I should be thinking like the activists all the time." If unsuccessful with the first course of action and a firm finds itself confronting an activist, then the second course of action implicit in the metaphor of the net is equally obvious: given the helplessness and powerlessness of boards under such circumstances, they should make concessions.

Several respondents noted occasions where, because directors were in possession of material, non-public information unavailable to an activist, they could not possibly implement some of the demands an activist was making, or perhaps were already pursuing some recommendations but could not disclose such a fact. In these infrequent instances where information asymmetries actually accrued to the favor of the board, directors nonetheless understood that, as D16 put it, activists "don't typically go away," and thus invited the activist to join the board:

> We looked at how we felt this shareholder would operate if not brought on the board and we felt that this sort of lobbying for in the court of public opinion… and not being fully – and this is key – and not being fully informed about the restrictions the company was operating under. Right? [It] was a very unhealthy situation and so we felt it was better to bring the shareholder on board so that that shareholder could become as informed as every other director about

> what were the limitations and restrictions of the company. And in doing so, we were betting that this shareholder, when as informed as the rest of us, would moderate his views as to which of the many actions he proposed were actually viable and that did happen. And that did happen. Some of the ideas that he had, once he had all of the information, he said, "Yeah, you're right. Those don't make sense, but I'm still really interested in you doing that." And we said, "Well, that's fine because we were already looking at that and let's just accelerate that process." We felt that up to a point some of his ideas could be implemented and, in fact, were very similar to a few ideas that management had already been working on. (D16)
>
> But we needed to be able to explain to him more fully why some of his proposals and some of his math and some of his underlying logic was inaccurate and to do that, we felt required, going into an area where we would be much happier if he were a director. (D15)

It is difficult to assess how frequently this sort of symbolic management occurs where a firm awards a board seat to an activist to effectively neutralize the activist, knowing full well that some demands, because of legal restrictions or for other reasons, are impossible to implement. But even in such situations, the board makes concessions – "let's accelerate that process" – and perhaps most importantly, the information asymmetry that the board enjoyed over the activist has been eliminated with the onboarding of the activist. Equally important, the board did not believe that completely rebuffing the activist was a viable course of action since the activist was likely to continue agitating "in the court of public opinion."

Indeed, with the knowledge of just how consuming and oftentimes futile resisting an hostile activist event can be in terms of time, resources, and morale, knowledge acquired either through personal experience or from seeing activist events play out around them, directors might be far more inclined to accommodate an activist making demands. In the following vignette, we do not get the sense of any resistance:

> Q When the activist made the demand for board seats, were you on the board at the time?

D I was on the board…and I … 'demand' is a word stronger than I might like. It was part of what [inaudible] you know they had a stake in the company, a large enough stake that they wanted two board seats, and teed up two folks from their organization for the board and it's worked fine.

Q So you wouldn't describe it as hostile or confrontational?

D I wouldn't describe it as hostile and I wouldn't describe it as confrontational, I don't think it was something that anybody was looking for, but I think to the credit of the CEO and the board it was managed and handled and to the credit of the investor. You know, sometimes you can have dialogue and it can actually be productive.

Q: One of the misgivings that I hear frequently articulated is that the activist comes with a certain level of hubris that they understand the company better than the company does itself or the company's board does. That's not what I'm hearing here. I get the impression that the activist was respected.

A: I don't know if respect is the right word; I think it was made…the activist understood the knowledge in what was at hand and in terms of the CEO, where the board was coming from, etc. and it was able to not be hostile. It wasn't something that was looked for but on the other hand it was managed like I said.

Q: So in your opinion the activist had credibility in terms of their request?

A: Like I said, the activist was managed and there was a resolution that could work for all sides. I didn't say "respect."

Q: Great.

A: And I was pretty clear about that. It was managed and it was managed in a way that could be calm…

Q: Right. The only thing I'm getting at and – we can move on – but the only thing I'm trying to get at is those situations where boards or management tell the investor to, you know, it's a free market, you know, if you don't like it you can sell your shares and move, versus engaging with the activist.

A: Well, there was a point where obviously it was felt that would be non-productive for a variety of reasons and therefore dialogue was created and the dialogue went in the other direction. (D6)

Ignoring or resisting the activist, according to D6, would have been "non-productive," suggesting that, despite the language of "managed" and "dialogue," there was an inevitability in the board agreeing to give the activist two board seats. In fact, consistent with the metaphor of the net given by D11, it would appear that this inevitability is the very

reason why the board accommodates the activist in a way that is "managed" and "calm." Awarding this activist two board seats was not "something that anybody was looking for," nor was the board accommodating the activist because they viewed the activist's contribution or input as critical to the success of the firm. On the contrary, D6 at first quibbles with whether or not the board "respected" the activist's knowledgeability, but then, upon mishearing my question, insists rather testily that "respect" is not the word D6 would use to describe the board's attitude towards the activist. In the face of an activist whom the board neither courted nor necessarily respected, D6's aversion of the terms "demand," "hostile," and "confrontational" and repeated insistence on how the situation was "managed" betrays a strained collegiality masking the fact that the board apparently had little choice but to accede to what the activist "wanted."[86]

If boards are frequently helpless and powerless once entangled in an activist's net, then the frequency with which boards acquiesce to activists' demands (or "wants") is simply a reflection of this power differential between boards and insistent shareholders. Resistance can be costly and often futile in large part because of shareholder power. Indeed, as discussed in the *Introduction* and in the earlier chapters, shareholders have acquired substantially more power over firms in which they invest than they possessed a quarter century ago or even ten years ago. Declassified boards, "say-on-pay," relaxed rules governing shareholder communication amongst themselves, more favorable proxy access rules – shareholders have new levers with which to exert and magnify their power. But boards not only do not counter these widening power differentials, they exacerbate them by virtue of path-dependent normative arrangements based on the principle that *boards do not manage*. Thus, boards' increasing power disadvantages vis-à-vis legitimate and insistent shareholders worsen because of directors' interactional and knowledge deficits, deficits which directly arise from seemingly anachronistic normative arrangements.

[86] The author is unaware of evidence on the effects on board size from activists gaining a board seat(s). Unless the activist is specifically negotiating for the removal of a suspected underperforming director, the activist's addition to the board likely represents an expansion of the board. While it is in the interest of the firm to let board size increase, thereby diluting the voting power of the newly seated activist director, boards are also cognizant of what constitutes an optimal board size and thus, even if no sitting directors are the target of investors' displeasure, may nevertheless encourage a director(s) close to retirement to exit.

Normative and cultural arrangements eventually do change when the underlying social and economic structures that once supported them change (Yu 2009). As a result of Sarbanes-Oxley (2002), the knowledge and skillsets of many directors have been substantially upgraded as boards must demonstrate that capable and experienced individuals chair audit committees and compensation committees. Because negative "say-on-pay" votes, though non-binding, nevertheless place enormous pressures on boards to respond, more and more chairs of compensation committees are meeting in a routine fashion with their large shareholders to walk them through their executive compensation discussion and analysis disclosures (CD&A, a mandated SEC disclosure since 2006). One director interviewed for this study pointed to a director at JPMorgan as an example of director-shareholder interaction:

> I think JP Morgan Chase has a director who actually goes out and meets with large clients, meets with investors all the time. I think that's a very unique situation. (D2)

Although this still represents the exception rather than the rule, as D2 opines, it nevertheless represents a rupture with a normative framework in place for decades that strongly discourages such interaction. The proximate impetus for this rupture most likely has been the growing demand from shareholders that JPMorgan eliminate Jamie Dimon's dual position as CEO and Chairman of the Board. More generally, the motivation for this governance innovation is pragmatic: early adopters who innovate do so to address some problem in order to improve firm performance (P. J. DiMaggio and Powell 1983). Thus, beyond the immediate goal of defending Dimon's dual positions, such an action by JPMorgan's board reflects an awareness that social interaction between boards and legitimate shareholders, focusing on relationship and trust building, carries tremendous potential for reducing power differentials between boards and shareholders. Directors pursuing shareholder interaction would acquire an understanding of what shareholders are thinking, unmediated by the firm's CEO. Additionally, the pursuit of shareholder

interaction would in and of itself serve as an impetus for directors to understand their firms more thoroughly in order to be credible interlocutors. In these ways, the pursuit of shareholder interaction would likely also address the knowledge deficits that exacerbate boards' power disadvantages relative to shareholders. Given JPMorgan's high status among multinational banks, others are likely to adopt this new practice in mimetic fashion, further dislodging the normative prohibition on director-shareholder interactions.

Given that 13 out of the 29 activist events reported by the directors interviewed for this project were conducted by hedge funds (not tabulated), one might be legitimately skeptical of the efficacy of increased board-shareholder interactions if directors were to pursue such engagement with hostile hedge funds. Indeed, given that dedicated hostile activists invest only at the point when they believe that they can drive a higher share price by focusing on some specific issue, opportunities for such interactions do not even exist. Nevertheless, pursuing director-shareholder interactions with *preferred* shareholders – those which are large, knowledgeable, and longer-term oriented – would likely be enormously beneficial for the reasons already described, including the possibility for these relationships to counterbalance the power of hostile activists if and when they appear.

At the time of these interviews, however, regular and on-going board-shareholder interactions remained the exception rather than the rule and seemed to be confined to explaining and defending executive compensation plans within the new regime of "say-on-pay." Additional catalysts for such a transformation, however, are emerging. Earlier this year, industry behemoths Blackrock and Vanguard, the number one and number three largest institutional investors respectively with combined assets under management of more than $7 trillion, have communicated with the companies they invest in, urging them to pursue regular director-shareholder interactions (Grind and Lublin 2015). In February of 2014, the Shareholder-Director Exchange (SDX), a working group of independent directors from large public companies as well as large institutional investors, issued their SDX Protocol that describes when board-shareholder engagement makes sense and provides guidance on how to conduct such interactions. Institutional investors within SDX have broadcast this Protocol to the largest 1000 U.S. public companies. In March of 2014,

the Conference Board Governance Center also weighed in on the issue of board-shareholder engagement by promulgating its own set of recommendations (Nili 2015).

It will be extraordinarily interesting to watch the evolution of the normative framework that governs the behavior of directors and their relationships with shareholders. In addition to the above catalysts for change – including the actions of industry exemplars such as JPMorgan, prominent investors such as BlackRock and Vanguard, and leading institutional actors such as the SDX and the Conference Board – widening power differentials between the two sets of actors arising from future legal and regulatory changes that continue to favor shareholders over boards, together with an increasing frequency of hostile hedge fund activism, will likely advance the transformation of this normative framework at a quicker pace.

Chapter 5: *Conclusion*

This study has examined the struggle among hedge funds, CEOs, and directors over the control of capital at public corporations through the lens of hedge fund activism. Before the 1970s, CEOs exercised managerial prerogatives largely unimpeded by dispersed shareholders, an autonomy captured by the concept of the separation of ownership and control. As investment capital became reconcentrated in the hands of institutional investors, they became more powerful, enabling them to assert their views on underperforming firms and on those management teams and boards reluctant to recognize the primacy of shareholders. The revolutionary character of these initial breaches in the separation of ownership and control has become normalized, if not routinized, in the form of hedge fund activism. Since the dot-com induced stock market downturn of 2000-2002, hedge funds have enjoyed massive asset growth, the incidence of hedge fund activism has more than doubled, and the number of U.S. domiciled hedge funds dedicated to activism has climbed to several hundred.

In attempting to understand the competition over the control of capital in the context of the U.S. public corporation, this study has tried to answer a number of questions concerning how and why hedge funds engage in activism, both hostile and friendly, and how CEOs and boards respond to these insistent shareholders. The motivation for focusing on hedge funds rather on the broader class of institutional shareholders such as pension funds or mutual funds derives from the fact that, unlike virtually any other type of institutional investor, hedge funds are *unconstrained, lightly regulated, aggressive, pure capital allocators*, representing a sort of epicenter of capitalist action. Further motivating the focus on hedge funds is that their current prominence is a relatively new phenomenon: they did not figure prominently in Useem's work (1996) because they were minor players at the time, nor did they garner any attention in Kang and Sorensen's (1999) work on investor power; and for unknown reasons, Westphal does not accord hedge funds any attention in his multiple articles on the interactional dynamics between management and institutional investors (Westphal and Bednar, 2008; Westphal and Clement, 2008;

Westphal and Khanna, 2003; Westphal and Zajac, 1998; Westphal and Zajac, 2001; Zajac and Westphal, 2004).

Considerable attention has been given to the effects of hostile hedge fund activism on activist targets, with much of this research concluding that the effects are generally salutary (Bebchuk, Brav, and Jiang, 2013; Boyson and Mooradian, 2011; Brav et al., 2013; Brav et al., 2008; Clifford 2008; Klein and Zur, 2009). Some have challenged these positive evaluations, however, and thus a fair assessment of the literature in its entirety is that it paints a mixed picture (Coffee and Palia 2014; Gillan and Starks 2007; Greenwood and Schor 2009). This study has not tried to adjudicate the disagreement over these proximate effects; on the contrary, it questions the broader import of many of its mixed conclusions which rely in large part on market returns as the arbiter of success or failure of activism. This shareholder centric assessment of activism privileges capitalist accumulation over the wider social ramifications of hedge fund activism specifically and shareholder value ideology generally. This economistic approach to evaluating the merits of hedge fund activism is consistent with much of economic positivism that disembeds economic action from its social context, ignoring the fact that society and economic action are "densely intertwined" (Streeck 2011, 138). Indeed, the literature on financialization, by contrast, marshals substantial evidence that ties recurring financial crises, anemic economic growth, and widening inequality to an increasingly finance-centric economy, conclusions that could only be reached through a recognition of the interconnectedness of the economy with the state and wider society (Krippner 2011; Lin and Tomaskovic-Devey 2013; Tomaskovic-Devey and Lin 2011; Tomaskovic-Devey, Lin, and Meyers 2015).

Instead, this study examines what this research on hedge funds has overlooked: Why do hedge funds even pursue activism? In comparison to every other type of institutional investor, hedge funds have far more significant investment flexibility and have access to a far greater variety of investment tools and techniques. Also missing from this research is an examination of why and how managements and boards resist or acquiesce to activism. Despite these rather modest micro-analytic goals, the findings reveal that "investor capitalism" that first emerged in the 1980s has intensified to such a degree that

the notion of a separation of ownership and control is fast becoming a meaningless description of the relationship between the modern public corporation and its shareholders. To the extent that institutional shareholders contribute to the financialization of the economy, this increasingly aggressive investor capitalism epitomized by hostile hedge fund activists, which privileges shareholder primacy over other stakeholders and accumulation over wider social benefits, does not augur well for any diminution, let alone reversal, of the ill effects tied to financialization. In what follows, we will review the empirical findings from the earlier chapters together with their theoretical implications, and then conclude with some observations on responses to hedge fund power.

REVIEW OF FINDINGS

Hedge Funds

Conditions (Un)Favorable to Activism

To understand why some hedge funds choose to pursue activism, be it hostile or friendly, we observed that the choice is structured in part by the opportunities and constraints a hedge fund confronts including the asset class in which the manager invests and the strategy or strategies she executes. While hedge fund managers can 'short' stocks if they expect a stock's share price to decline, many managers practice so-called value investing and thus often invest in stocks with already depressed share prices, limiting, if not eliminating, the opportunity to short the stock. In such cases, a frustrated shareholder may opt to 'go active' rather than simply sell the shares. Most of the hedge fund respondents in this study practiced value investing, and of these, more than 75% pursued some form of activism. We can appropriately refer to such managers as reluctant and occasional, rather than dedicated, activists. Interestingly, most of the few value managers who never pursued activism actually desired to do so but were limited by the small size of their funds.

Size is indeed a relevant factor in whether and how a fund pursues activism. Both hostile and friendly activism require sufficient financial resources in order to acquire meaningful shareholder positions in companies, and in the case of hostile activism, in order

to cover the legal expenses associated with filing Schedule 13Ds and with engaging in proxy contests. Given that most hedge funds are small, the resources available to such funds dictate that most activism occurs at smaller companies. The corollary is also true: behemoth hedge funds, those with more than $10 billion in AUM, can only pursue activism with very large companies.

Additional opportunities and constraints influencing whether hedge fund managers engage in activism also include the attitudes and expectations of a fund's underlying investors and the skillsets of the manager. Because of the time and expense required to launch an activist engagement, a fund's underlying investors may object, preferring that their manager devote these resources to finding attractive, standard investment opportunities. Given the small number of underlying investors, a hedge fund manager cannot ignore their preferences as every manager hopes that her investors will invest in follow-on funds that a manager might launch. Similarly, an activist hedge fund manager will face very irate investors if he suddenly abandons activist investing for another strategy. Like any human capital, a hedge fund manager's skillset is the product of prior experiences and formal training. Activism, like any other investment approach, requires unique skills and thus additional investments in time and effort, investments that may or may not be reasonable or practical for a manager given a set of already existing skillsets.

The proliferation of hedge funds may have devalued managers' skillsets, inducing some to take up activism. With many, many more hedge funds in existence today than twenty years ago, many formerly profitable investment strategies deliver subpar returns because many managers are pursuing similar strategies, with some managers even replicating the strategies of known successful managers. While this argument was made by just one respondent, the facts on the ground lend it credence. The explosion in the number of managers pursuing dedicated activism, now numbering more than 300 (Preqin, 2014), may very well be the result of profit opportunities from pursuing more traditional strategies having been thus competed away. With outstanding performance increasingly difficult to come by, it is difficult to stand out and attract assets, a difficulty which may contribute to the migration to dedicated activism. With assets flooding into activist funds at an annual

growth rate of 25% since 2010 (Turner 2015), and with activists' target share prices jumping at the mere announcement of the arrival of an activist investor, formerly non-activist hedge funds are likely to see the profit opportunities in dedicated activism worth the investments in the necessary skillsets and legal support appropriate to the strategy.

This proliferation of hedge funds dedicated to hostile activism, however, risks creating havoc within public corporations. In order to satisfy the implied promises to underlying investors, these now numerous activist funds must extract higher share prices from their target firms by pressing companies to restructure, to become more 'efficient', to divest pieces of the business, to increase share buybacks, to adopt varying corporate governance measures, to reconfigure capital structures, to alter growth strategies and focus, and to enact other measures. In addition to the increased likelihood of companies having to contend with an activist due to this proliferation of activist funds, companies are having to contend with *multiple* activist campaigns, where when one campaign concludes, a different hedge fund launches yet another campaign focusing on a different issue. With data from FactSet, the *Wall Street Journal* reported that 39 companies faced multiple activist campaigns in 2014, up from 20 in 2011 (Hoffman 2015). As dedicated activism proliferates, therefore, the risk rises that this crowded field of hostile activists proposes solutions in search of problems, an absurd denouement to the evolving evisceration of the separation of ownership and control.

While a predominantly economic calculus is clearly behind this growth in dedicated activism, many respondents pointed to the critical role of dispositions, a decidedly non-economic determinant of whether or not to pursue activism. A manager's temperament was a surprisingly important factor among respondents in determining not only whether they engaged in activism at all, but also whether this activism was friendly or hostile. Some respondents appeared to revel in the confrontational character of hostile activism and expressed passion for attacking a management's or board's shortcomings, and such emotions appeared to be a critical animating force in these managers' choice in pursuing activism. Others were markedly averse to confrontation, instead finding satisfaction in nurturing collaborative relationships with target managements. Highlighting the emotional

dimensions of investment decisions hardly precludes rationality playing a role in such decisions, but does serve to draw out, in a manner consistent with findings in both behavioral economics and economic sociology, the complexities of such decisions not captured by a purely calculative perspective (Ariely 2008; P. DiMaggio 2002; Kahneman and Tversky 1979; Shiller 2000; Zelizer 2011).

Legitimacy

Legitimacy emerged from the interviews as a critically salient concept. Hostile shareholder activism ultimately depends on support from other institutional shareholders, and friendly activism requires the assent of management. For either to succeed, both must appear to be acting legitimately by their respective audiences. Shareholder value ideology is foundational: in its absence, shareholders would have to compete with other stakeholders in asserting the greater legitimacy of their recommendations to or complaints against management over those which other stakeholders might make; given shareholder primacy, management's placing *any* other interests ahead of those of shareholders is sufficient grounds to legitimately challenge management, especially since shareholders 'own' the firm. Not surprisingly, legitimacy exists on a sliding scale with greater legitimacy accorded to those with greater ownership positions in a firm's shares. Sociologists have long been critical of shareholder value ideology, but one elision overlooked in these criticisms is that institutional shareholders' appeal to the presumed moral authority of 'ownership' is in the vast majority of instances groundless: they cannot possibly be owners when they are simply acting as stewards of capital that belongs to others, the actual owners, who have no voice in how firms are run.[87]

In addition to pointing to shareholder value to legitimate hedge fund activism, respondents who practiced or supported *hostile* activism highlighted other ways of legitimating it, including: rejecting being labeled a short-term investor, or rejecting the stigma associated with short-term investing; asserting that problems afflicting a target firm

[87] I thank Professor Glass for this observation.

or management are obvious and thus uncontroversial; and portraying management and/or the board as illegitimate.

As we have seen throughout this study when CEOs and boards disparage short-term oriented hedge funds or when long-term value investors inveigh against short-term investors, the 'short-term' label is widely accepted as an indication that an economic actor is in certain respects illegitimate. No one would disagree that a CEO should be incented to manage her firm for the long-term, and actions which seem motivated by short-term gain are widely derided. The pejorative character of 'short-term' shows up in the language we use to distinguish between investors who display a 'trader's mentality' as compared to those who hold for the long-term, or equivalently, between 'traders' and 'investors', or between 'renters' and 'owners'. Critics of Wall Street, including many policy makers, will often accuse market participants of having a 'short-term' orientation and maintain that 'short-term' actions can jeopardize firms as well as the wider economy.

Despite this broad agreement on the connotations of 'short-term', the meaning of the term is murky and its usage contested, especially in the context of hedge fund activism. For example, the short duration of an activist's share ownership is distinct from the short-term or long-term nature of the activist's demands. If a hostile activist buys shares in order to push a company to initiate, increase, or accelerate share buybacks, and the company agrees, the share price will see an immediate improvement and the activist will likely then exit. Thus, the activist's holding period is short-term, and the effect of his actions on the share price has also occurred in the short-term.[88] The actual consequences of the action for the firm and for capital markets, however, can be favorable over the long-term. Optimistically, reducing cash on the balance sheet by "returning it to shareholders" will force the firm to exercise greater care and discipline in deploying what cash remains, reducing the possibility of squandering cash on low return projects or acquisitions, and will further enable institutional investors to reallocate this cash to higher return prospects. With such favorable long-term outcomes, labelling the share buybacks as indicative of short-

[88] While the share price improvement occurs in the short-term, research shows that the improvement persists over time (Bebchuk et al., 2013; Brav et al., 2013)

termism would be inaccurate. Less optimistically, however, lowering cash balances worsens a firm's debt ratios (especially if the firm actually borrows to fund the repurchases) and thus may place the firm in a precarious position in the event of an economic downturn when "cash is king" as banks retreat from extending credit. Buybacks may also reduce the ability of a firm to reinvest in the business or restrict the firm's ability to seize attractive opportunities that unexpectedly arise. Under this set of outcomes, the share buybacks would appear to be an example of short-term action.

Rather than a hostile activist with a short holding period pushing for share buybacks, it is also possible that a long-term holder, seeing cash build up on the balance sheet resulting from a dearth of attractive investment opportunities, urges the firm to initiate or accelerate share buybacks. Thus, it is possible that both short-term holders and long-term holders can advocate for identical actions to be taken by their target firms, actions which can have either short- and/or long-term consequences. What it seems to ultimately mean when using the phrase 'short-term' to express disapproval over some corporate action which an activist might demand is that the action has clear *immediate benefits* for the activist and for its shorter-term shareholders, but also has potentially *harmful long-term effects* for the firm and for its longer-term shareholders.

Since the future is shrouded in uncertainty, however, and is ultimately unknowable, the trustworthiness of the shareholder sponsoring some proposal now enters the assessment of that proposal, thereby linking the sponsor's holding period to an estimation of the proposal's effects on the firm. Thus, even though, as we just observed, either a short-term holder or a long-term holder could recommend to a target firm that it pursue share buybacks, other shareholders are more likely to trust a long-term shareholder who presses a firm to take a certain action: the sponsoring shareholder is likely to experience the long-term effects of that action and thus is far less likely to advocate for an action that has immediate benefits but harms the firm in the long run since, in doing so, he would harm himself. By contrast, other shareholders will place less trust in a short-term holder advancing an identical demand since the short-term shareholder will not likely be a share owner when the future consequences from executing the proposed action reveal themselves

and so will not personally experience these consequences, whether good or bad. To borrow the idiomatic usage of HF15, long-term investors have more "skin in the game" than do short-term investors. Again, that trust is relevant derives from the fact that the future is unknowable. Sophisticated investors, when deciding whether or not to support an activist, will of course rigorously test the merits of the activist's demand by adjusting their stock valuation models to reflect the changes being proposed, but since any model is highly sensitive to slight alterations in assumptions and forecasts of the unknowable future, trust becomes a salient factor for even quantitatively inclined investors in determining whether or not to support an activist. Thus, delegitimizing hedge fund investors by labelling *them* "short-term" rather than focusing on their *actions* exploits this trust differential.

All of the hedge fund respondents, while sometimes employing language that questioned the legitimacy of short-term investing, defended an investor's *right* to engage in it. Others rejected the moral overtones of the short-term/long-term distinction, simply insisting that short-term investing is just one approach among many. The more interesting and revealing rejection of the short-term/long-term distinction was theoretically based and can be illustrated with an activist pushing for the sale of an underperforming company, a demand that Carl Icahn has frequently made. Putting a firm up for sale is generally seen as a short-term action for an underperforming company. Rather than making an attempt to turn things around by making new investments, reorganizing leadership, or reengineering operations – i.e., attempts that are costly, take time, and have uncertain outcomes – the firm's existence as an independent entity is brought to an end. Shareholders cheer because the stock price enjoys a quick appreciation, and critics cry "short-termism" because there is no longer a long-term future as an independent entity. The theoretical defense hangs on the faith (mis)placed in capital asset pricing models which manufacture an atemporal world of comparable asset prices. Specifically, the depressed price of the target firm, *before* the activist shows up pressing for the sale, already reflects the firm's lackluster future profit opportunities. This price can be compared to the higher price the firm will fetch when selling itself. In this line of reasoning, there is no short-term solution opposite a long-term solution; there are simply two capital allocation choices, one clearly superior to the other

as reflected in the higher share price from selling the firm as compared to the lower share price of the firm as an ongoing independent entity.

Another reason why identifying an action that is 'short-term' is so difficult is that its understanding depends on a subject's investment horizon, thereby making it a relative concept. Different investors have different investment horizons. A mid-career employee saving for retirement may have an investment horizon of thirty years, while a floor trader at one of the exchanges may have one of only a few minutes. Most importantly, as CEO15 contended, the investment horizons of virtually all investors are fundamentally shorter than the investment horizons which confront firms. Even among firms, investment horizons will differ as a function of the industry a firm competes in, often reflected in the duration of product cycles. Despite the elusiveness of a reliable way for identifying short-termism – i.e., actions that are near-term beneficial but longer-term harmful to organizations and their shareholders – the term retains considerable pejorative force, requiring hedge fund activists to defend themselves against the accusation of short-termism lest they appear illegitimate.

Beyond deflecting the short-term label, hedge fund activists sought to preserve their legitimacy by describing their demands as simply attempts at addressing obvious problems with obvious solutions, a defense which we saw can quickly run out of road. A more effective technique, however, was to enhance their own legitimacy by highlighting the illegitimacy of their targets. They accomplished this by pointing to insufficient stock ownership by management and/or the board, by accusing CEOs of engaging in empire building, and by identifying CEOs who they believed were fostering a culture of cronyism. Here again, as was the case with the role of dispositions in deciding whether or not to engage in activism, an emotive element was present when respondents delegitimized activists, evident when they sometimes expressed a moral outrage directed at what they perceived as egregious managerial conduct such as the foregoing sins.

Criticizing CEOs for not owning enough shares in the company stock was common among respondents. It is here, however, that institutional shareholders' hubris, if not narcissism, regarding 'ownership' reveals itself. Alignment with shareholders through significant share ownership by CEOs and directors is orthodoxy among institutional

shareholders and corporate governance experts, and hedge fund respondents similarly pointed to low CEO share ownership to delegitimize CEO targets, thereby legitimizing their own activism and, going so far as to claim that, by virtue of their own higher share ownership, they had a greater "vested interest" and more "skin in the game" than such CEOs. Hedge fund activists taking this moral high ground vis-à-vis seemingly recalcitrant, poorly aligned CEOs who display insufficient share ownership conveniently ignore the fact that a hedge fund manager can remove his skin *from* the game by the close of trading on any given market day simply by selling his shares. CEOs and directors, by contrast, still have to show up for work the next day, a commitment that likely spans many years.[89] Further belying the equivalency institutional shareholders draw between share ownership and true 'ownership' of the firm is their distrust of founder CEOs and other such insiders with *substantial* share ownership: rather than applauding such insiders for their 'alignment' with shareholders, they are just as likely to accuse such CEOs of entrenchment (Griffith, 1999; Griffith *et al*., 2002; Morck *et al*., 1988; Nelson, 2003).

There are numerous other reasons to be highly suspect of institutional investors' faith in the aligning powers of high share ownership by management. The so-called 'alignment' requires that there be an actual link between a firm's share price and the effort and ingenuity of its CEO, yet this link is questionable given the many factors other than CEO effort and ingenuity which can affect share prices, including the distortions to share prices resulting from financial engineering and obvious instances of glaring market inefficiencies resulting in asset bubbles.[90] Chief among these factors, however, is a fact that every institutional money manager is well aware of – a firm's stock price is extraordinarily correlated with wider market movements. No matter. For the purposes of delegitimizing target CEOs, just as with the concept of short-termism, the nuances and complexities of CEO share ownership – whether 'alignment' even makes sense, whether high managerial share ownership is a reasonable expectation, or what the optimal level of

[89] This point of view on "vested interest" also betrays the market conceit that commitment is a purely monetary phenomenon, and similarly, that the only meaningful incentives to action are monetary ones.
[90] The insistence that CEOs own shares is predicated on this link: if CEOs want to be richly rewarded, they need to manage astutely in order to increase their firm's share price.

ownership actually is – are less important than exploiting the pejorative force associated with the indictment of "low share ownership."

The emotive element present in the process of legitimizing or delegitimizing action and actors is essential because, rather than making private buy/sell decisions based on synthesizing considerable information, on running models and calculations, on assigning probabilities to alternative scenarios, hostile hedge fund activism involves collective action. While it is true that emotions are present in private buy/sell decisions, these seem to be qualitatively different from the emotions expressed in public and hostile activism. Rather than fear, greed, and euphoria that might be present when an investor sits in front of their computer screen ready to enter a trade, we see anger, disdain, and shaming when a hostile activist is delegitimizing a target's management or board. These emotions are further intended to cast the activist as legitimate, and perhaps most importantly, to resonate with the emotions of an audience.

The fact that hostile hedge fund activists must appear legitimate *to other shareholders* highlights a paradox of hostile activism. Hedge fund managers, as I have said elsewhere, are *unconstrained, lightly regulated, aggressive, pure capital allocators*, representing a distilled form of capitalist action within markets. But, as Preda observes: "Marketplace transactions are ultimately individualistic and different from forms of action which aim at attaining a common goal" (2009, 7). Reliance on collective action, therefore, by hostile activists and any other institutional shareholder activists, cannot but imply a certain negation of the efficacy of marketplace transactions. Activists are adopting tactics and techniques more similar to social movement protesters than to atomized rational economic actors acting anonymously within the boundaries of established capital markets. The evisceration of the separation of ownership and control, resulting not from marketplace transactions but (in part) from the collective action of hedge fund activists, would seem therefore to have profound consequences for how we conceive of securities markets, for how their function changes, and for the linkages between market-setting pricing mechanisms and firm behavior. Indeed, the fact that the mere announcement of activism at a firm is enough to cause a spike in its share price is but one example of how activism

affects market pricing mechanisms. The equity markets no longer just assign prices to firms; they also price activists.

The increasing frequency of hedge fund activism is hardly a declaration of victory for proponents of so-called shareholder alignment. Linking CEO pay to a firm's stock price was supposed to alleviate if not eliminate the principal-agent dilemma arising from the separation of ownership and control. The current and increasing level of hedge fund activism would appear to imply that this effort to align CEO's interests with those of shareholders has been an abject failure. In fact, hedge fund activism can be seen as an alternative solution to principal-agent conflict by simply breaching the barrier between management and shareholders that gives rise to the problem in the first place. The high and growing incidence of hedge fund activism strongly suggests that alignment is a dead letter, a conclusion that points to jettisoning equity-linked CEO pay.

Social Influence

Kang and Sorensen (1999) identified social influence arising from repeated interactions of a shareholder with management as a source of shareholder power. While this captures the character of the relationship between a friendly hedge fund activist and management, it does not accurately describe the behavior of a dedicated hedge fund activist. Dedicated activists who invest solely to pressure management to pursue some preferred course of action clearly have not been longer-term shareholders cultivating a relationship with management through repeated interactions. The fact that dedicated activists are also hostile further emphasizes the salience of coercion rather than influence over their targets. Instead, hostile activists exercise social influence not over target firms but over other institutional shareholders whose support is necessary should an activist engagement proceed to a proxy contest. While hedge fund activists have been known to operate in groups to pressure target firms, none of the respondents in this study attested to having done so (Coffee and Palia 2014). Instead, the mechanism for exercising social influence over other shareholders was the filing of the Schedule 13D, widely perceived as indicating the intent of a shareholder to pressure a target firm on some issue. Indeed, some

respondents even admitted to exploiting this perception by filing the 13D despite having no intention of pursuing an activist agenda with their target firm, using the filing instead to simply draw investor attention to what was typically an overlooked and underfollowed company. This sort of usage is an example of social influence through symbolic management. Given the importance of reputation, however, in exercising social influence over other investors, it seems unlikely that using the 13D symbolically would have any sort of sustained efficacy as observers would note the absence of any activist follow through, though such a hypothesis would require empirical confirmation.

While investor reputation and the use of 13Ds were important mechanisms for hostile hedge fund activists in exercising social influence over both targets and other institutional investors, some hedge fund managers eschew these avenues in order to preserve access to company managements. The revelation that some hedge funds outsource activism in order to *not* cultivate the reputation as a hostile activist, thereby preserving access to company management teams, was a surprising finding. These "shy investors" get to have their cake and eat it too: they retain the anonymity characteristic of marketplace transactions while enjoying the benefits accruing to the collective action conducted by other activists. While the emergence and extent of such a phenomenon requires further empirical investigation, especially with respect to how such a practice does not run afoul of SEC rules on group formation and disclosure, it seems self-evident that it is likely to contribute to the increase in the incidence of hedge fund activism as such referrals increase the information flow and monetary incentives to known activists.

Knowledge of the Firm

Perhaps the central issue regarding hedge fund activism is this: What makes them think they know better? Respondents revealed a number of ways by which they might command superior knowledge necessary for improving a firm's prospects as compared to insiders. Critically important is that the targets of the overwhelming majority of hostile hedge fund activist engagements are small companies whose management teams will, by definition, lack the broader and deeper experiences enjoyed by those at large corporations.

Also, with the average tenure of CEOs at about six years, many CEOs simply are not that experienced, and such inexperience is compounded if the CEO is an external hire or if the CEO is a relatively insulated founder. By contrast, many institutional investors, including hedge fund managers, may follow a given company for years, both when they own shares and even when they do not, accruing substantial knowledge of the firm by observing its public actions and studying its public reporting. At the extreme, an experienced hedge fund manager may have more institutional knowledge of a given firm than does its new, externally hired CEO. Even when confronting more seasoned CEOs, a number of hedge fund managers reported having had substantial managerial experiences of their own prior to taking up the hedge fund mantle, and for those who did not, they could easily hire such experience and expertise just as companies will often hire management consultants.

The knowledgeability of a hedge fund activist must also be compared to that of directors. In part because they must adhere to the norm that *directors do not manage*, and because they typically have more than one board commitment, directors' own knowledgeability is structurally inferior to management's. Also, just like CEOs of small firms, directors at small firms simply will not have the level of knowledge and experience that directors at large companies enjoy. All of these factors lower the knowledgeability bar for an activist in comparison to directors.

Most importantly, hedge fund activists, like all institutional shareholders, are full-time capital allocators as compared to management for whom the allocation of capital is a part-time exercise as well as one for which they have had limited experience. Moreover, the overwhelming majority of other issues that are of concern to activist investors, friendly or hostile, ultimately concern capital allocation, precisely where investors' expertise likely is superior to that of a firm's management. Respondents provided ample examples of managements allocating capital in suboptimal ways, either for want of expertise or from conflicts of interest. While many who insist on a more expansive view of the firm as organizations embedded in society as well as the economy, and who likely prefer stakeholder views of the firm over shareholder centric views, it must nevertheless be

conceded that poor capital allocation can inflict serious harm on firms and thus on all of its stakeholders.

If CEOs are indeed prone to suboptimal capital allocation decisions, certain structural elements surrounding the office of the CEO may help explain why. CEO compensation is central. As one observer[91] remarked: "If a CEO wants to make more money, he has to run a larger company." There is therefore, a structural propensity for CEOs to pursue acquisitions, which many in fact do, so long as they can avoid the charge of 'empire building'. This structural propensity to pursue acquisitions can easily subordinate optimal capital allocation to getting deals done. Critics of CEO compensation have highlighted the fact that stock options provide asymmetric rewards. If a CEO is successful and the firm's share price reflects this, her stock options will in turn be quite valuable; on the other hand, if a CEO fails to perform well, and the stock price does not rise, and perhaps even declines, then her stock options simply expire as worthless. In short, stock options provide marvelous upside rewards with no downside and thus may encourage CEOs to "roll the dice" by deploying capital suboptimally. Another structural element conducive to poor capital allocation is the shorter tenures of CEOs affording them narrow windows in which to make their mark. This too may encourage risk-taking rather than patience, the result again being suboptimal capital allocation decisions. One hedge fund manager empathetically observed (unreported) that the typical CEO doesn't have the luxury of waiting for compelling opportunities to present themselves and thus must force them to happen: time is not on their side and the opportunity set is small. Contrast this with an institutional investor who, if for no other reason than that their investable universe includes hundreds of companies, can afford to wait until something goes on sale. As compensation structures loom large in creating perverse incentives for CEOs to pursue suboptimal capital allocations, and hedge fund activists try to redress these frequently errant decisions by breaching the separation of ownership and control, it once again raises

[91] Professor Cunningham made this observation to me.

a question over the efficacy of the idea of aligning CEOs' interests with those of shareholders.

CEOs

Understanding of Ownership

A surprising finding was the tenor of CEOs' embrace of the shareholder value view of the firm. Sounding more Catholic than the Pope, CEOs referred to shareholders as "owners," described their jobs as "serving shareholders," and generally expressed remarkable deference to shareholders. While these attitudes may be part impression management, part learned behavior from countless utterances of the phrase "shareholder value" in earnings calls, at industry conferences, at company presentations on roadshows, and in letters to shareholders, and part an expression of utter fear and panic should their fealty be suspect, CEOs are all too aware of the transfer of power from firms to shareholders that have occurred over the past several decades. From the explosion in AUM at mutual funds and at other institutional funds and the subsequent creation of the Council of Institutional Investors, to the rise of powerful shareholder proxy advisory service firms, to regulatory changes such as Sarbanes-Oxley and Dodd-Frank, to more firms adopting declassified boards, majority voting, and easier proxy access rules – CEOs are fully cognizant that institutional shareholders simply enjoy more power today over the firms they invest in than at any time in the past.

While it appeared that CEOs were reflecting the internalization of the norms of shareholder value, the salience of shareholder power in shaping CEOs' attitudes towards shareholder primacy was evident in their disdain for certain classes of less powerful, marginal shareholders. Thus CEOs were dismissive of so-called corporate gadflies, individual investors who routinely lodge hundreds of shareholder proposals annually in corporate proxies. They were similarly dismissive of labor union sponsored shareholder activism, short-term investors, short-sellers, and hedge funds. This heterogeneity of shareholders, and the varying levels of respect they garner from CEOs, reveals a tension between the actual world of shareholders and the ideal, homogenous shareholder type

implied in shareholder value ideology. Indeed, that CEOs do not indiscriminately adopt a deferential posture towards just any kind of shareholder highlights the contingent manner in which they hue to shareholder value ideology: with knowledgeable and/or large shareholders, i.e., fully legitimate shareholders, CEOs do enact the normative behavior consistent with shareholder value ideology.

We should also be cautious in setting up a dichotomy between internalizing norms and behaving instrumentally. As DiMaggio and Powell point out, the mechanisms driving institutional isomorphic behavior and change can "intermingle in empirical setting" (2002, 150). Thus, firms that were early adopters of declassified boards likely did so in response to specific, coercive pressures from pension funds who leveraged the power of the proxy advisory service firms. Later, more firms adopted such board structures likely out of imitation, and still later, other boards did so because failure to declassify set one glaringly apart from what had become normative. But even when new normative frameworks are firmly established, such norms still require enforcement and thus coercive isomorphism can operate concurrently with normative isomorphism. Indeed, the fact that hostile hedge fund activism occurs concurrently with CEOs, as I have emphasized, being thoroughly embedded with institutional shareholders is an example of the intermingling of coercive, mimetic, and normative isomorphism.

CEO respondents' framework for assessing shareholder legitimacy was quite consistent with Kang and Sorensen's framework for shareholder power (1999). CEO's assigned higher legitimacy to shareholders with higher levels of formal authority, i.e., those owning a significant level of shares and who thus command significant voting power. They also saw as more legitimate those shareholders who demonstrated greater knowledgeability and expertise than less expert or less informed shareholders. And by preferring long-term shareholders over short-term ones, CEOs placed a premium on recurring interactions with patient shareholders, sources of shareholder social influence. Paradoxically, while Kang and Sorensen point to formal authority, expertise, and social influence as sources of *shareholder* power, these in fact become sources of *managerial* power when CEOs welcome friendly activists who possess these very characteristics but who are yet very

unlikely to opt for coercive force. Not only can the engagement with a friendly activist potentially improve firm performance from incorporating their unique perspectives and insights, but having a large, knowledgeable shareholder as an ally can possibly enable management to deflect unwelcome intrusions by hostile hedge fund activists, shareholders who *are* in fact powerful, but whose power derives from sources other than those which Kang and Sorensen identify.

While a friendly activist can enhance managerial power, and while a friendly activist is unlikely to exercise coercion, and while hostile activists enjoy greater power than friendly activists, all of this is not to suggest that friendly activists are powerless. Knowing that a firm can benefit from their presence, a friendly activist exercises their power prior to investing when they can still decide to withhold committing their dollars. They can also exercise their more limited power after an investment is made by using the threat of selling. The actual influence by friendly, constructive activists on their targets requires further empirical analysis, as does the number, size, and characteristics of such investors, as well as whether they have any effect on the occurrence of hostile activism in targets where they own sizeable share positions.

CEO respondents were surprisingly supportive of hostile activism – when it occurred elsewhere. This attitude seemed to contradict their negative opinions of hedge fund managers, who are themselves the sponsors of much activism. I accounted for this apparent contradiction by recalling the variety of hedge fund activists and arguing that CEO respondents perhaps had in mind *dedicated* hedge fund activists who are fundamentally short-term holders and thus negatively regarded, rather than the reluctant and *occasional* hedge fund activists who are likely longer-term holders who have lost patience with poorly performing firms, whom CEOs may hold in higher regard. But given that dedicated hedge fund activism is itself a sizeable portion of the activism observable by CEOs, the contradiction remains: CEOs expressed favorable attitudes towards activism (occurring elsewhere) while deriding the sponsors of much of this activism – short-term, dedicated hostile hedge fund activists.

Contradictory Attitudes Towards Hedge Funds

That CEO respondents were inclined to describe hedge fund managers as short-term investors is also at odds with how the hedge fund respondents described themselves. About two-thirds of hedge fund respondents were value managers, meaning that they invested in inexpensively priced stocks based on their valuation metric(s) of choice and *waited patiently* for some expected catalyst that would improve company performance and lead to a higher share price. Thus, the overwhelming majority of hedge fund respondents in this study were longer-term investors, the opposite of how the CEO respondents characterized them. This divergence may simply be the consequence of assembling non-representative, non-random, and therefore biased samples. Perhaps there are CEOs who have had interactions with longer-term hedge funds but, in a form of response bias, chose not to participate in the study because their experience might not comport with the widely held view of hedge funds being short-term oriented. Perhaps the CEOs who chose to participate did so because they saw my research as an opportunity to promulgate their negative views of hedge funds. Similarly, short-term hedge fund managers may have self-selected out of the study because they did not want to contend with the perceived illegitimacy of short-term investing.

Another possible explanation is that, given the vast size of the hedge fund universe, CEOs and their investor relations professionals may be unaware of the presence within their shareholder rosters of many longer-term oriented hedge fund managers who are outside of the smaller but more familiar universe of higher profile hedge funds with reputations for hostile activism and short-term holding periods. Thus, with these types of highly visible hedge fund managers in mind, CEOs and directors stereotype any hedge fund manager as short-term oriented. It could also be the case that believing most hedge funds to be short-term results from a familiarity bias: short-term hedge funds (excluding hostile activists), while perhaps fewer in number than long-term, value style hedge funds, are more noticeable because their trading activity is more frequent which is likely to cause greater

price disruptions than compared with long-term investors who infrequently trade their positions.

Because my sample of hedge fund managers is also non-random, it is possible that many short-term focused hedge fund managers who are not dedicated activists may have opted out of the study because shareholder activism is a phenomenon very remote from their day-to-day activities.[92] For example, hedge fund managers employing quantitative, momentum, merger arbitrage, short-biased, market neutral, or sector rotation strategies all invest in the equity of corporations but often do so with very short-term holding periods.[93] It should be noted, however, that *the style mix of hedge fund respondents who participated in this study is not dissimilar to available data on the hedge fund industry*. BarclayHedge, a hedge fund research firm, tallies equity long bias (which use some shorts, but far more long positions) and equity long-only hedge funds, *categories most likely to contain value investors*, at 74% of all domestic equity hedge funds (barclayhedge.com).[94] While this remains a highly inexact assessment of the representativeness of the hedge fund respondent sample in this study, it is still noteworthy that unambiguously short-term oriented strategies – short-biased, market neutral, quantitative, merger arbitrage and the like – represent

[92] I did, however, emphasize to all prospective recruits that I was equally interested in those who did have experience with activism as well as in those who had no such experience.

[93] Quantitative strategies employ mathematical models utilizing numerous real-time data inputs to generate buy and sell signals. Momentum strategies invest based on perceived price trends, established through technical analysis and/or through more quantitative means. Merger arbitrage makes bets on the estimated likelihood that announced mergers or acquisitions will or will not consummate. Short-biased funds will have more short positions than long ones, while market neutral funds hedge out market risk by holding offsetting values of short and long positions. Sector rotation funds try to identify and capitalize on those economic sectors currently in favor, such as pharmaceuticals over utilities. All of these strategies, for reasons not necessarily germane to the ongoing discussion, are optimal over the short-term and are suboptimal, if not unworkable or even hazardous, over the long-term.

[94] Data on hedge funds generally lacks precision. Performance numbers for the same classification of hedge funds, for example, can and do differ from one index aggregator to another. According to Brown, Goetzmann, and Ibbotson (1999), there are over fifteen index providers who collect and report hedge fund performance numbers, frequently using different classification criteria. This lack of precision stems from three causes. First, hedge funds, under no regulatory requirement to report performance publicly, do so voluntarily and choose which performance aggregator(s) to whom they will supply data. Second, a hedge fund may shift strategies over a business cycle, say from short-biased to long-biased, making classification difficult. Third, there is substantial churn in the hedge fund universe. In 2007, 1,197 new funds were launched, but 563 were liquidated according to Hedge Fund Research. During the financial crisis, 2008 through the first half of 2010, 1,898 new funds were launched, but 2,911 funds were liquidated.

roughly just a quarter of the hedge fund universe. Simply put, there is no reason to conclude that the portion of the hedge fund respondents in this study who identified with a value investing style is terribly different from that found in the larger hedge fund universe.

In sum, given that we *cannot* conclude that the hedge fund sample in this study is grossly different from a truly random sample, and also given that CEOs' broadly held view – that *most* hedge funds are short-term oriented – does not at all fit with the reality that, at best, *only one-quarter* of the equity hedge fund universe is unambiguously short-term focused, we must lean towards viewing CEOs' conception of hedge funds skeptically. Another reason to be skeptical is that their less than charitable opinions of hedge funds contradict their own support of hostile hedge fund activism they see occurring elsewhere, which is typically at the hands of short-term hedge funds. What is going on here?

The contradictory posture of CEO respondents towards hedge funds – viewing them positively when they are seen fixing other underperforming firms, but viewing them negatively when they show up in their own share rosters – is best understood in the context of identity threat. Blaming *other CEOs* who are the targets of activism for not performing, for not creating shareholder value, for not implementing those actions that an activist would likely want a firm to take, carries the implication that the CEO respondents making these statements believe *themselves* to be performing, creating shareholder value, and staying one step ahead of activists. Their identities as successful CEOs are validated by the activism happening *elsewhere*. Despite the normalization of activism, hostile hedge fund activism is still disruptive, confrontational, unpleasant, distracting, costly, and a challenge to the status quo – and a grave threat to any CEO's identity as a capable leader. Thus when CEOs see hedge funds show up *in their own* rosters, this identity threat becomes real: activism is no longer something happening elsewhere but something that could happen at the CEO's own firm. This identity threat, then, reveals itself in the delegitimizing language of short-termism that CEOs apply to hedge funds in their own share rosters that contrasts with the laudatory language of creating shareholder value used when hedge fund activism is occurring at other firms. This bipolar view which many CEO respondents had of hedge

funds, then, seems entirely contingent upon the proximity of the hedge fund to the CEO and the likelihood of identity threat.

Embedded with Shareholders

In contrast to their attitudes towards marginal investors, CEOs had quite positive views of their knowledgeable shareholders and welcomed their input. The level of legitimacy CEOs ascribed to their shareholders was a function of the size of the shareholder's equity ownership position and their knowledgeability and expertise. Of course, a legitimate shareholder is simply one which a CEO must take seriously and not ignore, not necessarily one which a CEO prefers. Thus, while both expertise and share ownership size contribute to shareholder legitimacy, CEOs prefer knowledgeability without significant shareholdings over large shareholdings without significant knowledgeability. With *fully* legitimate shareholders, those who rank high on *both* characteristics, CEOs obviously prefer patient and friendly shareholders over hostile ones.

Given this preference, it is unsurprising that firms will try to exercise their own social influence to cultivate an ideal shareholder base. CEOs exploit multiple levers to shape their shareholder rosters, including striking the optimal balance between dividend policy and share buybacks, clearly communicating strategic and profit objectives, delivering on such promises, and pursuing repeated interactions with preferred shareholders while minimizing interactions with less desirable shareholders. These efforts, however, stand in tension with the desire of every CEO for a higher stock price which requires stoking demand for the firm's shares, regardless of whether buyers fit the preferred characteristics or not. But even with CEOs who resist this temptation, the ability to shape the perfect shareholder roster is as difficult as Sisyphus getting his boulder up the mountain. Investors are constantly buying and selling shares, and this constant turnover of a firm's shares results from a number of factors beyond management's control, including: the relative appeal to investors of other companies' shares, investors' cash flow needs and obligations, and the relative predictability of earnings or the lack thereof across industries

which affects the price volatility of a company's shares, with greater price volatility resulting in greater share turnover.

But the mere appearance of a hostile activist in a firm's share roster can by itself cause price volatility, specifically an increase in share price, which will lead to higher share turnover with other hedge funds buying in as existing shareholders cash out. As if cultivating the ideal shareholder base was not already a difficult enough task, a hostile activist on his own can render management's efforts all for naught. All of these difficulties with cultivating the ideal shareholder base reveal an acutely diminished ability to wield social influence by firms in comparison with institutional investors, an asymmetry which highlights a critical power disadvantage of firms relative to shareholders, especially hostile hedge fund activists.

When assessing *shareholder* power, therefore, it is insufficient to analyze it separately from *firm* power. As investors gain greater formal authority through legislative and regulatory changes, the formal authority of firms is diminishing as the evolution of norms defining what constitutes good governance lead many firms to adopt such measures as declassified boards and easier proxy access, further enhancing the power of shareholders and diminishing the power of firms.[95] While the degree of social influence an institutional investor can exercise either over firms, or, more importantly, over other investors in the case of hostile hedge fund activists, is clearly an important factor in assessing the power of shareholders, equally important is the *inferior ability* of firms to consistently exercise social influence over their investors. Still, managements have no choice but to continue trying.

It is likely, therefore, that the sum of these asymmetric power advantages of institutional shareholders over firms has drawn CEOs closer to their shareholders. Indeed, one of the central findings of this study is the extraordinary degree to which CEOs are embedded with their shareholders, contributing to the diminution of the separation of

[95] Power is no doubt a factor in these changing norms: powerful proxy advisory service firms such as ISS and the large pension funds such as CalPERS have exerted pressure on firms to make these adoptions. But as these corporate governance structures become normative, many firms adopt them voluntarily. To dismiss this 'voluntary' adoption of corporate governance norms as nothing more than a submission to shareholder power is to ignore the fact that flouting norms of behavior risks sanctions for any social actor and thus that norms are inherently infused with social force that structures individual action.

ownership and control. Based on CEO responses, many spend a quarter of their time interacting with shareholders, and for a firm trying to rebuild trust and confidence among its shareholders, a CEO will devote even more time with them. Being closer to shareholders through "perpetual dialogue" affords CEOs alternative sources of power: by engaging with their preferred institutional shareholders, CEOs can build trust and goodwill, gather information on their industry and competitors, and ensure that shareholders have a clear understanding of what the firm is trying to accomplish. In "thinking like the activists" they can hopefully inoculate themselves to their intrusions. Within this context of engagement, shareholders not only listen but voice their concerns and make suggestions. Even though it was rare for a CEO to act on an idea or recommendation from a legitimate shareholder, they conceded that they incorporate what legitimate shareholders articulate into the corporate decision-making process, and that such input at a minimum helped them hone their thinking, fine tune their messaging, and sometimes accelerated actions that management had already planned on taking.

Again, the role of friendly activists – hedge funds or other institutional investors who desire to take substantial share positions in exchange for constructive collaboration with management – warrants further investigation. As hostile activism becomes more frequent if only by virtue of the fact that the number of dedicated hostile activists continues to increase, it would seem that the demand from firms for striking closer relationships with friendly activists would similarly increase. In either case, however – whether it is hostile activists muscling their way inside of firms or CEOs reaching outside to friendly activists – the process of a substantially diminished separation of ownership and control advances with institutional investors exercising considerably greater control over the allocation of capital than has historically been the case.

Directors

The contrast between CEO embeddedness with their favored institutional investors and the disengagement of directors with the shareholders who elect them could not be greater. I argued that the absence of engagement between directors and shareholders has

several unfavorable consequences. First, when circumstances demand that they actually must dialogue with an activist, directors lack the preparation to do so because of interactional deficits. Second, because of such interactional deficits, and because of the normative requirement that *directors do not manage,* as well as their commitments to multiple boards, directors' knowledge of the firm suffers as does, therefore, their ability to more adeptly resolve or deflect activist complaints and criticisms. Third, the institutional culture of boards privileges collegiality, deliberation, and consensus, cultural values that are not well-suited for confrontations with aggressive and hostile activists, further impairing their ability for handling activist pressures. Director disengagement with shareholders, therefore, ultimately increases the difficulty of resisting activists, making acquiescence to activist demands, either partially or fully, the more likely outcome.

While there are practical reasons why CEOs should manage shareholder engagement, the unusually strict prohibition of board engagement with shareholders smacks of mid-century managerial capitalism when directors served at the pleasure of CEOs rather than the other way around. While such an assertion is clearly an exaggeration – boards are today predominantly independent and more professionalized – the restrictions on board engagement with shareholders continues to foster a curious dependence of directors on their CEOs which can only have a disempowering effect on directors' abilities to fulfill their responsibilities of oversight and advice. Additionally, with little to no shareholder engagement, boards are unable to build relationships based on trust that only emerge from repeated interactions with shareholders. The inertial force of this normative arrangement is so strong that even when activists or their representatives attain board seats, the very individuals who presumably are highly critical of a given board's abilities and performance, they insist on maintaining these very arrangements, failing to see the deleterious effects not engaging with shareholders can have on their performance as directors.[96]

[96] A cynical view is that an activist investor who has won a board seat is very much interested in only one shareholder's thinking and wants – his own. From this point of view, it actually makes considerable sense for an activist to insist on board disengagement so as to preserve his own power and interests. We would

Not engaging with shareholders results in knowledge deficits for directors as they do not enjoy the rich informational benefits that CEOs enjoy from being thoroughly embedded with shareholders. Although directors are keen on knowing what shareholders think and want, they depend for this information on their CEO, already filtered and processed, placing directors in dubious positions of dependency on their CEOs. Directors' knowledge deficits also stem from the normative proscription that *directors do not manage* which effectively discourages directors from developing an intimate understanding of the firms they oversee and advise. Because directors are thus unburdened, they can have board seats on more than a single company, commitments which reinforce the limitations on acquiring the depth and breadth of knowledge of the firms they oversee and advise.

The knowledge deficits that directors suffer are not benign. With little to no social influence, directors suffer knowledge asymmetries between themselves and both management and knowledgeable shareholders, further reinforcing the normative prohibition on directors pursuing shareholder engagement and disadvantaging directors vis-à-vis more knowledgeable activist shareholders making demands. It is likely that the combination of directors' knowledge deficits and their commitments to multiple boards does not augur well for dealing with a hostile activist: both point to settling with the activist, either by fully or partially acquiescing to the activist's demands. We saw that the time demanded of a board confronting a hostile activist can be substantial, and yet these directors' fiduciary duties to the other boards with which they have commitments do not get placed on hold. The situation is even worse if the director is a sitting CEO at another firm. It is worth investigating whether or not hostile activists target companies in which directors sit on a greater number of outside boards than the average director, or count current CEOs among their board ranks, under the assumption that such 'overextended' boards would show a greater propensity for settling. Of course, the hypothesis itself that such boards are more likely to acquiesce than are boards with less taxed directors should be empirically tested.

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hope this is not the case given that an activist who takes a board seat now must act in the interests of all shareholders. In any event, board incumbents have no such cynical excuse.

There is a curious sense that emerges from conversing with directors that there is a tradeoff between independence and intimate knowledge. It seems likely, for example, that corporate governance experts would frown on restricting directors to serving on just a single board while simultaneously requiring more than the typical 5 to 8 annual board meetings. Would it still be accurate to characterize such a hypothetical board as independent because directors were dedicated only to that one firm? If directors subsequently acquired much more knowledge about a firm than is possible when serving on multiple boards, might they lose their independence and objectivity? By becoming intimately more knowledgeable about a firm, would they therefore identify more closely with the organization, thus forfeiting the dispassion and distance that purportedly is the essence of their independence which enables them to make the "tough" decisions that those more closely aligned with the organization cannot? Independence of thought is also partly a function of the knowledge gained from being embedded in a rich network of weak ties that is enhanced by sitting on other boards. Thus, to what extent would the advantages accruing to directors from gaining deeper knowledge of the single firm they hypothetically oversee and advise be offset by the knowledge lost from forfeiting other board seats?

While these questions remain moot, the knowledge deficits which directors suffer, emanating from and contributing to shareholder disengagement, as well as from normative proscriptions and structural constraints militating against the acquisition of deeper knowledge of the firms they oversee and advise, exacerbate the power disadvantages of firms vis-à-vis hostile activists. But just as we argued that these power disadvantages might explain the increasing embeddedness of CEOs with their institutional shareholders, contributing to the diminishment of the separation of ownership and control, so too might we expect directors to draw nearer to shareholders. Indeed, there is evidence that this is starting to occur. With the introduction of so-called "say-on-pay" rules codified in Dodd-Frank in 2010, shareholders can approve or disapprove management's pay packages. While these are non-binding votes, boards nevertheless are quite sensitive to "no" votes since shareholder displeasure could ultimately translate into shareholders voting against the reelection of directors viewed as complicit in extravagant executive compensation. Thus,

in the years since Dodd-Frank, more and more board chairpersons, lead directors, and compensation committee chairs have increased their outreach efforts to their large shareholders to explain and defend pay packages.

Additional moves are afoot. In early 2015, industry behemoths Blackrock and Vanguard, the number one and number three largest institutional investors respectively with combined AUM of more than $7 trillion, communicated with the companies they invest in, urging them to pursue regular director-shareholder interactions (Grind and Lublin 2015). In 2014, the Shareholder-Director Exchange (SDX), comprised of institutional investors and independent directors from large public companies, released their SDX Protocol which provides guidance on how and when to conduct board-shareholder engagement (Nili 2015). Also in 2014, the Conference Board Governance Center promulgated its own set of recommendations for board-shareholder engagement (Gelles 2014).

THEORETICAL SUMMARY

This study has argued that the separation of ownership and control is breaking down as powerful institutional shareholders, and hostile hedge fund activists in particular, are insisting on exercising influence over how capital is allocated not just outside of firms, but inside as well. Activism is far more pervasive today than only twenty years ago, and while it represented a seismic shift for Useem (1996), today it represents a normal recurring dynamic in the relationship between firms and institutional shareholders. Whether it is at the hands of dedicated activists, occasional activists, or friendly activists, activism today is normalized and no longer idiosyncratic. From the other side of the barrier, perhaps because shareholder value ideology has been internalized by management and boards, or perhaps simply because it is the only rational course of action, and likely because of both, most CEOs are thoroughly embedded with their legitimate institutional shareholders and boards are showing signs of following a similar path leading to a new dynamic of director-shareholder engagement.

The process of normalization following disruption is familiar to sociologists.[97] Within the domain of capital markets, structural changes affecting the relative power of institutional shareholders vis-à-vis the corporations they invest in initially created new interactional dynamics between the two types of actors, which in turn slowly led to changing attitudes and beliefs that were more consonant with these new relational dynamics. Central to these new attitudes and beliefs was the transformation of shareholder value from a theoretical perspective hawked by Chicago economists to a hegemonic ideology shaping and guiding the actual behavior of investors, CEOs, and directors. Westphal and Zajac are skeptical that CEOs have truly internalized shareholder value perspectives as evidenced, they argue, by the symbolic management they engage in with their institutional shareholders in order to preserve space for managerial discretion (1998). I suggest that hedge funds, an investor type absent from even Westphal's more recent work, *do not permit room for symbolic management to be a successful tactic*; at best, CEOs may engage in symbolic management with their marginal, and less knowledgeable investors, highlighting a contingent aspect of their internalization of shareholder value. I maintain that the emergence in the early 2000s of hedge fund activists – unconstrained, lightly regulated, aggressive, pure capital allocators – dramatically reduced the ability of CEOs and boards to dissemble. The internalization of shareholder value – reflected in the embeddedness of CEOs with their institutional shareholders, in their support of much of the activism that they see occurring around them, in their reports of "thinking like activists" – and *not* symbolic management enables CEOs to navigate and survive in their more severely restricted spaces.

Instances of symbolic management, however, showed up elsewhere. Some directors reported exploiting the possession of material, non-public information unavailable to shareholders by inviting activists to take board seats, not as an act of capitulation but as a means of neutralizing the activist: once on the board, the firm can

[97] Wei-hsin Yu (2009) elucidates the adoption of the idea of the devoted mother as a Japanese cultural norm only after the occurrence of underlying economic structural changes that effectively excluded women from career advancement.

reveal such information to the activist that demonstrates the infeasibility of adopting the activist's demands. Also, some hedge fund managers reported using the Schedule 13D symbolically in that they had no intention of engaging in activism, but, knowing that many investors key off of the 13D to invest alongside activists, used the 13D to generate investor interest in smaller and poorly followed companies. Other hedge fund managers, as an example of impression management, outsourced activism in companies they were invested in to dedicated activists so that they would not be linked with hostile activism, thereby preserving access to company management teams on whom they depended for obtaining information and data critical to their investment decisions.

Hedge fund activists are clearly powerful economic actors. Like other large institutional shareholders, hedge fund activist power derives from their formal authority, their social influence, and their expertise (Kang and Sorensen, 1999). Applied to *hostile* hedge fund activists, however, the Kang and Sorensen framework of shareholder power reveals some difficulties. Rather than social influence over CEOs and boards, these actors employ coercive force or the threat of coercion. The social influence that they do exercise is not over managements, but over other institutional shareholders through informally communicating with them, sometimes by forming more formal groups with them, through signaling with Schedule 13D filings, and through mounting proxy campaigns. Their expertise does not arise through repeated interactions with target firms, but from their training and extensive practice in financial analysis and asset valuation techniques, from their experiences from running firms in the past or from participating in the oversight and governance of other firms gained from winning Board seats in other hostile contests, and from hiring experts.

The Kang and Sorensen framework displays a much nicer fit with the character of *friendly* hedge fund activism. Unlike hostile hedge fund activists, friendly activists do enjoy substantial social influence over management because there exists a basis of trust resulting from repeated interactions over time, and because management recognizes the expertise of the friendly activist. The irony, however, is that while the framework nicely captures the salient characteristics of friendly activists, power likely accrues more to

management than it does to the friendly activist. As reported, friendly activists eschew coercion, and if they believe that their relationship with management is no longer fruitful, are far more likely to sell their shares than opt for a confrontation. Management, however, by having a large shareholder as an ally, enjoys a more stable shareholder base insulating it to some extent from the more hostile elements in that base.

Managerial power during the age of managerial capitalism stemmed from dispersed shareholders and handpicked boards. These sources of power are no longer available to CEOs, but this does not mean that CEOs are powerless. The substantial degree to which CEOs are embedded with their shareholders, action facilitated and reinforced by shareholder value thinking, affords management with new sources of power, albeit in diminished form compared to what they once enjoyed. Although investor capitalism generally, and hostile hedge fund activism specifically, have eroded the degrees of freedom within which CEOs run their firms, being close to large and knowledgeable shareholders offers opportunities for trust building, for obtaining new ideas and information, and for calibrating their own thinking. Boards too are beginning to appreciate the benefits that flow from drawing closer to shareholders, breaking with a 1950s normative framework that has somehow persisted through accounting scandals, substantial regulatory reform, and a decade's worth of hedge fund activism. To the extent, however, that there is a tradeoff between acquiring greater firm knowledge and maintaining their independence, directors' ability to engage with a firm's shareholders will likely remain challenging.

FINAL THOUGHTS

While hedge fund activism has become normalized, this hardly means that it remains uncontested. Indeed, hostile hedge fund activists' efforts to appear legitimate, together with their efforts to delegitimize their targets, are evidence that activism remains contested. Underscoring the contested character of hostile hedge fund activism is the fact that, according to Larry Fink, CEO of BlackRock, the world's largest asset manager with over $4 trillion in AUM, the firm supported hostile hedge funds only 39% of the time in

18 of the largest proxy contests in 2015 (Stein 2016). In a *Bloomberg News* interview, Mr. Fink said:

> We're all in favor of making companies more efficient, we're all in favor of making sure that - whoever that may be a long-term investor or an activist – is working with management to have the company perform better over the long-term. If that's the motivation, then we're very happy working alongside with them. If we find the motivation is to just get a really quick pop, and so I can't be in favor of that. (Larry Fink, *Bloomberg News*, 2/5/14)

Mr. Fink sees activists as legitimate actors and in fact frequently supports them, but BlackRock evaluates activism on a case-by-case basis to determine if BlackRock's support will be forthcoming. This sort of contingent support by a very prominent capital markets actor demonstrates that, despite the fact that activism has become normalized, it still retains an unsettled, provisional, and continuously contested character. Nevertheless, Mr. Fink quite noticeably takes for granted the array of processes that have blurred the boundaries between companies and shareholders. In fact, although contesting some instances of hostile activism, BlackRock supports others and also devotes considerable resources to engaging in constructivist, or friendly, activism. Asked during that same interview on *Bloomberg News* if management teams reach out to BlackRock for advice and guidance, he replied:

> Continuously – we recommend they reach out to us…Our job is to making sure that we're *fully engaged in a dialogue with a management team continuously*. We believe that we have to be fully engaged with management. I believe the best solution – because we do wield a lot of shares – is to do it quietly and constructively…*Our job is to making sure the company is performing properly over a long cycle.* (Larry Fink, *Bloomberg News*, 2/5/14; emphasis added)

Thus, while BlackRock contests specific instances of hostile activism, Mr. Fink underscores what he believes to be the optimal form and content of activism. Without knowing the authorship of such a statement, one could be forgiven for attributing it to either a company CEO or to a firm's board, as the duties he ascribes to himself and to BlackRock

are the very same duties we would expect a CEO to fulfill or that might appear in a board of directors' code of conduct. It is a statement that very much positions large institutional shareholders squarely within the decision-making processes that occur *within* firms and that sees no separation between ownership and control, a statement entirely consistent with the findings of this study.

Looming large over a diminished, if not eviscerated, separation of ownership and control is the question: What will be the effects on firms and the wider society from ever greater enmeshment of firms with shareholders?

The answer to this question depends on what kinds of investors firms will enmesh with. As described earlier, most companies would welcome closer ties with friendly, patient capital, i.e., large, knowledgeable institutional investors with long holding periods. BlackRock, based on Mr. Fink's nod to constructive engagement, would seem to fit the bill. But will "*making sure the company is performing properly over a long cycle,*" what we might accept as a basic definition of the much lauded long-term investing perspective, be a panacea for a slow growth economy with widening inequality? So long as long-term investing retains shareholder value as its true north where the pursuit of efficiency demands that labor costs are ground down along with the costs of any other 'input', and where the pursuit of favorable tax treatments and jurisdictions benefits shareholders while starving the social institutions which made the firm's success possible in the first place – the answer is likely not. As companies draw closer to their institutional investors, a reasonable expectation is that their demands for attractive returns will have to be heeded more fervently than ever. As companies draw closer to their shareholders, does this not imply that they draw even further away from their other stakeholders?

Perhaps CEOs and boards might find strong allies in pension funds, institutional investors who are structurally oriented to the long-term. With nearly $15 trillion in AUM at U.S. pension funds ("Pension Funds in Figures" 2015), surely these managers would be enviable allies to have. Among pension fund managers, CalPERS stands out for what we might describe as enlightened capitalists. CalPERS has a long history of managing pension investments with an eye to the impact of their decisions on a broader set of stakeholders.

They helped found CERES (the Coalition for Environmentally Responsible Economies) in 1989, were founding members of the International Corporate Governance Network in 1995, and contributed to the formation of the U.N. Principles for Responsible Investment in 2005. Similar to BlackRock, their preferred mode of company interaction is quiet and constructive; unlike BlackRock, CalPERS emphasizes environmental, social, and corporate governance issues (ESG) in the pursuit of long-term, sustainable returns on its investments.[98] Alone among most institutional investors, CalPERS seems to realize that shareholder value pursuit of efficiency has, over thirty years, hollowed out the middle class, and is thus an *unsustainable* way to manage companies. Whether or not CalPERS' emphasis on sustainability can have the transformative effect on market and economic behaviors conducive to healthy individuals, communities, and societies is an open question. Results from proxy proposals are not encouraging. According to the *Wall Street Journal*, only 5% of shareholder proxies in both 2014 and 2015 included proposals touching on any ESG issues, suggesting that such proposals are not garnering much attention (Monga 2016). Equally disappointing is that CalSTRS, the smaller pension sibling to CalPERS, seems intent on *not* following CalPERS lead. While CalPERS voted with management in opposition to Trian's activist engagement with DuPont, CalSTRS sided with Trian. In fact, CalSTRS has voted against management and in favor of hostile activists in 45% of proxy contests, while CalPERS has done so only 8% of the time (Hoffman and Martin 2015). This divide among two of the largest pension funds should give one pause in thinking that pension funds by definition represent long-term, patient capital, let alone a reliable countervailing force to aggressive hedge fund activism.

It is unclear just how far into the future an enlightened capitalism can peer (with CalPERS in mind) if profit maximization and wealth accumulation are its principal animating forces. A glance at the *AFL-CIO Proxy Voting Guidelines* is illustrative. Rather than a socialist manifesto advancing workers' rights throughout corporate America, the *Guidelines* mimic many of the same positions as do Institutional Shareholder Services and

[98] Unlike the various mutual funds that *screen* their investment holdings based on ESG factors, CalPERS actually tries to change corporate behavior to reflect ESG concerns.

other corporate governance experts on matters of staggered boards, majority voting for director elections, shareholder proxy access, separation of CEO and board chair, board size and independence, poison pills, executive compensation, and other matters. Like CalPERS, they also promote ESG issues. The reason for the milquetoast character of the AFL-CIO's approach to capital stewardship is the fiduciary standard of duty of loyalty. In a nutshell, a fiduciary must pursue an investment that offers a higher potential return for a given level of risk as compared to the alternatives, including those alternatives that might have so-called collateral benefits such as providing youth employment or increasing the supply of affordable housing. Only when the potential risk and return profiles are identical may a fiduciary consider collateral benefits among investment alternatives. The fiduciary standard, in other words, keeps many asset managers, including labor union pension plans, on the capital market reservation.

The fact that presumably more enlightened investment approaches that emphasize sustainability – not only of long-term returns, but of the societies and the planet that are the foundation for the economic activities generating these returns – are hamstrung by the edifice of fiduciary duties suggests a more energetic role for the state in the capital allocation decisions of companies. Of course, free market proponents would likely greet such a suggestion with an apoplectic fit as they find the existing level of state intervention in the affairs of corporate America already far in excess of what is conducive to economic growth and prosperity. Still, it must be conceded that even long-term oriented investors will never take the truly long view that might encourage business practices that do not generate negative externalities such as inequality or environmental degradation. Recent ideas such as tenure voting which assigns greater voting power to a shareholder of record for three years as compared to one who has held shares for just three months are quite interesting and an improvement over the current state of affairs that treats short-term holders and long-term holders identically. But the problem remains: will a shareholder of three years be at all inclined to peer out over thirty years?

Not all firms, however, want to draw closer to their large institutional shareholders, and not for reasons having to do with a nostalgia for the days of managerial capitalism. In

recent years, newly minted corporations have opted for dual-class shareholding voting structures where regular shareholders get one vote per share (or even no votes), while the founders of the firm get more than one vote, sometimes considerably more (Davidoff 2015). This arrangement effectively renders any form of hostile activism pointless because an insurgent will never be able to win a proxy fight. While the major stock exchanges such as the NYSE and NASDAQ prohibit already listed companies from creating new dual-class shares, they do permit such structures if adopted before an initial public offering (IPO). Companies such as Facebook and Google have such voting structures, justifying the arrangements on the grounds that they provide stability to firms that are new and transitioning through intense growth phases. While this sounds plausible for small upstart companies, how this applies to the likes of a Facebook or Google perplexes many corporate governance experts.

The desire to not be burdened with shareholders at all has motivated many companies to either delist or to not go public. In 2015 there were half as many publicly listed companies in the U.S. as there were in 1996, roughly split between companies delisting (half of these explained by acquisitions) and companies choosing to not go public (Doidge, Karolyi, and Stulz 2015). Many companies are also incorporating as so-called "benefit corporations" which permit directors to consider the impact of corporate actions on stakeholders in addition to shareholders. Such corporations enjoy certain legal protections in pursuing broader social missions that consider such things as environmental and social impacts of corporate activity (Clark Jr and Babson 2011; Reiser 2011).

Each of these developments – denying shareholders voting rights, choosing to not have public shareholder ownership, or adopting a stakeholder view of the firm – represents a rejection of shareholder value ideology. Examining the success or failure of such firms that adopt these very different conceptions of what a corporation is all about, and specifically examining the effects of these alternative conceptions of corporate control on workers, communities, and the environment could be a profitable exercise. Such alternative understandings of the firm might illuminate alternative ways for understanding capitalism

more generally as a system subordinate to society rather than one that shapes society for its own purposes.

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