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Shareholder Social Responsibility

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I. INTRODUCTION

Many corporate managers cater to the preference of institutional shareholders for short-term stock price performance, even though this is widely understood to threaten the sustainability of American business. For these investors, the focus is on quarterly earnings rather than long-run value that may not be reflected in the current share price. Corporate executives respond by managing the business with an emphasis on meeting quarterly earnings targets. Often this can mean avoidance of expenditures that reduce current earnings and generate payoffs only in the future.

Casualties of short-termism can include a range of investments that may be necessary to the corporation's long-run profitability. These include neglected expenditures on capital assets, research and development, maintenance, advertising, employee training, and customer service. Yet because they reduce current earnings and therefore threaten share prices, corporate managers are reluctant to make them. This has implications not only for the long-run viability of American business, but also for its ability to compete in a world that does not necessarily embrace short investment horizons.

Amidst concerns about the negative effects on long-run value and competitiveness, one overlooked consequence of short-termism is its impediment to corporate social responsibility (CSR). This oversight is not surprising because it is entirely possible to be alarmed by short-termism while remaining uninterested in CSR. Nevertheless, for those who are concerned about CSR, it is important to pay attention to short-termism and its negative impact. Like research and development, advertising, and the like, CSR also requires current expenditures that reduce earnings. Sometimes these expenditures—on the well-being of key stakeholders or the sustainability of the environment—can contribute strategically to the

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corporation's long-run success or might even be necessary for its survival. In other words, they might be important for business reasons. Or they might be justified on ethical grounds as "the right thing to do" regardless of their potential to increase future profits. In either case, a short-term orientation stands in the way. Whether undertaken for strategic or ethical reasons, spending money to promote nonshareholder interests reduces current earnings. Even if there is the prospect of a net financial benefit to the corporation, it will not come to pass, if it does at all, until some future time. Meanwhile, investors have lost value. Thus, short-termism not only jeopardizes research and development, capital investment, and the like, but also impedes expenditures on CSR initiatives. Until investors are willing to jettison a short-term outlook, CSR seems even less likely than it otherwise might be. Corporate social responsibility therefore requires shareholder social responsibility in the form of more patient investment strategies.

It needs to be noted that this Article is not about "socially responsible investing" (SRI). SRI encompasses the idea that investment decisions should be made not solely in terms of financial risk and return but also with attention to "some combination of ethical, religious, social, and environmental concerns."[1] A number of investment funds focus on society or the environment in their mission statements. Depending on the definition one uses, SRI investing could comprise as much as 10% of the U.S. stock markets.[2] There are important questions surrounding the actual and potential impact of SRI and its influence on CSR policies, but these questions are beyond the scope of this Article.

In this Article, Part II examines the short-termism phenomenon, first from the point of view of investors and then from that of corporate managers, and summarizes widely held views about the social costs of short-termism. Part III then shifts the focus to the impact of short-termism on CSR, a problem that has been largely overlooked, and develops two theories or models of CSR: the "ethical" and the "strategic." Part III also explains how short-termism presents a significant obstacle to both models of CSR, which compounds concerns about the impact of short-termism on long-run corporate success. Accordingly, it is all the more urgent to understand the causes of institutional investor short-termism, a subject that has not received the attention that it deserves. In Part IV, the Article first examines the pressures that institutions—particularly public and private pension funds—face to meet their current obligations. It then turns to competition among institutions for investor

1. Lloyd Kurtz, *Socially Responsible Investment and Shareholder Activism*, *in* THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY 249, 250 (Andrew Crane et al. eds., 2008).

2. *Id.* at 252.

funds, a problem for mutual funds in particular. Finally, the Article touches briefly on competition among independent investment advisors and fiduciary duty law as potential contributors to the short-termism phenomenon. Part V is a brief conclusion.

II. INSTITUTIONAL INVESTORS AND SHORT-TERMISM

A. Short-Term Investment Horizons

Institutional investors are the dominant players in today's stock markets. These shareholders include public and private pension funds, mutual funds, insurance companies, university endowments and foundations, and bank trust departments. As a group, they own approximately three-fourths of the 1,000 largest U.S. corporations[3] and around 70% of the shares of all U.S. corporations.[4] For some U.S. corporations, the percentage of institutional investor stock ownership is even higher.[5]

Many institutional shareholders pursue short-term investment strategies. These investors hold broadly diversified portfolios and buy and sell frequently in order to realize trading profits. Among all shareholders, the average holding period for particular stocks is now very short, perhaps as low as five months.[6] For short-term investors, the focus is on quarterly earnings rather than other possible measures of value. Traders respond to share price movements and are largely unconcerned with underlying company fundamentals and possible differences between current share price and long-run value.[7] They are likely to dispose of underperforming stocks rather than take a more patient approach. Brian Bushee, a widely respected expert on accounting and financial disclo-

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3. As of 2010, the figure was approximately 73%, and it is likely to be even higher today. *See* MATTEO TONELLO & STEPHAN RABIMOV, 2010 INSTITUTIONAL INVESTOR REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION (2010), *available at* http://www.conferenceboard.org/publications/publicationdetail.cfm?publicationid=1872.

4. John C. Bogle, *Restoring Faith in Financial Markets*, WALL ST. J. (Jan. 18, 2010), http://online.wsj.com/article/SB10001424052748703436504574640523013840290.html.

5. For Google, for example, the figure is 83%. YAHOO! FINANCE, http://finance.yahoo.com/q/mh?s=GOOG&ql=1 (last visited Oct. 30, 2012, 6:10 PM).

6. Bogle, *supra* note 4. *But see* BEN W. HEINEMAN, JR. & STEPHEN DAVIS, MILLSTEIN CTR. FOR CORP. GOVERNANCE & PERFORMANCE, ARE INSTITUTIONAL INVESTORS PART OF THE PROBLEM OR PART OF THE SOLUTION? (2011), *available at* http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/80235_CED_WEB.pdf (seven to nine months); Dominic Barton, *Capitalism for the Long Term*, HARV. BUS. REV., Mar. 2011, at 85, 87 (seven months).

7. Most scholars now reject the idea that current share price necessarily reflects long-run value. LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 64–65 (2012).

sure, refers to these shareholders as "transient"[8] because they come and go.

Critics argue that short-termism is increasingly the norm among institutional shareholders. John Bogle, founder of the Vanguard Group mutual fund family, writes that "the folly of short-term speculation has replaced the wisdom of long-term investing."[9] Another observer of the short-term approach to investment—and to corporate management—criticizes its pervasiveness even since the financial crisis. He refers to this phenomenon as "quarterly capitalism" because of the obsession with quarterly accounting results.[10]

Not all institutions subscribe to short-term investment philosophies. Some invest with the goal of realizing long-term value. Bushee calls these the "dedicated"—patient—investors.[11] Others are passive indexers who build portfolios that mirror the stock market as a whole and engage in trading only infrequently.[12] Nevertheless, there is broad agreement that short-termism is widespread in the current investment landscape.[13]

B. Managing for Short-Term Results

Short investment horizons appear to be a significant cause of short-term corporate managerial perspectives. Institutional shareholders that follow short-term investment strategies tend to favor companies that focus on short-term, quarter-to-quarter accounting results.[14] These shareholders may also be a source of pressure on those companies to produce those results.[15] One observer notes that "there is now a growing move-

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8. Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCT. REV. 305, 326 (1998).

9. Bogle, *supra* note 4.

10. Barton, *supra* note 6, at 87.

11. Bushee, *supra* note 8, at 326.

12. *Id.*

13. Lynne L. Dallas, *Short-Termism, the Financial Crisis and Corporate Governance*, 37 IOWA J. CORP. L. 265, 269 (2012). This article presents a comprehensive analysis of the short-termism phenomenon and a careful evaluation of possible reform initiatives.

14. Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?*, 18 CONTEMP. ACCT. RES. 207, 213–15 (2001); Francois Brochet et al., *Short-Termism, Investor Clientele, and Firm Risk* (Harv. Bus. Sch., Working Paper No. 12-072, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1999484.

15. *See, e.g.*, Samuel B. Graves & Sandra A. Waddock, *Institutional Ownership and Control: Implications for Long-Term Corporate Strategy*, 4 ACAD. MGMT. EXECUTIVE 75 (1990); Michael E. Porter, *Capital Choices: Changing the Way America Invests in Industry*, 5 J. APPLIED CORP. FIN. 4 (1992). For discussion of the literature on this issue, see Dallas, *supra* note 13, at 302–07.

ment to examine institutional shareholders critically and systematically as a cause of the short-termism that drives bad corporate behavior."[16]

Corporate law does not require managerial short-termism. Rather, it accords management broad discretion to use its authority in the long-run best interests of "the corporate enterprise."[17] Only in one narrowly defined set of circumstances is maximization of share value required,[18] and corporate management can readily avoid this requirement by choosing not to enter into transactions that trigger it. The primary cause of managerial short-termism is not the law, but instead the demands from shareholders and the effects of other incentives.

Short-term-oriented investors can put pressure on corporate managers to produce short-term results in a number of ways. The specter of large-scale sell-offs in response to failures to meet quarterly performance benchmarks is especially important. Most major corporations provide "earnings guidance" to stock analysts on a regular basis.[19] From this information, analysts construct estimates of quarterly earnings performance. If, at the end of a quarter, a corporation fails to meet the analysts' consensus estimate, institutional shareholders may sell, and share prices fall as a result.[20] Managers generally cannot afford the risk of these share price declines. Some institutional shareholders may put pressure on boards of directors to remove senior executives who fail to produce acceptable quarterly results. According to an experienced management consultant, "[i]f CEOs miss their quarterly earnings targets, some big investors agitate for their removal. As a result, CEOs and their top teams work overtime to meet those targets."[21] One executive put it bluntly: "If I miss the target, I'm out of a job."[22] A recent study supports this claim, documenting a strong relation between poor stock price performance and CEO turnover.[23] Short of termination, managers also face the risk of pay

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16. Ben W. Heineman Jr., *Shareholders: Part of the Solution or Part of the Problem*, THE ATLANTIC (Oct. 28, 2009), http://www.theatlantic.com/politics/archive/2009/10/shareholders-part-of-the-solution-or-part-of-the-problem/29188/.

17. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1989); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985). *See generally* STOUT, *supra* note 7, ch. 2.

18. Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 37 (Del. 1994); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986).

19. Some well-known companies refuse to do this, including Coca-Cola, Ford, Google, and Unilever. Barton, *supra* note 6, at 87.

20. *See, e.g.*, Douglas J. Skinner & Richard G. Sloan, *Earnings Surprises, Growth Expectations, and Stock Returns or Don't Let an Earnings Torpedo Sink Your Portfolio*, 7 REV. ACCT. STUD. 289 (2002).

21. Barton, *supra* note 6, at 87.

22. John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 28 (2005).

23. Dirk Jenter & Katharina Lewellen, Performance-Induced CEO Turnover (Feb. 2010) (working paper), *available at* http://www.stanford.edu/~djenter/CEO_Turnover_February_2010.pdf.

cuts[24] or lower bonuses.[25] Further, since the enactment of the Dodd-Frank's "say-on-pay" advisory vote,[26] companies whose stock price has underperformed have been far more likely to receive negative votes than have over-performing or even neutrally performing corporations.[27] Pressure can also take the form of informal, behind-the-scenes engagement.[28] Or it can come through exercise of voting rights or use of shareholder proposals.[29]

In addition to pressure from institutional shareholders, corporate managers are also subject to other incentives that encourage short-term horizons. Executive compensation arrangements typically include a significant equity component in the form of stock grants or stock options.[30] This gives managers a personal stake in stock price movements. A record of consistent earnings performance may also have important reputational value. One study finds that reputational considerations may be even more important than bonus concerns.[31] Managers also have an incentive to boost current share prices in order to deter potential hostile takeover bids that would threaten their control of the firm.[32] More generally, widespread acceptance of short-termism by corporate management and investors may indicate a "social norm" that leads actors to assume uncritically that focus on current share prices at the expense of long-term fundamental value is appropriate.[33]

Although the reasons for corporate managerial short-termism cannot be reduced to a single cause,[34] it does seem clear that the managers of

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24. Steven R. Matsunaga & Chul W. Park, *The Effect of Missing a Quarterly Earnings Benchmark on the CEO's Annual Bonus*, 76 ACCT. REV. 313 (2001).

25. For some corporations, a manager's bonus may be based on earnings targets that are higher than external analysts' consensus benchmarks. Graham et al., *supra* note 22, at 28.

26. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010) (providing for shareholder advisory votes on management compensation).

27. Joseph E. Bachelder III, *Institutional Shareholders and Their "Oversight" of Executive Compensation*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG., (July 23, 2012, 9:31 AM) http://blogs.law.harvard.edu/corpgov/2012/07/23/institutional-shareholders-and-their-oversight -of-executive-compensation/.

28. Stuart L. Gillan & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, 13 J. APPLIED FIN. 4, 10 (2003).

29. *Id.*

30. Andrew C.W. Lund & Gregory D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677 (2011).

31. Graham et al., *supra* note 22, at 28.

32. Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988).

33. *See* STOUT, *supra* note 7, at 113 (referring to "the business world's own intellectual embrace of shareholder value ideology"); Dallas, *supra* note 13, at 320–21 (discussing firm "culture").

34. Individual and firm-specific factors may also be important. David Marginson & Laurie McAulay, *Exploring the Debate on Short-Termism: A Theoretical and Empirical Analysis*, 29 STRATEGIC MGMT. J. 273 (2008).

many U.S. corporations are concerned—almost to the point of obsession—with meeting quarterly targets, despite the potential negative effects on the corporation's long-term value. To a significant degree, this results from the demands of shareholders. In effect, investors excessively discount future returns in favor of current share price increases.[35] Corporate managers, concerned about share prices for reasons discussed above, respond accordingly, managing the company's earnings in ways that maximize current share price even at the expense of long-term value considerations. Scholars have referred to this practice as "managerial myopia,"[36] but investor myopia is also part of the equation. As legal scholar Lynne Dallas explains, myopia is "the excessive focus of corporate managers, asset managers, investors, and analysts on short-term results, whether quarterly earnings or short-term portfolio returns."[37] The consequence of this shared outlook is a tendency for corporations to sacrifice long-run value for short-term stock price performance.

C. The Social Costs of Short-Termism

There is an emerging chorus of concern among business leaders and academics that corporate short-term strategies raise significant public policy questions. The central issue is the negative effects of short-termism on businesses' long-run performance. For example, according to the Aspen Institute's Business & Society Program, "boards, managers, shareholders with varying agendas, and regulators, all, to one degree or another, have allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corpora-

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35. Andrew G. Haldane, Exec. Dir., Fin. Stability, & Richard Davies, Speech at the 29th Société Universitaire Européene de Recherches Financières Colloquium: New Paradigms in Money and Finance? (May 2011) (transcript available at http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech495.pdf).

36. *See, e.g.*, Sanjee Bhoraj & Robert Libby, *Capital Market Pressure, Disclosure Frequency-Induced Earnings/Cash Flow Conflicts, and Managerial Myopia*, 80 ACCT. REV. 1 (2005); Natalie Mizik, *The Theory and Practice of Myopic Management*, 47 J. MARKETING RES. 594 (2010). The disjunction between managerial emphasis on short-term share price and long-term fundamental value suggests that at least some companies would be more valuable if there were a change in orientation toward the long term. In other words, there is a "horizon arbitrage" opportunity available to those who might be in a position to replace current management with a new team willing to embrace longer horizons. *See* Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148, 148 (1990). Gaining control, replacing management, reorienting the company's temporal perspective, and then realizing added value from new approaches to internal investment policies are expensive and risky propositions. They require large commitments of capital to individual companies in order to gain control of management. This may explain why there does not appear to be a significant number of investors willing to undertake this kind of project.

37. Dallas, *supra* note 13, at 268.

tion."[38] In a similar vein, two concerned observers refer to short-termism as "a market failure . . . [that] would tend to result in investment being too low and long-duration projects suffering disproportionately."[39]

Excessive focus on short-term earnings can come at the expense of a corporation's long-run sustainability. Quarterly earnings are a function of standard accounting principles. Revenue enhances the bottom line, while expenses reduce it. There is, therefore, a built-in incentive for corporations focused on short-term performance to avoid discretionary expenditures that reduce current net income. These can include research and development, advertising, maintenance, employee training, and customer-service expenses. U.S. accounting rules treat these as expenses that reduce net income.[40] Most executives would apparently avoid these kinds of discretionary spending if necessary to meet their quarterly earnings targets.[41] Bushee finds that corporations are likely to cut research and development expenditures if stock ownership by transient institutional investors is high.[42] Corporations may also resist making capital investments, even though these costs can be spread over several accounting periods. Crucially, all of these expenditures can be of great importance to the corporation's long-term success. The pressure to produce quarterly accounting results nevertheless discourages managers from making them. The consequence may be stronger short-term share price performance, but over the long run, the corporation will fail to achieve its financial potential.

One survey of 401 corporate executives documents the economic costs of managerial short-termism.[43] Reacting to their understandings of market expectations, chief financial officers believe that quarterly earnings, computed according to the Generally Accepted Accounting Principles, are the single most important performance metric.[44] A steady, predictable record of earnings bolsters share prices and avoids the harsh consequences of failing to meet an earnings target at the end of a particular quarter. Remarkably, executives are candid in acknowledging that the desire to maintain share price justifies sacrificing investment decisions

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38. ASPEN INST. BUS. & SOC'Y PROGRAM, OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (2009), *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/bsp/overcome_short_state0909.pdf.

39. Haldane & Davies, *supra* note 35, at 14.

40. Bushee, *supra* note 14, at 211.

41. Graham et al., *supra* note 22, at 32, 35.

42. Bushee, *supra* note 8, at 328; *see also* Cherian Samuel, *Does Shareholder Myopia Lead to Managerial Myopia? A First Look*, 10 APPLIED FIN. ECON. 493 (2000) (looking at institutional ownership in general).

43. Graham et al., *supra* note 22.

44. *Id.* at 5.

that create long-term value for the corporation.[45] Many would be willing to reject a project with net positive present value if undertaking it would cause the company to miss the next quarter's accounting estimate.[46] Hence Porter's conclusion that "[t]he U.S. system first and foremost advances the goals of shareholders interested in near-term appreciation of their shares—even at the expense of the long-term performance of American companies."[47]

III. SHORT-TERMISM AND CSR

A. What is CSR?

There is no single, generally accepted definition of CSR. Even among sympathetic analysts, key questions generate controversy.[48] There is disagreement about the role of business in society, the persons to whom a business should be responsible, the responsibility that should entail, and so on. Even so, it is possible to sketch the concept's meaning in broad outlines.

The "social" element of CSR is the idea that corporations have responsibilities to the broader society. Some have claimed that corporations serve society simply by seeking to maximize financial returns for investors.[49] It is true that attempting to promote shareholder interests can create employment, financial returns for lenders of capital, valued consumer goods, and business opportunities for suppliers. But there can be a dark side as well. Profitable corporations also generate social costs. The company may pollute the environment or exploit workers, especially in developing countries. Because compensation is not required in many cases and shareholders enjoy limited liability, corporations may have economic incentives to disregard third-party effects as long as profits are increased. This is what law professor Joel Bakan had in mind when he called the corporation the "externalizing machine."[50]

Once one appreciates that large corporations affect the well-being—for good or ill—of many people besides shareholders in direct

45. *See id.* at 34–35.

46. *Id.* at 37.

47. Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARV. BUS. REV., Sept.–Oct. 1992, at 67.

48. Two important general studies of CSR are THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY, *supra* note 1, and TINEKE E. LAMBOOIJ, CORPORATE SOCIAL RESPONSIBILITY: LEGAL AND SEMI-LEGAL FRAMEWORKS SUPPORTING CSR (2010).

49. The classic statement of this position is Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32.

50. JOEL BAKAN, THE CORPORATION: PATHOLOGICAL PURSUIT OF PROFIT AND POWER 60–84 (2005).

and important ways, it becomes apparent that the social dimension of business activity extends beyond the shareholders to a broad array of other stakeholders. Specifying the class of relevant stakeholders has proven to be controversial,[51] but the pragmatic definition advanced by business ethics expert R. Edward Freeman has intuitive appeal, is reasonably workable, and has proved to be durable: a stakeholder of a particular corporation is anyone who "can affect or is affected by the achievement of an organization's objectives."[52] These include workers, creditors, local communities, suppliers, consumers, and those affected by the corporation's impact on the environment.

A second key element of most definitions of CSR turns on the distinction between legal obligation and voluntarily chosen conduct. One might say that obeying the law itself amounts to socially responsible behavior. This might be especially so in situations where a corporation confronts a burdensome regulation that is underenforced such that violations are unlikely to have negative legal consequences. Compliance would benefit some nonshareholder constituencies—workers or consumers, for example—but it would also raise costs and reduce profits. It could be claimed that compliance in these cases amounts to CSR, especially where profits that exceed the value of offsetting nonshareholder benefits are sacrificed.

The notion of CSR as legal compliance offers little value if that is all it has to say. No one seriously claims that the profit motive might justify violation of the law. It is generally accepted that legitimate decisions about whether to respect the law should not turn on cost–benefit analysis.[53] Even those like Milton Friedman, who insist that businesses' sole obligation is to generate profits for corporate shareholders, acknowledge that corporations should comply with applicable laws and regulations and honor contractual obligations.[54]

CSR should refer to voluntary undertakings—voluntary in the sense of not being required by law—that are designed to create social value in

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51. Thomas W. Dunfee, *Stakeholder Theory: Managing Corporate Social Responsibility in a Multiple Actor Context*, *in* THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY, *supra* note 1, at 353.

52. R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 46 (1984).

53. Legal philosophers have offered a number of arguments in support of a general duty to obey the law. *See, e.g.*, Kent Greenawalt, *The Natural Duty to Obey the Law*, 84 MICH. L. REV. 1 (1985); M.E.B. Smith, *The Duty to Obey the Law*, *in* A COMPANION TO PHILOSOPHY OF LAW AND LEGAL THEORY 465 (Dennis Patterson ed., 1996).

54. Friedman, *supra* note 49. One influential commentary states, "Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business: (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law." AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(b)(1) (1994).

some way. This is particularly important to the extent that law does not currently do enough to protect human rights or the environment, especially but by no means exclusively in developing countries. For advocates of CSR, corporations contribute importantly to social well-being when they choose to avoid harming people or damaging the environment regardless of profit.[55] More ambitiously, one could argue that corporations have an affirmative duty even in the absence of legal obligation to contribute in some way to their stakeholders' quality of life or, more broadly still, "to further some social good," at least in those areas where corporations are in positions to make a positive difference.[56]

It may be acknowledged, as critics have pointed out,[57] that at least some of what corporations do in the name of CSR amounts to little more than public relations maneuvers—"greenwashing"—designed to respond to pressures from nongovernmental organizations (NGOs), activists, and consumers for responsible behavior. While recognizing that greenwashing occurs and provides little social value, it is also important to see that corporations have the capacity to do much more than that. Many companies have voluntarily undertaken important initiatives in areas such as improvement of working conditions and reduction of greenhouse gas emissions. The idea of CSR encompasses these kinds of meaningful activities without claiming that all that passes for CSR creates significant value.

B. Ethical CSR

Given the lack of an agreed definition of CSR, it comes as no surprise that there are several different models or theories of CSR.[58] The various theories are in turn derived from a range of different normative

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55. *See, e.g.*, John L. Campbell, *Why Would Corporations Behave in Socially Responsible Ways? An Institutional Theory of Corporate Social Responsibility*, 32 ACAD. MGMT. REV. 946, 951 (2007). In the language of economics, this can be referred to as a duty to internalize the corporation's externalities. *See, e.g.*, Andrew Johnston, *Facing Up to Social Cost: The Real Meaning of Corporate Social Responsibility*, 20 GRIFFITH L. REV. 221 (2011); Beate Sjåfjell, *Internalizing Externalities in EU Law: Why Neither Corporate Governance nor Corporate Social Responsibility Provides the Answers*, 40 GEO. WASH. INT'L L. REV. 977 (2009).

56. *See, e.g.*, Abagail McWilliams & Donald Siegel, *Corporate Social Responsibility: A Theory of the Firm Perspective*, 26 ACAD. MGMT. REV. 117 (2001).

57. *See, e.g.*, Steven D. Lydenberg, *Envisioning Socially Responsible Investing: A Model for 2006*, J. CORP. CITIZENSHIP, Autumn 2002, at 57.

58. *See, e.g.*, Domènec Melé, *Corporate Social Responsibility Theories*, *in* THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY, *supra* note 1, at 47. For alternative views, see Aviva Geva, *Three Models of Corporate Social Responsibility: Interrelationships Between Theory, Research, and Practice*, 113 BUS. & SOC'Y REV. 1 (2008); Min-Dong Paul Lee, *A Review of the Theories of Corporate Social Responsibility: Its Evolutionary Path and the Road Ahead*, 10 INT'L. J. MGMT. REV. 53 (2008).

imperatives.[59] At a general level, it is helpful to talk about two different models or theories of CSR: the ethical and the strategic.[60]

The ethical model of CSR asserts that the corporation's management should attend to the interests of nonshareholder constituencies as well as to those of the shareholders. In other words, this theory rejects the shareholder-primacy conception of corporate purpose and management responsibility.[61] Instead of asserting that the corporation should be managed with primary regard for the shareholders' interest in profit maximization, this model defines fiduciary obligation in more expansive, pluralistic terms.

Thinking of CSR in terms of duties owed to all the corporation's stakeholders is often assumed to necessitate "trade-offs" or "zero-sum" choices. It is generally taken for granted—often, though not necessarily, with justification—that the interests of nonshareholders conflict with those of shareholders. So, if management acts in the interest of some nonshareholder constituency, it is assumed that corporate profits are reduced accordingly, and shareholder wealth is thereby diminished. For example, management may decide to install expensive new equipment to reduce air pollution, even though it is not legally required to do so. The public stands to benefit, but the added expense will reduce corporate profits. Certainly, one hears this complaint from partisans of shareholder primacy, who insist that CSR comes at the shareholders' expense and is illegitimate for that reason.[62]

The flip side of this coin is that acting in the interests of shareholders by seeking to maximize profits will often come at the expense of nonshareholders. For example, faced with a plant that is losing money, management may have to decide between closing it, which would be bad for workers, suppliers, and the local community, or keeping it going, which would be bad for shareholders. Or it may decide not to undertake recycling or emissions-reduction programs in order to save costs. In cases like these, decisions in favor of shareholder interests will have a negative impact on nonshareholder stakeholders.

CSR rejects the idea that these questions should necessarily be decided in the interests of the shareholders, but complex allocation questions are embedded here. Under what circumstances might management

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59. One analysis identifies four: instrumental, political, integrative, and ethical. Elisabet Garriga & Domènec Melé, *Corporate Social Responsibility Theories: Mapping the Territory*, 53 J. BUS. ETHICS 51 (2004).

60. *See generally* David Millon, *Two Models of Corporate Social Responsibility*, 46 WAKE FOREST L. REV. 523 (2011). In that article, I refer to these theories as the "constituency" and "sustainability" models. *Id.* at 525, 530.

61. *See, e.g.*, D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998).

62. For the classic statement of this position, see Friedman, *supra* note 49.

of the corporation legitimately prefer shareholder interests over those of other stakeholders? Shareholders being stakeholders as well, it is surely unsatisfactory to claim that shareholders must always lose. And what about cases in which there are conflicts of interest among nonshareholder constituencies? How are choices to be made? As of yet, stakeholder theory does not offer clear answers to these questions.[63]

Even so, the stakeholder approach to CSR has value primarily because it rejects the narrow notion of corporate purpose that would focus first and foremost on shareholder wealth maximization. Instead, it asserts a broader conception that sees corporations as actors in society that are responsible for the consequences of their actions. The complexities of this problem cannot command definitive ex ante resolutions, but CSR denies that this should be a basis for refusing to insist on corporate accountability.

From the shareholders' perspective, the idea of CSR as requiring balancing of stakeholder interests might be thought of as charity. As far as the shareholders are concerned, it is as if management has made a gift of the corporation's assets. The value of the shareholders' equity declines, and they receive nothing in return. Shareholders might therefore call this approach to CSR the "philanthropic" model. They might also label it an illegitimate wealth transfer—from the shareholders to the benefited stakeholder group.

Other stakeholders would see the matter differently. For them, the issue is not whether management might choose to confer gratuitous benefits out of charitable motives, but whether there is an obligation to confer these benefits in appropriate cases. Scholars primarily in the field of business ethics have developed a number of normative theories that can ground these obligations.[64] For this reason, the term ethical CSR[65] is more appropriate when referring to stakeholder theories that argue for a balancing of shareholder and nonshareholder interests.[66] This captures the idea of moral obligation that may exist independently of law.

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63. *See* Dunfee, *supra* note 51.

64. For a brief summary with references, see SUZANNE BENN & DIANNE BOLTON, KEY CONCEPTS IN CORPORATE SOCIAL RESPONSIBILITY 13–17 (2011).

65. For a discussion of various versions of ethical CSR and their normative foundations, see Garriga & Melé, *supra* note 59, at 60–62.

66. A stakeholder balancing or multifiduciary approach to corporate management can also be justified on efficiency grounds, without reference to CSR, as being necessary to encourage employees and other nonshareholders to make firm-specific investments in the firm. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

C. Strategic CSR

From a shareholder-primacy perspective, ethical CSR is inherently problematic. This is because of the assumption that regard for nonshareholder interests comes at the expense of the shareholders. Zero-sum trade-offs are assumed to be inevitable once management deviates from commitment to shareholder wealth maximization and turns instead to stakeholder balancing.

A strategic model of CSR avoids this objection by insisting that business decisions that confer benefits on nonshareholder constituencies have the potential to enhance corporate profits and shareholder wealth.[67] Strategic CSR is thus instrumental in the sense that it is undertaken to promote the interests of shareholders rather than out of a sense of ethical obligation to the stakeholder constituency that receives the benefit.[68] This is, therefore, an instance of the "business case" for CSR.[69]

Strategic CSR asserts that a long-term sustainability orientation requires that management nurture its relationships with key stakeholders, including workers, customers, suppliers, and the communities in which production is located. The company's future depends on the long-range well-being of these people and the durability of its relationships with them. Business strategy theorists Michael E. Porter and Mark R. Kramer provide several illustrations of companies that have invested heavily in stakeholder relationships to strengthen the company's future financial prospects.[70] For example, a corporation may invest in transportation infrastructure in an underdeveloped market to facilitate increases in agricultural production that will in turn generate increased demand for the corporation's fertilizer products. Increased production will mean better incomes for farmers as well as increased sales for the corporation. Or a corporation seeking to increase its access to dairy products might make substantial investments in well-drilling and irrigation, refrigeration, veterinary medicine, and training for animal husbandry in a new production location. The corporation benefits from increased supply and product

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67. Michael E. Porter & Mark R. Kramer, *Strategy and Society: The Link between Competitive Advantage and Corporate Social Responsibility*, HARV. BUS. REV., Dec. 2006, at 78. I term this the "sustainability" model because an important aspect is the long-run sustainability of the corporation. Because that term can also refer to environmental sustainability, I use the term *strategic* here instead to avoid ambiguity. *See* Millon, *supra* note 60.

68. *See* Garriga & Melé, *supra* note 59, at 53–55.

69. For a general discussion of various business case justifications for CSR, see Elizabeth C. Kurucz et al., *The Business Case for Corporate Social Responsibility*, *in* THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY, *supra* note 1, at 83.

70. For these and other examples, see Michael E. Porter & Mark R. Kramer, *Creating Shared Value: How to Reinvent Capitalism—and Unleash a Wave of Innovation and Growth*, HARV. BUS. REV., Jan.–Feb. 2011, at 62; Porter & Kramer, *supra* note 67, at 89–90.

quality, while the dairy farmers enjoy better living standards. Or, a third example, a corporation might spend heavily on improving employee health through lifestyle training and antismoking programs. The company realizes large savings in health care costs and enhanced employee loyalty and productivity, while the workforce experiences better health. In each of these cases, the corporations choose to create significant benefits for key stakeholder groups (customers, suppliers, or employees) and therefore act in a socially responsible manner. Even if the focus is on strengthening the capabilities of key nonshareholder constituencies in furtherance of the corporations' own long-range business strategies, the result for each of these populations is enhanced quality of life.

A strategic model of CSR can also justify expenditures on environmental sustainability, even though they could be problematic under the ethical model because of the assumed negative effects on shareholder wealth. This is because a proactive commitment to environmental sustainability (rather than a minimalist, reactive one) can create value for the corporation as well as for society at large. All corporations concerned about the long-term future of their businesses must attend to the impact of their activities on the environment because large-scale environmental destruction threatens the future of all business. Corporations must also pay attention to the long-term availability of reliable sources of raw materials. Some industries such as tourism and agriculture may be especially threatened by environmental degradation. Corporations that sell directly to consumers must be wary of the potentially long-lasting negative reputational effects resulting from disregard for environmental values. A strategic approach to waste reduction and energy efficiency can reduce costs, and the development of new eco-friendly products and services can enhance future revenues.

A number of companies have used process and product-design innovations effectively to reduce costs while also contributing to environmental sustainability.[71] For example, a shipping company may invest heavily in computer software and new aircraft and hybrid motor vehicles to enhance scheduling efficiency and reduce fuel consumption substantially.[72] A computer hardware manufacturer may develop new uses for out-of-date equipment to reduce recycling expenses.[73] Or a corporation might develop new products that allow consumers to reduce their energy

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71. Ram Nidumolu et al., *Why Sustainability Is Now the Key Driver of Innovation*, HARV. BUS. REV., Sept. 2009, at 59; *see also* Michael E. Porter & Claas van der Linde, *Green and Competitive: Ending the Stalement*, HARV. BUS. REV., Sept.–Oct. 1995, at 119.

72. *See* Nidumolu et al., *supra* note 71, at 60.

73. *See id.* at 61.

costs significantly.[74] These are examples of companies that have moved forward proactively to identify ways to reduce expenses and increase revenues while contributing to environmental sustainability. Although they may have to spend large sums of money on marketing, research and development, and new processes and equipment, companies like these expect to eventually increase their profits and enhance their prospects for long-term success. At the same time, they reduce their own negative effects on the environment and make it possible for consumers to do the same.

The standard objection to ethical CSR—that it is bad for shareholders—should not apply to these kinds of business policies. Corporations do not make these large expenditures, thereby reducing current profits, out of a sense of ethical obligation, or at least that is not their primary motivation. Rather, these investments are designed to generate future returns and thereby promote the corporation's financial interests. In the short run, profits are reduced because these initiatives require substantial up-front cash outlays. But adding in the long-run perspective changes the analysis because it is expected that the return on these investments will eventually result in net gains for the corporation and its shareholders. They are also supposed to contribute to the corporation's continued existence and profitability decades into the future.

There is significant evidence that strategically motivated CSR can generate net positive value for corporations and their shareholders. Over the past thirty years, many researchers have attempted to determine whether corporations can in fact "do well by doing good."[75] The meta-analysis of CSR scholar Marc Orlitzky critically evaluates existing studies and seeks to correct statistical and research-design inaccuracies.[76] In contrast to earlier literature reviews that have tended to be inconclusive, he finds that primary studies in the aggregate indicate a positive correlation between financial and social performance.[77] Reputational benefits, improved management learning, and internal efficiencies are identified as causal linkages.[78] It goes without saying, of course, that these conclusions do not imply that adoption of CSR strategies will always yield net benefits for all corporations.

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74. *See id.* at 61–62.

75. For a critical analysis of this literature, see Marc Orlitzky, *Corporate Social Performance and Financial Performance: A Research Synthesis*, *in* THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY, *supra* note 1, at 113.

76. *Id.*

77. *Id.* at 127.

78. *Id.*

One recent study provides particularly intriguing evidence of the financial benefits of CSR policies and practices.[79] This study is important because it supports the idea that strategic CSR may be a source of competitive advantage. Harvard Business School scholar Robert G. Eccles and his colleagues Ioannis Ioannou and George Serafeim examined ninety companies that began to adopt environmental and social policies during the early 1990s.[80] This set of companies—labeled by the authors as the "high sustainability" group—chose to develop "a culture of sustainability by adopting a coherent set of corporate policies related to the environment, employees, community, products, and customers."[81] These policies resulted in corporate governance changes and stakeholder engagement and commitment to a long-term performance time horizon. In contrast, a set of ninety "low sustainability" firms did not adopt these policies.[82] The members of this group were matched with their high sustainability counterparts with respect to industry sector, size, capital structure, performance, and growth opportunities.[83] Using both stock market results and accounting measures, the authors found that the companies in the high sustainability group significantly outperformed their low sustainability counterparts over an eighteen-year period.[84] Coinciding with Orlitzky's conclusion, the findings of Eccles and his coauthors imply that firms committed to strategic CSR "generate significantly higher . . . stock returns, suggesting that developing a corporate culture of sustainability may be a source of competitive advantage for a company in the long-run."[85]

While there appears to be a compelling business case for strategically motivated CSR, it is important to bear in mind that this model has built-in limitations that some advocates of corporate responsibility may find troubling. The strategic approach is based on cost–benefit analysis. The benefit side of the equation considers only financial benefit to the corporation, whether in the form of increased efficiency, enhanced revenues, or reputational payoffs. Additional social benefits, even if substantial, are not relevant because the key question is whether the corporation and its shareholders stand to gain value. This means that corporations will only invest in strategic CSR if they are confident of net financial

79. Robert G. Eccles et al., *The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance* (Harv. Bus. Sch., Working Paper No. 12-035, 2011), *available at* http://www.hbs.edu/research/pdf/12-035.pdf.

80. *Id.* at 5.

81. *Id.* at 8.

82. *Id.* at 5.

83. *Id.* at 10.

84. *Id.* at 33.

85. *Id.* at 27.

gains, at least in the long run. Accordingly, potentially important human rights or environmental problems may be ignored because it may not appear to be financially advantageous to address them. Strategic CSR would not expect expenditures in these cases even if the corporation itself may be a significant cause of the problem and may be well positioned to contribute to a solution. Nevertheless, even though some might say that strategic CSR does not go far enough, it is important to appreciate that it can have positive social effects. Further, it has the potential to avoid the shareholder-primacy objection, although it will not necessarily succeed, as discussed immediately below.

D. Short-Termism, CSR, and Shareholder Social Responsibility

For investors whose goal is short-term financial returns, ethical CSR is obviously unacceptable. These shareholders do not want to see corporate management spending money to benefit nonshareholders when regulations and contracts do not require it. They are likely to insist on shareholder primacy and reject the idea that management has an ethical obligation to balance shareholder and nonshareholder interests.

Strategic CSR is also problematic from a perspective that prioritizes short-term financial returns. This is so even though strategic CSR justifies expenditures on nonshareholders by reference to payoffs to shareholders. The problem is time; the costs and benefits of particular corporate decisions need not and indeed often do not occur simultaneously. For example, a decision to invest corporate funds in the enhancement of working conditions requires a current expenditure that will reduce corporate earnings in the accounting period in which it is made. At the close of that accounting period, shareholders are less wealthy as a result of that expenditure than they would have been had it not been made. If the expenditure has caused the corporation to miss its earnings target, the share price is likely to fall. The point of strategic CSR, however, is that this expenditure is designed to enhance employee productivity and lower workforce turnover. If those benefits actually come to pass, the financial payoff to the corporation—and therefore to the shareholders—may eventually exceed the cost. Impatient, short-term-oriented investors may not, however, be willing to wait for the long-run payoffs. In the words of one executive, "[a]nalysts and investors are focused on the short term . . . . They believe social initiatives don't create value in the near term."[86] Even when stakeholder benefits can be justified in strategic terms, without resort to claims of ethical obligation, the argument is still likely to fall on deaf ears in a world of short-term time horizons.

86. Barton, *supra* note 6, at 89.

This problem is compounded by the fact that it may be very difficult to calculate expected future financial payoffs. To the corporation, the benefits of investing, for example, in better working conditions are speculative in the sense that there is no certainty they will actually come to pass. Beyond that, even taking various possible future scenarios into account, it is extremely difficult to monetize the benefits to the corporation that flow from better morale, health, and efficiency. Shareholders who are already skeptical about the value of future profits relative to current expenses may find an additional reason to resist the proposition.

Corporations are unlikely to pursue CSR as long as institutional shareholders embrace a short-term investment perspective. Ethical CSR asserts an obligation to nonshareholders even if that means shareholders lose value. Investors fixated on quarterly results will not settle for that, and managers concerned about the costs of failing to meet earnings targets will also want to avoid shareholder losses. Similarly, even if management were to consider spending money on workers' well-being or environmental protection as part of a strategy for the corporation's long-term future, the immediate impact on quarterly earnings would be a significant deterrent. Thus, an overlooked consequence of short-termism is its discouragement of CSR. Shareholders need to be patient before we can expect corporate management to do so. *Corporate* social responsibility may depend on *shareholder* social responsibility.

IV. Understanding Shareholder Short-Termism

If it were simply a matter of shareholders changing their investment horizons and managers adjusting accordingly, one might be inclined to see this as a relatively minor issue. Arguments about the social costs of short-termism might gradually gain traction. Legal reforms might discourage short-term orientation at both the shareholder and management levels by creating incentives for more patient perspectives.[87] Corporations might then find themselves liberated to pursue strategic CSR policies and increase investment in research and development, capital assets, and other initiatives that require current expense to generate future returns. If investors were to become less fixated on quarterly results, corporations might even have more space for ethical CSR expenditures by virtue of their discretion to define and pursue long-term goals.

When one looks more closely at the drivers of institutional investor short-termism, it becomes apparent that the matter is a good deal more complex than it is typically assumed to be. Important classes of institu-

87. For discussion of various reform proposals, see, for example, ASPEN INST. BUS. & SOC'Y PROGRAM, *supra* note 38; HEINEMAN & DAVIS, *supra* note 6; Dallas, *supra* note 13.

tional shareholders face significant external pressures that shape their short-term orientation. To a significant degree, these pressures seem inevitable. Shareholders' responses to them are built into their existing business models. Advancing CSR by addressing short-termism is, therefore, likely to present difficult challenges. This Part analyzes key causes of institutional shareholder short-termism so that this challenge might be better understood.

A. Meeting Current Obligations

It is often said that public pension plans are the ultimate long-term investors.[88] These funds provide retirement income for state and local government employees. As a group, they own approximately 8% of the U.S. stock market,[89] down somewhat from the 10% stake they held before the financial crisis.[90] Some of these institutions are huge. For example, the California Public Employees Retirement System (CalPERS), the largest U.S. public pension fund, has assets worth over $225 billion and current obligations to over half a million retirees and contingent liabilities to over a million more.[91] Because public pension funds are obligated to existing and future retirees for decades to come, they are necessarily thought to have a long-term orientation. To meet future obligations, they must invest plan assets with an eye toward long-term sustainability.

While pension funds do have obligations extending long into the future, observers have typically failed to note that they also have substantial current obligations. Public pension funds have traditionally been structured as defined benefit plans, meaning that the employer has promised its employees pension benefits that are definite in amount. These pension funds must write checks to existing retirees each month in amounts that are contractually determined. It is therefore up to the managers of these funds to ensure that the plan assets earn sufficient returns to meet their commitments to retirees.[92] This differs from defined contribution plans, in which the employer commits to only a specified contri-

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88. *See, e.g.*, François Derrien et al., *Investor Horizons and Corporate Policies*, J. FIN. & QUANTITATIVE ANALYSIS (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1491638.

89. HEINEMAN & DAVIS, *supra* note 6, at 8.

90. Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245, 266 (2009).

91. *Facts at a Glance*, CALPERS (Jan. 2013), https://www.calpers.ca.gov/eip-docs/about/facts/facts-at-a-glance.pdf.

92. Pension plans also receive funds from employees and their employers, but investment returns typically constitute approximately 60% of their revenues. *The Widening Gap Update*, THE PEW CTR. ON THE STATES 4 (June 2012), http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Pensions_Update.pdf. Sometimes the number is higher. In 2010–2011, investment and other income for CalPERS amounted to 80% of total revenue. *Facts at a Glance*, *supra* note 91.

bution toward the employee's retirement. It is then up to the employee to invest these contributions so as to meet his or her retirement objectives. Employees bear the investment risk in defined contribution plans, while that risk falls on the pension fund itself in defined benefit plans.

The need for large amounts of cash on a monthly basis necessarily influences investment strategies. To meet their current obligations, public pension funds have historically assumed an annual rate of return of 8%, give or take a half point depending on the plan.[93] This is still largely true in the wake of the 2008 financial crisis,[94] although some plans are considering reducing their assumed rate of return by a point or so.[95] If plans do not attain the 8% target, they may have insufficient investment income to pay their retirees, and they may turn to other sources of funds such as proceeds from asset sales. Ultimately, the state and local authorities that sponsor these plans—and their taxpayers—must make up any shortfall.

The pressure to generate strong returns may be even greater in light of the well-known and much-discussed fact that public pension plans in the aggregate appear to be massively underfunded.[96] This means that many plans do not hold sufficient assets to generate the income needed to

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93. Mary Williams Walsh, *Public Pension Funds Are Adding Risk to Raise Returns*, N.Y. TIMES (Mar. 8, 2010), http://www.nytimes.com/2010/03/09/business/09pension.html. Historically, accounting rules have provided a further reason to invest in stock and other potentially high-earning securities rather than less risky and less volatile assets. Funds have been allowed to discount their liabilities at the same rate as their expected return on assets, so using an expected return of 8% allows a corresponding discount rate, even though public pension plan claims are essentially risk free, "making an accrued public-pension plan benefit one of the most secure assets in the world." Andrew G. Biggs, *The Market Value of Public-Sector Pension Deficits*, RETIREMENT POL'Y OUTLOOK, Apr. 1, 2010, at 1, 4, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1991361. Because it encourages investment in equities, the accounting rule discussed here has been described as a "perverse incentive." Deborah J. Lucas & Stephen P. Zeldes, *How Should Public Pension Plans Invest?*, 99 AM. ECON. REV. (PAPERS & PROC.) 527, 527 (2009). The Government Accounting Standards Board has approved a revision to this rule that would require lower discount rates in certain cases. For some pension funds, this will increase the extent to which they appear to be underfunded. Lisa Lambert & Nanette Byrnes, *New Rules May Make Public Pensions Appear Weaker*, REUTERS (June 25, 2012, 6:29 PM), http://www.reuters.com/article/2012/06/25/us-usa-pensions-standards-idUSBRE85O01Z20120625.

94. *See Public Plans Database: Actuarial Assumptions*, CTR. FOR RETIREMENT RES. AT BOSTON COLL., http://pubplans.bc.edu/pls/apex/f?p=1988:17:275542703837601::NO:RP,17:: (last visited Oct. 26, 2012).

95. Mary Williams Walsh & Danny Hakim, *Pension Funds Faulted for Bets on Rosy Returns*, N.Y. TIMES (May 27, 2012), http://www.nytimes.com/2012/05/28/nyregion/fragile-calculus-in-plans-to-fix-pension-systems.html.

96. *See, e.g.*, Roger Lowenstein, *The Next Crisis: Public Pension Funds*, N.Y. TIMES, (June 27, 2010), http://www.nytimes.com/2010/06/27/magazine/27fob-wwln-t.html; Peter Whoriskey, *Economists: State, Local Pension Funds Understate Shortfall by $1.5 Trillion or More*, WASH. POST (Mar. 3, 2011, 8:08 PM), http://www.washingtonpost.com/wp-dyn/content/article/2011/03/03/AR2011030302918.html.

pay the pensions owed to current and future retirees. The actual amount of the long-term deficit is controversial,[97] with estimates ranging from $438 billion to over $3 trillion.[98]

In the current economic environment, it is impossible for public pension funds to achieve 8% returns on an annual basis. Historically, over a twenty- or thirty-year period, it could reasonably be assumed that a diversified portfolio of stocks would earn an average of 8% or more annually.[99] But that assumption may no longer hold. And it bears emphasizing that the 8% figure is an average; one can never assume that it will be achieved in any given year. Since 2008, it has been impossible to come close for many public pension funds. Median investment returns over the past five years have been 3.2%.[100] CalPERS earned 1.1% in 2011.[101] Compounding this problem is the fact that since 2008 the economic and political situation has led states and local authorities to attempt to reduce their contributions,[102] which results in greater pressure on fund managers to produce sufficient investment income to meet current obligations.

The burden of meeting their legal obligations to their beneficiaries creates enormous pressure for public pension funds to generate investment income. In terms of trading strategies, this means a focus on short-term stock price performance. It also means high turnover rates necessitated by the need to realize short-term price increases in order to obtain cash. Although their obligations extend far into the future, public pension funds do not have the luxury of waiting patiently for long-term value to be reflected in share prices. Nor, with their massive portfolios, do they have the capability of identifying companies that possess significant hidden value.

Because it is now difficult to realize sufficient income on equity investments, some funds have moderated their reliance on short-term stock trading strategies. Some public funds are moving portions of their portfolios out of stocks into even riskier "alternative investments" such as

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97. *See* Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSP. 191, 203, 206 (2009) (concluding that public pension plans are underfunded by an amount ranging from $.93 to $3.23 trillion).

98. Biggs, *supra* note 93, at 5.

99. Matt Krantz, *Investors Question Wisdom of 10% Rate of Return Rule*, USA TODAY (Oct. 17, 2011, 9:08 PM), http://www.usatoday.com/money/perfi/columnist/krantz/story/2011-10-17/rate-of-return-for-stocks/50807868/1.

100. Sam Forgione, *Cash-Strapped U.S. Pension Funds Ditch Stocks for Alternatives*, REUTERS (Aug. 20, 2012, 3:56 PM), http://www.reuters.com/article/2012/08/20/us-pension-investing-alternatives-idUSBRE87J0QX20120820.

101. *Facts at a Glance*, *supra* note 91.

102. Forgione, *supra* note 100.

hedge funds, private equity, and real estate.[103] On average, public plans went from 60% to 50% invested in stocks, with some plans now lower than that figure.[104] Even so, public funds still rely heavily on equities to meet their cash needs.[105] Downward revision of 8% return assumptions has no impact on short-term cash flows. Some plans are also considering shifting from actively managed equity portfolios to passive investments in index funds that essentially mirror the market as a whole. Plans do this because passive investing saves fees and because it is extremely hard for portfolio managers to "beat the market." These are not short-term investments, but pressures for cash discourage large-scale movements in this direction.

Private, employer-sponsored pension plans face similar pressures for cash. These investors collectively own approximately 13% of the stock market.[106] The company is on the hook if the plan itself cannot meet the corporation's obligations to its retirees, which can mean reduced earnings and a possible decrease in stock price. In extreme cases, the corporation could default on its pension obligations and even end up in bankruptcy. Traditional defined benefit pension plans are disappearing. Among Fortune 100 companies, there were eighty-nine defined benefit plans in 1985; by 2011, that number was down to thirteen.[107] Even so, for corporations that continue to bear the investment risk, there is significant pressure to realize cash through short-term stock trading.

Colleges and universities may also find it necessary to pursue short-term trading strategies. These institutions are often heavily invested in stock, and they typically use income from their endowment portfolios to supplement tuition revenues to meet their operating expenses.[108] To the extent this is so, they too are likely to have short investment horizons.

Mutual funds may also have to rely on short-term investments to meet their obligations. The redemption-on-demand requirement allows investors to cash out their mutual fund holdings at any time. The need for liquidity encourages focus on short-term stock performance rather than long-run value so that gains can be realized when selling is necessary.[109]

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103. *Id.*; Walsh, *supra* note 93.

104. *See Public Plans Database: Actuarial Assumptions*, *supra* note 94.

105. *See* Forgione, *supra* note 100.

106. HEINEMAN & DAVIS, *supra* note 6, at 8.

107. Brendan McFarland, *Prevalence of Retirement Plan Types in the Fortune 100 in 2011*, TOWERS WATSON 3 (July 2011), http://www.towerswatson.com/assets/pdf/mailings/TW-21621_July-Insider.pdf.

108. Bob Morse, *Rise in Endowments May Impact Best Colleges Rankings*, U.S. NEWS (Feb. 9, 2012), http://www.usnews.com/education/blogs/college-rankings-blog/2012/02/09/rise-in-endowments-may-impact-best-colleges-rankings.

109. Jeremy C. Stein, *Why are Most Funds Open-End? Competition and the Limits of Arbitrage*, 120 Q. J. ECON. 247, 250 (2005).

In contrast, long-term investments are less liquid even if they are potentially more valuable because current share price is less likely to reflect underlying fundamentals in the short term.

In summary, various institutional investors face differing pressures to pursue short-term investment strategies. This is especially so for institutions that rely heavily on investment income to meet their own obligations to others. Pension funds in particular face this challenge, even though they are often assumed to be long-horizon investors. Given the importance of investment income and the magnitude of current and future liabilities, it seems unrealistic to suppose that pension funds might give up a short-term focus for longer, more patient investment horizons.

B. Competition for Investor Funds

Another driver of institutional investor short-termism is competition among mutual funds for investors' dollars. As a group, mutual funds own approximately 21% of U.S. equities.[110] Mutual fund fees are typically based on a percentage of the total assets under management.[111] This means that the larger the fund, the greater the fees payable to those who control it. This translates into pressure on those who actually manage fund portfolios to achieve results that will attract new investment and that will not trigger outflows of already-invested dollars.

Several studies document that a particular mutual fund's performance—the return on its assets—strongly influences the flow of money into and out of the fund. Mutual funds that earn the highest returns tend to attract the most new money.[112] At least for growth and similar styles of mutual funds,[113] year-to-year results are important measures of performance. Investors rely on annual performance reports. Year-end rankings published by the business press and information services are especially important.[114] Fund performance can also spur movement of dollars out of

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110. HEINEMAN & DAVIS, *supra* note 6, at 8. Prior to the financial crisis, the figure was nearly 25%. Palmiter, *supra* note 90, at 263.

111. Richard A. Ippolito, *Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry*, 35 J.L. & ECON. 45, 47 (1992). A small number of mutual funds use incentive fees based on performance relative to some index. Edwin J. Elton, Martin J. Gruber & Christopher R. Blake, *Incentive Fees and Mutual Funds*, 58 J. FIN. 779, 780–81 (2003).

112. *See, e.g.*, Ippolito, *supra* note 111; Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589 (1998).

113. Stephen J. Brown & William N. Goetzmann, *Mutual Fund Styles*, 43 J. FIN. ECON. 373, 373–74 (1997). Different styles of mutual funds concentrate on different asset classes. Short-termism is likely to be a feature only of those that invest in equities, as opposed to debt securities, commodities, and currency.

114. Keith C. Brown et al., *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. FIN. 85, 87–88 (1996).

lower performing mutual funds into higher performing ones, though the outflow is not as great as might be expected.[115]

Mutual funds that seek to attract investors motivated by short-term fund performance do so by adopting short-term investment strategies focused on realizing trading profits through relatively frequent buying and selling. One study identifies these investors as those who are likely to move their money into or out of a mutual fund according to its short-term (recent) performance.[116] Holding periods of individual stocks and portfolio turnover rates indicate that investor short-termism correlates with fund managers' short-term orientation.[117] Using several causality tests, the authors conclude that investor short-termism causes fund-manager short-termism, rather than the other way around, as might be the case if investors responded to managers who pursued short-term trading strategies.[118] Investor pressures may lead fund managers to choose short-term trading profits even when longer-term investments might produce more value: fund managers "might be forced to concentrate on 'short-term' investment opportunities, i.e., opportunities that are more likely to yield positive performance in the short run. . . . [They must] shy away from the really long term investment opportunities, even if such opportunities have higher expected returns than those shorter-term opportunities."[119]

Those who actually manage the individual fund portfolios face the threat of termination or reduced compensation if their performance does not measure up. Managers who underperform can be fired. One study finds that poor fund performance (measured either by growth of the asset base or by portfolio returns relative to similar fund styles) is likely to lead to replacement of the fund manager.[120] More recent rather than less recent underperformance tends to be especially significant, indicating that mutual fund governance mechanisms function effectively to sanction

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115. This may be due in part to psychological factors. Investors who bought into a particular fund based on its positive past performance may experience cognitive dissonance, in effect being unable to admit their mistake when things turn bad. William N. Goetzmann & Nadav Peles, *Cognitive Dissonance and Mutual Fund Investors*, 20 J. FIN. RES. 145, 146 (1997). Transaction costs involved in moving out of one fund and into another may also be a factor. Ippolito, *supra* note 111, at 54.

116. Li Jin & Leonid Kogan, Managerial Career Concerns and Mutual Fund Short-Termism (Oct. 20, 2007) (working paper), *available at* http://business.missouri.edu/yanx/seminar/short_termism_paper_0710.pdf.

117. *Id.* at 14.

118. *Id.* at 15.

119. *Id.* at 21–22. Lin and Kogan's empirical study validates earlier theoretical predictions that investor short-termism might produce manager short-termism. *See, e.g.*, Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988).

120. Ajay Khorana, *Top Management Turnover: An Empirical Investigation of Mutual Fund Managers*, 40 J. FIN. ECON. 403, 404 (1996).

fund managers who fail to respond adequately to investors with relatively short time horizons.[121]

Fund performance also affects compensation. Especially in larger firms, current investment performance is an important factor in determining bonuses.[122] Performance may be measured by reference to a benchmark (such as a stock index) or to a peer group (such as other mutual funds of the same style), but managers also report that overall firm performance may be more important than the performance of the portfolios they manage.[123]

Because of the pressure to meet annual performance targets, fund managers will adjust their trading strategies to achieve acceptable year-end results. Thus, for example, fund managers who are below their year-end target halfway through the year are likely to trade aggressively during the second half of the year, assuming greater risk in their efforts to reach the goals that have been established for their funds. [124] "[B]y focusing so much attention on relative return performance that is assessed annually, the industry may be effectively changing managerial objectives from a long-term to a short-term perspective."[125]

To summarize, mutual funds compete for investor dollars because their fees are usually based on total assets under management. For most equity funds, investors respond to short-term performance, moving money in or out of funds accordingly. This creates incentives for fund managers to pursue short-term investment strategies. As long as investors themselves have short investment horizons, it is hard to see how mutual funds might be expected to adopt long-term investment policies.

C. The Role of Independent Investment Advisors

Short-term pressures may be amplified when institutional investors employ independent investment advisors to manage their portfolios. Some institutions use employees for fund management, but many do not. In the mutual fund industry, for example, the investment advisor is often a subsidiary of the investment company, and the fund manager is its em-

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121. *Id.* at 425.

122. Heber Farnsworth & Jonathan Taylor, *Evidence on the Compensation of Portfolio Managers*, 29 J. FIN. RES. 305, 319 (2006).

123. *Id.* at 318–19.

124. Brown et al., *supra* note 114. This behavior appears to be more likely when managers are concerned about the effect of performance on compensation. Where job loss is the primary issue, managers may tend to be more conservative out of concern that high-risk investment strategies increase the possibility of an especially bad outcome. Alexander Kempf et al., *Employment Risk, Compensation Incentives, and Managerial Risk Taking: Evidence from the Mutual Fund Industry*, 92 J. FIN. ECON. 92, 93–94 (2009).

125. Brown et al., *supra* note 114, at 109.

ployee.[126] This is also often the case with insurance companies and banks.[127] In contrast, many pension funds rely on independent investment advisors to manage their equity portfolios.[128] These advisors may simply provide advice to in-house fund managers, or they may take on full, discretionary fund-management responsibilities, making decisions about investment strategies, asset allocations, and trading.

Many institutions evaluate their investment advisors' performance on a quarterly basis, which naturally encourages short-term investment horizons that in turn can lead to efforts to influence corporate management to generate short-term results. "It is unsurprising, therefore, that asset managers focus on delivering short-term returns, including through pressuring investee companies to maximize near-term profits."[129] According to one expert, "fund managers—even seasoned ones—are under intense pressure from colleagues and clients if they experience a string of two to three quarters of underperformance."[130]

Exacerbating this incentive problem is the practice of some pension funds that employ several different investment advisors and evaluate their performance against each other on a quarterly basis. In effect, a tournament is created. One study of U.K. pension funds finds a correlation between tournament intensity—the number of fund managers competing against each other—and preference for short-term results versus longer-term value.[131] This study also concludes that fund managers operating in a competitive arena are more likely to disregard or negatively view corporations' social and environmental performance when making stock-investment decisions.[132] As discussed above, this is to be expected when fund managers pursue short-term strategies because social and environmental performance generally requires current expense that generates compensating payoffs only in the long run.

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126. Farnsworth & Taylor, *supra* note 122, at 305 n.1.

127. *Id.* at 309.

128. Mary Williams Walsh, *Adviser Firm on Pensions Is Rebuked*, N.Y. TIMES (Sept. 21, 2007), http://www.nytimes.com/2007/09/21/business/21pension.html ("Pension trustees often hire outside investment managers to handle the money in their care . . . .").

129. Simon Wong, *Tackling the Root Causes of Shareholder Passivity and Short-Termism*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 31, 2010, 9:41 AM), http://blogs.law.harvard.edu/corpgov/2010/01/31/tackling-the-root-causes-of-shareholder-passivity-and-short-termism/.

130. Simon C.Y. Wong, *Why Stewardship Is Proving Elusive for Institutional Investors*, BUTTERWORTHS J. INT'L BANKING & FIN. L, July/Aug. 2010, at 406, 407.

131. Paul Cox et al., *Pension Fund Manager Tournaments and Attitudes Towards Corporate Characteristics*, 34 J. BUS. FIN. & ACCT. 1307, 1322–24 (2007).

132. *Id.*

In the United States, pension funds often engage consultants to help them select investment advisors.[133] The consultants maintain records of advisors' performance to facilitate selection. Competition among advisors for pension fund business is so intense that it raises concerns that consultants might accept bribes in return for steering pension fund business to particular investment advisors. Even when investment advisors compete honestly for pension fund business, it is an aggressive process that emphasizes recent financial performance.[134]

The point here is that pension funds and other institutions that already face strong pressure to meet their own short-term obligations may exacerbate their short-term orientation when they employ independent investment advisors. These actors compete with each other for business. When their clients are already oriented toward the short term, the advisors have strong incentives to produce those results. While in-house fund managers are also subject to compensation incentives and the threat of job loss, it is possible that they may enjoy a degree of security that outside managers do not. To the extent this is so, the short-term behavior of institutional investors may be intensified.

D. Fiduciary Obligations

A final cause of institutional investor short-termism deserves mention, though it is of relatively minor significance because a relatively small number of institutions are affected. Bank trust companies, which own less than 2% of the U.S. stock market,[135] are subject to fiduciary obligations owed to those on whose behalf assets are being managed. Courts have developed a "prudent investor" standard.[136] Traditionally, these obligations have been interpreted strictly, and personal liability for investment losses is a real possibility. As a consequence, fund managers tend to pursue conservative investment strategies, tilting significantly toward large capitalization companies with strong earnings and dividend records.[137] Bushee shows that banks, in common with short-term oriented transient investors, favor stocks of companies whose value is based on

133. Walsh, *supra* note 128.

134. Graves & Waddock, *supra* note 15, at 76.

135. Palmiter, *supra* note 90, at 277.

136. *See* Harvard Coll. v. Amory, 26 Mass. 446, 466 (1830); *see also* RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 90 (2007).

137. *See* Diane Del Guercio, *The Distorting Effect of the Prudent-Man Laws on Institutional Equity Investment*, 40 J. FIN. ECON. 31 (1996). Del Guercio finds a significant preference for stocks that earn S&P A+ rankings. *Id.* at 39–42. S&P rankings are based on earnings-per-share and dividend records over a ten-year period. *S&P 500 Quality Rankings Index: Index Methodology*, STANDARD & POOR'S 3 (Mar. 2011), http://www.standardandpoors.com/indices/articles/en/us/?articleType=PDF&assetID=1245212399111.

near-term earnings as opposed to long-term, future value.[138] In other words, the emphasis tends to be on easily ascertainable metrics—accounting results and share price—rather than less readily quantifiable long-run considerations.

It is possible that similar fiduciary duty considerations influence pension fund managers to behave similarly. Most states apply a prudent investor standard to managers of public pension funds.[139] Private pension funds are subject to the Employee Retirement Income Security Act, which includes a prudent person standard that applies to portfolio management.[140] Therefore, as with managers of bank trust fund portfolios, concerns about legal obligation and personal liability may motivate pension fund managers to pursue investment strategies that emphasize short-term performance. In contrast, fiduciary duty considerations are less likely to be a factor in the decisionmaking of mutual fund managers because of the low probability of liability for imprudent investments.[141]

V. CONCLUSION

Institutional shareholder short-termism can cause corporate managers to prioritize short-term earnings at the expense of potentially greater long-run firm value. Expenditures like research and development, advertising, employee training, maintenance, and the like reduce net income in the quarter they are made and produce value for the corporation only in future accounting periods. A short-term orientation means reluctance to make these kinds of investments, even though the long-run success of the corporation may depend on them.

Managerial short-termism also discourages CSR initiatives. Ethical CSR requires balancing of shareholder interests against those of other stakeholders. Shareholders fixated on quarterly earnings are likely to find this unacceptable. Even strategic CSR initiatives, which promise long-term payoffs from investment in stakeholder well-being, are problematic because of the short-term costs. Here, too, impatient transient investors are unwilling to trade current earnings for future value.

Because of the large consequences of shareholder short-termism, it is important to understand its causes. When these causes are examined, it turns out that institutional investors face significant pressures that constrain their investment choices. Pension funds have large current obligations to their retirees. Mutual funds compete with each other for investor dollars on the basis of their performance, and potential investors are most

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138. Bushee, *supra* note 14.
139. Del Guercio, *supra* note 137, at 36.
140. Employee Retirement Income Security Act, 29 U.S.C. § 1104 (2008).
141. Del Guercio, *supra* note 137, at 36.

interested in recent results. Independent investment advisors, competing with each other for business, exacerbate existing short-term tendencies, especially for pension funds that often rely on them for their portfolio-management services. Fiduciary obligations may also lead some institutions to prefer short-term results.

This is discouraging news for advocates of CSR because it is hard to see how current investment practices could shift to a patient, long-term perspective without some seismic changes to the surrounding landscape. Pension plans must pay their retirees. Public plans cannot expect public authorities to boost their contributions in today's economic environment. For private plans, corporations increasing their payouts would have to answer to shareholders disappointed in the earnings reduction that would result. Mutual funds cannot stop competing with each other without radical changes to their business models, and as long as competition persists, they must cater to investors who are themselves chasing short-term results. CSR, strategic or ethical, depends on a large measure of shareholder social responsibility that is unlikely to occur as long as major institutional investors are compelled to embrace narrow investment horizons.