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The SEC and the Institutional Investor: A Half-Time Report

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THE SEC AND THE INSTITUTIONAL INVESTOR: A HALF-TIME REPORT

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Nothing that the Securities and Exchange Commission ("SEC") has done in recent years has been as controversial or significant as its efforts to reform the proxy rules to permit greater communication among shareholders. Nothing that it has undertaken recently has also been left as incompletely or equivocally realized as these same efforts. That the SEC's efforts at facilitating shareholder communication have been controversial and significant is by now a commonplace observation.[1] That they are incomplete and equivocal requires more explanation. Although the discovery that an agency is behaving inconsistently is hardly a revelation, more than politics appears to be at work here. Fundamentally, the SEC has been attempting to broker marginal reform at a time when two fundamentally conflicting perspectives on institutional investors are competing for dominance. One side sees the consolidation of share ownership in the hands of institutional investors as a benign and progressive development; the other, as potentially ominous and disruptive. In this battle of paradigms, the SEC appears to be zealously and outspokenly—on both sides.[2]

The battle lines have been clearly drawn. On one side, a new generation of academics and reformers views the growth in institutional share ownership as promising a major revolution in business organization, one that signals the eventual end of the separation of ownership and control within public corporations.[3] Indeed, in their

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[1] For good detailed reviews of the new proxy rules, which this Article does not attempt to provide, see Harvey L. Pitt et al., *Proxy Reform: A New Era of SEC Activism*, INSIGHTS, Nov. 1992, at 2, 16 (proxy rule revisions are "far reaching and represent a permanent change to the fabric of registrant-shareholder communications"); Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1 (1992).

[2] For a similar view that the SEC is "repeatedly buffeted back and forth between various players in the corporate governance arena but apparently adrift from any predetermined course of its own" see Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1131 (1993).

[3] Probably the first academic to express this view (along with many other original views in a long and productive career) was Alfred Conard. *See* Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J. L. REF. 117 (1988). The leading spokespersons for this view are, however, my colleagues: Professors Bernard Black and Mark Roe. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) [hereinafter *Shareholder Passivity*]; Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM.

view, the separation of ownership and control was never inevitable, but rather was politically imposed. In contrast to Professors Berle and Means, who argued that modern technology vastly increased the capital needs of the twentieth century corporation, thus forcing corporations to seek equity capital from a broader class of shareholders than could effectively maintain control over their managers,[4] these new critics claim that ownership was separated from control as the result of political decisions, chiefly involving managerial manipulation of the regulatory system to protect corporate managers by constraining financial intermediaries. But for government interference, they contend, financial intermediaries—banks, mutual funds, insurance companies, and pension funds—would have assumed the same monitoring role in the United States as they allegedly have in Japan and Germany.[5] For this new generation, the traditional problems of corporate law would shrink in significance (some even call them trivial[6]) if institutional shareholders were permitted to monitor and replace corporate managers with less governmental interference.

From this perspective, the SEC is now increasingly viewed as the regulatory agency most able to delay the advent of this Brave New World of "investor capitalism." To the SEC, this academic criticism must have come as at least a mild shock. Long viewed and lauded as a model administrative agency, the SEC found itself, at the beginning of this decade, in the uncomfortable and unfamiliar position of having become a target for academic criticism, which viewed the agency less as a sword for shareholders, than as a shield for managers. The familiar "capture" theory, which political scientists have long used on

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L. REV. 10 (1991). Professor Black's views have been most recently summarized in Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) [hereinafter *Agents*] and Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992). *See also* Bernard S. Black, *Disclosure, Not Censorship: The Case for Proxy Rule Reform*, 17 J. CORP. L. 49 (1991). For the work of other scholars prominent in this new school, see Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991). Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89 (1990); John Pound, *Proxy Voting and the SEC: Investor Protection Versus Market Efficiency*, 29 J. FIN. ECON. 241 (1991); Nell Minow, *Proxy Reform: The Case for Increased Shareholder Communication*, 17 J. CORP. L. 149 (1991).

[4] ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

[5] For leading examples of this line of research, see Mark J. Roe, *Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry*, 93 COLUM. L. REV. 639 (1993); Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991).

[6] *See* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990).

other administrative agencies,[7] was now being brought to bear on the SEC to suggest that corporate managers had lobbied the SEC to frame its proxy rules so as to chill and silence dissident shareholders' voices.[8]

On the other side of this debate are corporate managers (and their representatives in the Bar). If the SEC experienced unexpected sniping from academic critics, its announcement in 1991 that it was undertaking a re-examination of the coverage of the proxy rules (partly in response to the foregoing critics)[9] subjected it to the direct frontal assault of the business community.[10] Under intense political pressure, the Commission deferred action on its proposals in late 1991, but it did not abandon its effort.[11]

Meanwhile, new themes entered this debate: to business groups,

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[7] "Capture theory" argues that regulation inevitably ends up serving some particular interest group, as the agency becomes dominated by one or more of the parties it was expected to regulate. *See* George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). For an attempt to compare the relative merits of standard "public interest" versus "capture" theories of regulation, as applied to the history of early business regulation in the United States, see HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937, at 133 (1991). *See also* John S. Wiley, Jr., *A Capture Theory of Antitrust Federalism*, 99 HARV. L. REV. 713 (1986).

[8] This claim was not entirely new. Economists had earlier argued that the sudden popularity of the tender offer in the late 1960s may have been the consequence of expanded SEC regulatory authority over (and actual regulation of) proxy contests earlier in that decade, which both raised the costs of proxy contests and made them a less feasible device by which to oust incumbent managements. *See* Gregg A. Jarrell & Michael Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371 & n.1 (1980).

[9] The modern history of proxy rule reform begins with a 1989 letter from CalPERS to the SEC, which detailed specific ways in which the proxy rules over-regulated and chilled dissident shareholders. *See* Steven A. Rosenblum, *Proxy Reform, Takeovers, and Corporate Control: The Need for a New Orientation*, 17 J. CORP. L. 185, 196-200 (1991); Patrick S. McGurn, *The Future of Proxy Reform*, INSIGHTS, Dec. 1991, at 3. In 1990, two rulemaking petitions were filed with the SEC by United Shareholders Association and Fidelity Management & Research Co., the mutual fund sponsor, each asking the Commission to amend the proxy rules to reduce this chill on shareholder activism. Rosenblum, *supra*, at 196-200. Commentators also prodded the Commission. *See* John C. Coffee, Jr., *SEC 'Overregulation' of Proxy Contests*, N.Y. L.J., Jan. 31, 1991, at 5. In Securities Exchange Act Release No. 29,315 (June 17, 1991), the Commission acknowledged that its proxy filing and disclosure rules were widely perceived to "restrict unduly" shareholder communications and requested comment on specified revisions to those rules (citing articles by Professors Coffee, Gilson & Kraakman, and Taylor). Regulation of Securityholder Communications, Exchange Act Release No. 29,315, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,811, at 81,843-45 n.31 (June 17, 1991) [hereinafter Release No. 29,315].

[10] The original CalPERS letter in 1989 prompted over 400 letters to the SEC from business groups. *See* McGurn, *supra* note 9, at 3. Over 2,200 letters were received in response to Release No. 29,315. *See* Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 at nn.27-29 (Oct. 16, 1992) [hereinafter Release No. 31,326].

[11] Some attributed the delay to the approach of the 1992 election and the need to appease the business community at a time when political contributions were being sought from it. *See*

the growth of institutional ownership implied not the end of the separation of ownership and control, but rather the consolidation of economic power in the hands of potentially unaccountable entities, who (in their judgment) often seemed more responsive to political than economic criteria.[12] In particular, they (and others) feared the new power and activism of the public pension funds, who, led by CalPERS and the Council of Institutional Investors, seemed intent on reshaping the balance of power between shareholders and managers across the face of Corporate America. Yet, to whom were public pension funds truly accountable? Were they guided by economic criteria, by a desire for political power and publicity, or by some private agenda?[13] American competitiveness in the global economy was in peril, some suggested, if long-term oriented corporate managers were subjected to the oversight of short-term oriented investors.[14]

Not surprisingly, progress on proxy reform came slowly. Only after the Commission's original proposal drew over 1700 letters of comment from the public[15] did the SEC cautiously promulgate Securities Exchange Act Release No. 31,326 ("Release 31,326") in October, 1992. Retreating marginally from its original proposals, the SEC diplomatically presented Release 31,326 as simply an effort at "removing unnecessary government interference in discussions among shareholders of corporate performance."[16]

Few believe that recent developments can be summarized that modestly or neatly. Although Release 31,326 did achieve significant deregulation, its overall impact remains legitimately debatable.[17] One effect is, however, undeniable: proxy reform has radically reduced the cost of shareholder communications. For example, after proxy dereg-

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SEC Delays Proxy Plan, N.Y. TIMES, Nov. 21, 1991, at D20; Stephen Labaton, *Policy Shift Is Seen at The SEC*, N.Y. TIMES, Dec. 23, 1991, at D1, D5.

12 Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163, 176-82 (1991). Mr. Rosenbaum served as counsel to the Business Roundtable in its negotiations with the SEC over proxy reform.

13 In particular, Professor Roberta Romano has argued that public pension funds are not economically accountable to their beneficiaries, tend to be poorly managed themselves, and may be run by persons seeking to maximize their political visibility in order to run for higher office. *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

14 This became a common theme by the end of the 1980s. *See, e.g.*, MICHAEL T. JACOBS, SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA (1991); LESTER THUROW, HEAD TO HEAD: THE COMING ECONOMIC BATTLE AMONG JAPAN, EUROPE AND AMERICA (1992); COMM. ON TIME HORIZONS AND TECHNOLOGY INVESTMENTS, NATIONAL ACADEMY OF ENGINEERING, TIME HORIZONS AND TECHNOLOGY INVESTMENTS (1992) [hereinafter TIME HORIZONS].

15 *See* Release No. 31,326, *supra* note 10, at n.27.

16 *Id.* at 83,353.

17 This Article will not attempt a detailed analysis of the proxy reforms implemented by

ulation, the United Shareholders Association estimated that it could target a mailing to a corporation's 1000 largest shareholders for a total cost to it of $5,000 to $10,000, whereas previously a full scale proxy statement would have cost it $1 million to prepare and distribute.[18]

Still, the greater significance of the Release may lie in the critical transitional moment it signalled. By acknowledging that overregulation had occurred and by scaling it back marginally, Release 31,326 conceded some of the criticisms of those academic commentators who argued that SEC proxy regulation had created an unlevel playing field. But once this concession is made, activists logically viewed it as implying a similar willingness to re-examine other constraints in the

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Release 31,326. In overview, however, Release 31,326 principally did the following things that were relevant to institutional investors:

1. The Release created a new safe harbor rule (Rule 14a-2(b)(1), 17 C.F.R. § 240.14a-2(b)(1) (1993)) to exclude from the definition of "solicitation" communications between shareholders that did not solicit proxy voting authority and that were sent by persons who had no material economic interest in the solicitation (other than their interest as shareholders). This safe harbor was intended and expected to encourage and permit broad communication among shareholder activists and institutional investors, which communications would formally have fallen within the definition of solicitation in Rule 14a-1(*l*)(iii), 17 C.F.R. § 240.14a-1(*l*)(iii) (1993).

2. The Release amended Rules 14a-11(d) and 14a-12, 17 C.F.R. §§ 240.14a-11(d), 240.14a-12 (1993), to permit a person to contest an election of directors or to oppose a non-election matter prior to the delivery of a definitive proxy statement. To use this procedure, a preliminary proxy statement must be filed with the SEC, no form of proxy may be provided by the person relying on the exemption, and such person had to provide a definitive proxy statement to those persons actually solicited as soon as practicable.

3. The Release adopted new Rule 14a-3(f), 17 C.F.R. § 240.14a-3(f) (1993), which permits a party who has filed a definitive proxy statement with the SEC to broadcast or publish its communications in advertisements, speeches, or columns, without preceding such communications with copies of the definitive proxy statement.

4. Under the Release, a party seeking minority representation on the board was permitted to distribute a proxy listing both its candidate or candidates as well as candidates nominated by management, even though it lacked permission from the nominee to include his or her name on its slate of candidates. Formerly, old Rule 14a-4(d) precluded an insurgent from listing persons who were not "bona fide nominees" (i.e., who had not consented to nomination by the insurgent); as a practical matter, this forced the party seeking only minority representation to run a short slate. *See* Ronald J. Gilson et al., *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors*, 17 J. CORP. L. 29 (1991).

5. The Release also eliminated the prior requirement of a preliminary filing of soliciting materials (except for the preliminary filing of the proxy and the proxy statement). This effectively eliminated any SEC prior restraint over newspaper ads and similar soliciting materials (although, of course, the antifraud rules continued to apply to all such materials).

[18] *American Corporate Governance: The Shareholders Call the Plays*, THE ECONOMIST, Apr. 24, 1993, at 83 [hereinafter *Corporate Governance*]. Although this tactic of targeting large shareholders arguably discriminates against small shareholders, it is noteworthy that the United Shareholders Association is an organization of small shareholders. *See infra* notes 113-16 and accompanying text.

federal securities laws to shareholder communication and collective action. Predictably, the SEC's critics have pressed for deregulation of these other restrictions under the federal securities laws (most notably, section 13(d) of the Williams Act[19]) that also inhibit the formation of shareholder coalitions. In contrast, for the business community, distasteful as the compromise embodied in Release 31326 was, it at least implied to them that the topic of institutional deregulation was now off the table. From their perspective, the Missouri Compromise does not work if one side can seek a year later to re-open the negotiation and pursue still further deregulation. In this light, an unresolved procedural issue for the future is whether Release 31326 was a first step or a sacred treaty that cannot be revisited.

Substantively, the issues go even deeper. One side in this debate tends to see institutional investors essentially as Gulliver tied down by a host of Lilliputian regulations enforced by petty (or perverse) regulators who lack any coherent policy objective (other than a desire to maximize their bureaucratic authority and significance). Free Gulliver, they argue, and the market will work. The other side not only believes that the market today is working satisfactorily, but that it is threatened by the size and scale of institutional investors (and in particular by the public pension funds) who in their view represent dangerously unaccountable giants, who want the legal right to form secret coalitions that could control even the largest public corporations.[20] Their nightmare vision of the future is a world in which invisible coalitions of institutional investors can form virtually overnight to pressure management into actions that may succeed in increasing securities prices over the short term, but that interfere with long-term economic planning.[21]

Lest there be ambiguity, this Article will argue that this vision is just that: a nightmare with little factual basis in reality. Still, the degree to which an idea accords with reality is seldom a measure of its ideological force or appeal. As others have noted, there is a deep and longstanding tradition in the United States that fears the accumula-

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19 *See* Securities Exchange Act of 1934, § 13(d), 15 U.S.C. § 78m(d) (1988).

20 *See* Allen D. Boyer, *Activist Shareholders, Corporate Directors and Institutional Investment: Some Lessons from the Robber Barons*, 50 WASH. & LEE L. REV. 977 (1993); Rosenbaum, *supra* note 12; David F. Shaffer, *SEC's Proposed Rules: Politicization*, WALL ST. J., Dec. 18, 1991, at A14.

21 Some serious academic research does suggest that managers may have a bias in favor of the short-term, which may lead to an underinvestment in long-term investments with greater value. *See, e.g.*, Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148 (1990). This article's claim is not that such a bias does not exist, but that institutional investors cannot organize and act effectively so as to enforce and exacerbate it.

tion of economic power in large financial institutions.[22] The assertion that deregulation will produce secret coalitions of institutional investors, able to control and dominate corporations, connects with this populist tradition and resonates with an ideological power that is wholly independent of its empirical validity.

At the same time, this Article will also assert that the new academic vision of institutional investors liberating corporate governance and emancipating shareholders from the tyranny of self-perpetuating corporate managers is equally a mirage. The basic force that explains shareholder passivity may not be legal restrictions or political pressures, but rational apathy. Put simply, both sides in the foregoing debate may have fallen prey to the fallacy of mistaking an ox for a bull. That institutional investors are large does not necessarily imply that they will be aggressive monitors. To the contrary, institutional investors (and, more importantly, those who manage them) may have only weak incentives to engage in managerial monitoring of their portfolio companies and thus will form effective shareholder coalitions only under limited circumstances. Today, such an assertion may seem counter-intuitive, as both the press and the public perceive institutions as increasingly activist and indeed eager to challenge corporate managements. Undeniably, heads have rolled in the executive suite over the last two years (at IBM, Shearson, Kodak, Westinghouse, and elsewhere). But whether this is a measure of institutional pressure or of board activism (or some combination of the two) remains debatable.

Both sides in this debate may have overestimated the desire of the institutional investor to participate in corporate governance, for at least four distinct reasons:

(1) both sides have underestimated the value of liquidity to investors; passivity may ultimately owe more to a preference for liquidity, which leads investors to rely more on exit than on voice;[23]

(2) both sides have also failed to examine closely the incentives of the agents within the institutional investor and how limited the payoff

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22 *See* Roe, *supra* note 3, at 31-36 (discussing populist tradition of objecting to accumulation of power in large financial institutions and its relevance to institutional fears of political reprisals for activism).

23 I have developed this theme at length elsewhere. *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) [hereinafter *Liquidity Versus Control*]; *see also* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991). The reference to "exit" and "voice" is to the terminology developed by Albert Hirschman that a dissatisfied individual faces two basic choices: to exercise "voice" (by seeking to change the status quo) or to rely on "exit" (by fleeing). *See* ALBERT O. HIRSCHMAN, EXIT, VOICE, LOYALTY (1970).

may be to them from involvement in corporate governance; in particular, the agent is less interested in the *absolute* performance of the fund it manages than in its *relative* performance versus its investment rivals; if its rivals can free ride on its efforts, then it is senselessly expending costs that do not improve its relative performance versus other fund managers;

(3) even though the total level of institutional ownership has risen dramatically, the level of institutional concentration has not kept pace and could in the future even fall. In large measure, this is because of the ease of entry into the money management market, but as a result the costs of collective action will remain significant because, absent a high level of concentration, effective institutional action will require the formation of sizable and thus costly coalitions;[24] and

(4) the new "political" theory of shareholder passivity advanced by academic critics is testable and the closest "natural experiment" yields results that do not strongly confirm this hypothesis.[25]

This last point requires a special word of explanation. Ultimately, the "political" theory predicts that institutional investors would behave very differently under a system of limited regulation. But do they in fact? As a control, it is only necessary to look to Great Britain, whose securities market structurally resembles our own and is populated by similar varieties of institutional investors, but is subject to much less regulation. When one examines the behavior of institutional investors in Great Britain (as I recently have with my colleague, Bernard Black[26]), one finds that the level of institutional investor participation in corporate governance in Great Britain is marginally higher. Although institutional investors in the U.K. do participate more actively, the difference is modest in comparison to the fears of those who predict secret coalitions of institutional investors dominating American corporations. More specifically, the one phenomenon that remains conspicuous by its absence in Great Brit-

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[24] *See infra* notes 52-64. This is an area where I disagree with Professors Black and Pound who, to varying degrees, suggest that, absent regulation, institutional investors would often choose to hold 5% to 10% blocks in large corporations, and would form effective coalitions able to vote, say, 40% of the corporation's stock.

[25] When social scientists cannot do controlled experiments, they often look for natural experiments that can be interpreted—for example, the crime rates in two adjoining and similar jurisdictions, one having and one lacking the death penalty. For a discussion of natural experiments, see FRANKLIN E. ZIMRING & GORDON J. HAWKINS, DETERRENCE: THE LEGAL THREAT IN CRIME CONTROL 263-70 (1973).

[26] Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, — MICH. L. REV. — (forthcoming June 1994) (draft on file with Columbia Institutional Investor Project).

ain—much like Sherlock Holmes's dog that did not bark in the night—is the formation of coalitions among any significant number of institutional investors. Rather, when management is approached by a dissatisfied institutional investor in the U.K., it usually is the corporation's largest shareholder, acting on an individual basis or joined by at most three to four other institutions. Larger groups rarely assemble.

Finally, the marginally greater activism that one does observe in Great Britain may be the product less of the more permissive regulatory approach in the U.K. (which places few, if any, barriers on group activity by institutions) than of the considerably greater degree of shareholder concentration in the U.K. As discussed later,[27] the United States presents the extreme case of shareholder dispersion among the world's established securities markets, and in such a context collective action will necessarily be more difficult and costly.

It substantially summarizes these points to say that the separation of ownership and control is likely to remain even with deregulation—but it is a new and different form of separation that will be most important. The critical separation of ownership and control will not be at the firm level on which Berle and Means[28] focused, but at the institutional investor level, where pension and mutual funds will be administered by money managers who are likely to remain generally apathetic about most corporate governance issues. In effect, the important agency problem shifts from the corporate-manager level to the financial-intermediary level. So long as economic incentives at the institutional level provide only weak incentives for agents at this level to participate in corporate governance, passivity will persist. This does not mean that shareholder passivity is inevitable, but that deregulation alone cannot solve it. Positive incentives to monitor must be affirmatively established.

That these agency problems at the institutional level have generally been slighted in the recent literature is attributable to the assumption made by most recent commentators that as institutions hold larger stakes, they will become more active in corporate governance.[29] This is logical, but the increase may be de minimis. The demand for participation in corporate governance may be highly inelastic, so that only modest increases in institutional participation in corporate governance result as the costs of participation are reduced with each mar-

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[27] *See infra* notes 51-71 and accompanying text.

[28] *See supra* note 4 and accompanying text.

[29] *See, e.g., Agents, supra* note 3, at 821-22. A few others have shared my doubts that larger stakes will automatically solve the collective action problem. *See* Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., Jan.-Feb. 1994, at 140; Rock, *supra* note 23 (analyzing when institutional investors are likely to take collective action).

ginal decrease in regulatory barriers. Three reasons for this inelasticity stand out: (1) the existence of substantial agency costs within the institution, (2) the need for fund managers to focus on their relative performance versus their competitors, and (3) the continuing high costs of collective action. Although both sides in the current debate tend to assume that further SEC deregulation will "unleash" institutional activism (for better or for worse), this Article's conclusion is that if the SEC were to "free Gulliver" through further deregulation, the result still might be a pretty somnolent giant—one sometimes capable of active involvement in the affairs of its portfolio companies, but easily placated by managerial stroking and very reluctant to devote substantial time or attention to monitoring any individual company within its diversified portfolio. In short, rational apathy may largely persist.

The one exception to this generalization may be the public pension fund, which does indeed march to a different drummer for reasons that will be discussed. But, although it is capable of greater activism and responds to different incentives, it cannot be an effective leader, unless others will follow. Because public pension funds as a class control insufficient stock by themselves to have decisive impact, the critical issue becomes when and under what circumstances coalitions can form among public pension funds and other institutional investors. Although it is predictable that public pension funds will play the role of a catalyst, it is far less predictable when other institutions will follow. This skeptical assessment implies that the fears of unaccountable power shared by many within the business community are greatly exaggerated.

Organizationally, this Article will have a dual focus: institutional investors and the SEC. Part I will focus on the entity being regulated—i.e., the institutional investor—in order to understand both the diversity of institutional investors and the uncertain incentives for agents within them. Its principal focus will be on the feasibility of institutional investor coalitions. When and how broadly are they likely to form? Part II will then focus on the SEC. How should we understand it: as a governmental agency seeking to mitigate the collective action problems inherent in dispersed shareholdings; or, as its new critics charge, as the de facto ally of management?

In that light, Part II will examine two "cutting edge" issues where the SEC's position seems most inconsistent with its praiseworthy efforts to simplify the proxy rules: (1) its continued unwillingness

to revise its rules under section 13(d) of the Williams Act[30] so as not to apply to shareholder "voting groups" formed by institutional investors,[31] and (2) its ambiguous and ambivalent pattern of conduct with regard to shareholder proposed bylaw amendments under Rule 14a-8.[32] In each area, the present position of the SEC is uncertain, but appears to have recently shifted in a manner adverse to institutional investors. Thus, those wishing to reduce the regulatory barriers to shareholder collective action may well have reason to view the SEC as much part of the problem as part of the answer. Why is this? The incentives of officials within large bureaucracies are not easily modelled. But beyond the usual turf-protecting motives for opposing deregulation, the SEC's behavior seems explained at least in substantial part by its fear of institutional investors as potentially the modern analogue to the investment banking cartels of J.P. Morgan and others that allegedly dominated the marketplace earlier in this century.[33]

Part III will conclude by surveying the kinds of deregulation that an SEC interested in facilitating institutional monitoring could undertake. Although the immediate prospect of such changes may at present be remote, they provide a longer-term roadmap for the SEC and, to the extent that most of the proposed changes could be accomplished without legislative action, a benchmark by which to assess the SEC's current attitude toward the institutional investor.

I. THE MYTH OF INSTITUTIONAL DOMINANCE

A. *The Cross-Sectional Data: Who Owns What?*

The very term "institutional investor" is a portmanteau word that needs to be unpacked. If one looks at institutional investors sim-

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30 15 U.S.C. § 78m(d) (1988).

31 *See infra* notes 137-46 and accompanying text.

32 *See infra* notes 156-90 and accompanying text.

33 Whether such Morgan-led cartels did dominate major U.S. corporations of an earlier era (before the Glass-Steagall Act separated investment and commercial banking) presents another question deserving closer examination on which this Article takes no position. Some recent historical research downplays the role of legal restrictions by suggesting that as U.S. corporations matured the Morgan firm became less active in monitoring them. By the 1920s (well before Glass-Steagall) the Morgan firm decided to cease becoming "involved in outside enterprises." *See generally* RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 258 (1990). However, it is clear as a historical matter that the belief that J.P. Morgan allocated securities at reduced prices to prominent individuals on its "preferred lists" deeply offended the American public and was cited at the Pecora Hearings as a major justification for legislative reform of the banking system. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 34-38 (1982). This fear of favoritism and reciprocal dealing has traditionally fueled Congressional actions designed to prevent the accumulation of significant power in financial institutions.

ply in terms of their collective ownership, their recent rate of growth has been phenomenal: as of 1990, institutions held 53.3% of all stock outstanding in the U.S.[34] The figure is up from 23% in 1955, 38% in 1981, and 44.8% in 1986.[35] As the post-war Baby Boom generation ages, the demographics of the U.S. population suggest that retirement savings will continue to flow into pension and mutual funds, expanding them like accordions well into the next decade. Mutual funds have recently experienced the fastest rate of growth,[36] and this trend may accelerate in the near future as the new popularity of the defined contribution plans increases (because mutual funds are the natural repositories for such plans).

But the simple statistic that institutions own roughly 53% of all equity can be misleading. One needs to look beneath the surface and see the breakdown of this figure among categories of institutional investors. As of 1990, that breakdown (among the principal categories) looked as follows:[37]

Institution Type	Equity Holdings (in billions)	Percentage of Total Equity Market
Pension Funds:		
Private	679.3	19.9%
Public (state or local)	282.5	8.3%
Total Pension Funds	961.8	28.2%
Mutual Funds	245.8	7.2%
Insurers (Life and Casualty)	235.7	6.9%
Bank Trusts	314.0	9.2%
Foundations/Endowments	61.7	1.8%
TOTAL	$1819.0	53.3%

These 1990 statistics may already be slightly dated, as more recent data suggests that pension funds and mutual funds are now up to 31% and 10%, respectively, of publicly held equity.[38] Nonetheless, what stands out from this breakdown is the dominance of the pension

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[34] *See* COLUMBIA INSTITUTIONAL INVESTOR PROJECT, CENTER FOR LAW AND ECONOMIC STUDIES, INSTITUTIONAL INVESTORS AND CAPITAL MARKETS: 1991 UPDATE 8 (Sept. 1991) [hereinafter 1991 UPDATE].

[35] *Id.* at 8 tbl. 10.

[36] Leslie Wayne, *Investment Soars in Mutual Funds, Causing Concerns*, N.Y. TIMES, Sept. 7, 1993, at A1.

[37] 1991 UPDATE, *supra* note 34, at tbl. 10.

[38] Using Federal Reserve System "Flow of Funds" data, Professor Roe finds that pension funds owned 31.3% and mutual funds 10.3% of all corporate equities outstanding at the end of the first quarter of 1993. *See* MARK J. ROE, THE MODERN CORPORATION AND PRIVATE

fund. With 28.2% in 1990 (and today probably 31% and rising), pension funds as a group are three times as large as their next nearest competitor. But equally important (if less obvious) is the ratio between public and private pension funds. Although the public pension funds have seized the headlines with their vocal criticism of corporate managements and high-profile activism, they pale in size when compared to private pension funds, which hold nearly two and one-half times the assets of public funds (i.e., 19.9% versus 8.3%). Nor is this disproportion changing. Federal Reserve data as of the end of the first quarter of 1993 show private pension funds to hold 22.0% and public funds 9.3% of all corporate equity.[39]

An implication of this ratio may be less obvious: because public pension funds control less than 10% of all corporate equity by themselves, they can have real impact only when they are able to form alliances with other categories of institutional investors. Thus, the frequently expressed fear that public pension funds will pursue ideological or simply non-wealth maximizing agendas involving the pursuit of social or political causes leads to an obvious rejoinder: "So what if they do?" Nine percent of the electorate cannot win a proxy contest, and there is no logical reason to believe that private pension funds (which are essentially controlled, directly or indirectly, by their corporate sponsors) or mutual funds (which, as discussed below, need to economize radically on their expenses[40]) will form an alliance with them.

The anecdotal evidence strongly suggests that other institutional investors are generally reluctant to join with public pension funds in a campaign to restrict managerial discretion—unless very high and immediate gains seem likely.[41] For example, in 1992, Robert Monks, a leading proponent of shareholder activism, won what seemed at the time a major legal victory when the SEC refused to accede to Exxon Corporation's request that it be allowed to exclude a proxy proposal submitted by Monks, which would have allowed shareholders to establish a mandatory shareholder advisory committee to oversee and evaluate the performance of Exxon's board of directors.[42] As a legal

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PENSIONS 1 n.1 (Columbia Center for Law and Economic Studies Working Paper No. 101, 1993) [hereinafter THE MODERN CORPORATION]; *see also* Wayne, *supra* note 36, at D4.

39 *See* THE MODERN CORPORATION, *supra* note 38, at 1 n.1.

40 *See infra* notes 89-94 and accompanying text.

41 William O'Barr and John Conley, two social scientists who have studied institutional investors, find a general reluctance on the part of private pension funds to support activism. *See* WILLIAM M. O'BARR & JOHN M. CONLEY, FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING 182 (1992).

42 *See* Charles F. Richards & Anne C. Foster, *Exxon Revisited: The SEC Allows Pennzoil to Exclude Both Mandatory and Precatory Proposals Seeking to Create A Shareholder Advisory*

matter, the SEC's decision seemed to signal that a potential new tool was available to investors. Yet, when the issue came to a vote, only 8% of Exxon shareholders voted for the Monks proposal.[43] This looks suspiciously as if the proposal received little support from institutions other than public pension funds.

Still, it would be incorrect to conclude that other institutions will never support activism. Data from the 1991 proxy season shows that shareholder proposals to redeem "poison pills" received 45% of the votes cast, confidential voting proposals received 35%, and proposals to bar or restrict "golden parachutes" gained 31.5% support.[44] The bottom line then seems to be that, although other classes of institutional investors are reluctant to support novel or untested proposals for the reform of corporate governance, they may well support specific restrictions on well-known managerial tactics that have a measurably negative impact on shareholder welfare.

These two assertions—(1) that institutional investors can only exercise "control" over a public corporation if and to the extent that a broad coalition can be formed across different categories of institutions, and (2) that such cross-institutional support is likely only for proposals having an immediate and significant impact on the share price—are subject, however, to a predictable rejoinder. In principle, ownership of 8.3% of the total public equity outstanding in the United States is sufficient to acquire control of any U.S. corporation. Thus, if public funds concentrated their investments on a relatively small number of companies, then in theory they could have a decisive impact. But for a variety of different reasons, concentration of share ownership by institutional investors is an unlikely scenario. Some of these reasons are essentially legal in character, and they include: (1) the portfolio diversification rules imposed by ERISA on private funds, by the common law "prudent man" rule on public funds, and by the Investment Company Act of 1940 on mutual funds;[45] (2) the disclosure requirements of section 13(d) of the Williams Act, which mandates a prompt filing once any shareholder crosses the 5% threshold of any class of a "reporting company";[46] (3) Section 16(b) of the Se-

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Committee, 48 BUS. LAW. 1509 (1993); Henry Lesser, *Shareholder Bylaw Amendment Proposals Under the Proxy Rules: The Impact of the Exxon Letter*, THE CORP. GOVERNANCE ADVISOR Oct./Nov. 1992 at 1. *See infra* notes 160-76 and accompanying text for a fuller account of this episode and its aftermath.

[43] Richards & Foster, *supra* note 42, at 1511.

[44] *Agents*, *supra* note 3, at 828 n.33 (citing various studies).

[45] For a discussion of the overreach of these rules beyond their economic logic, see *Liquidity Versus Control*, *supra* note 23, at 1353.

[46] 15 U.S.C. § 78m(d) (1988); for an overview, see *Shareholder Passivity*, *supra* note 3, at 542-44.

curities Exchange Act of 1934,[47] which effectively renders a 10% holder illiquid by requiring that, once its 10% threshold is crossed, all "short swing" profits[48]—i.e., profits on shares held for less than six months—must be returned to the corporation; and (4) "controlling person" liability under the federal securities laws, which holds a "controlling person" liable (subject to certain affirmative defenses) for securities law violations committed by the controlled person.[49]

Although these are "legal" reasons, precisely of the kind cited by proponents of the "political theory" of shareholder passivity as evidence of overregulation, only an ideologue believes that regulation can be addressed in "all or nothing" terms. Deregulation, if it comes, will be marginal and will leave many of the foregoing restrictions (such as the diversification requirement) largely intact. Thus, some legal barriers will remain to chill concentrated ownership, even if sensible deregulation does eliminate other overbroad rules. In addition, even absent the Williams Act or section 16(b), the desire to preserve liquidity would impose some constraint on the typical institution's ability to assemble and hold large blocks of stock in its individual portfolio companies. Indeed, for institutions such as mutual funds that must stand ready to redeem their shares on a daily basis, liquidity is not simply a preference but a necessity.[50]

As a result, there is a hidden check and balance on institutional activism that both proponents and critics of institutional participation in corporate governance have overlooked: because institutional investors cannot hold large blocks and because they value liquidity, they can influence control only to the extent they can form broad-based coalitions. Far from making such institutions dangerous, this economic fact of life means that institutional investors must win their contests based on the logic of their arguments, not the financial assets at their individual disposal. Even more importantly, the need for liquidity largely refutes the "secret coalition" scenario of those who

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47 15 U.S.C. § 78p(b) (1988).

48 The impact of "short-swing" profit liability on institutional investors is discussed in *Shareholder Passivity*, *supra* note 3, at 545-48.

49 *See* Securities Act § 15, 15 U.S.C. § 77o (1988); Securities Exchange Act § 20(a), 15 U.S.C. § 78t(a) (1988). For a nutshell treatment of these issues, see *Shareholder Passivity*, *supra* note 3, at 548-50.

50 Experience has shown such institutions that they can expect major fluctuations in the assets under their management and thus must stay liquid. The right of a shareholder in a mutual fund to demand that the mutual fund repurchase the shareholder's "redeemable securities" promptly after tender is set forth in section 22 of the Investment Company Act of 1940, 15 U.S.C. § 80a-22 (1988). Of course, "closed end" funds avoid this requirement by not issuing redeemable securities, but they are not nearly as popular with the investing public as "open end" mutual funds, whose securities are "redeemable."

object that any relaxation of regulatory rigor will allow institutions to form secret and shifting alliances. In truth, large member coalitions are probably inherently unstable, only occasionally effective, and almost never secret.

B. *The Level of Institutional Concentration*

Given that concentrated ownership of large stakes in a limited number of companies is today an unattractive strategy for most institutional investors, the next questions become: (1) how many institutions must typically be knitted together to form an effective coalition?, and (2) how feasible are such large coalitions? Here, we encounter a striking fact about the pattern of shareownership in the United States: namely, its relative lack of concentration. Although institutional investors may control the majority of publicly held equity in the United States, share ownership is broadly dispersed among them. One measure of this dispersion is the collective holdings of the largest institutional shareholders in the largest U.S. corporations. Investment managers with investment discretion over at least $100 million are required to make quarterly filings (known as "Form 13F filings") with the SEC.[51] Examining the holdings reported by the twenty-five largest institutional investors in the largest twenty-five U.S. corporations as of December 31, 1990, the Columbia Institutional Investor Project calculated the following aggregate holdings by such institutions in the top twenty-five U.S. corporations:[52]

Ownership Group	Percentage of Equity
Largest 5 institutions	10.58%
Largest 10 institutions	15.21%
Largest 20 institutions	21.23%

After the aggregate holdings of the top twenty institutions are calculated, the Columbia study noted that "concentration in institutional ownership falls off dramatically."[53] Although it is theoretically possible that these same institutions own an even larger percentage of

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[51] Section 13(f) of the Securities Exchange Act of 1934 requires institutional investment managers who exercise investment discretion with respect to accounts holding equity securities of "reporting" companies totaling at least $100,000,000 to file quarterly reports showing, among other things, their aggregate holdings in such companies. *See* 15 U.S.C. § 78m(f)(i) (1988). *See also* Rule 13f-1, 17 C.F.R. § 240.13f-1 (1993).

[52] *See* INSTITUTIONAL INVESTOR PROJECT, CENTER FOR LAW AND ECONOMIC STUDIES, INSTITUTIONAL INVESTOR CONCENTRATION OF ECONOMIC POWER: A STUDY OF INSTITUTIONAL HOLDINGS AND VOTING AUTHORITY IN U.S. PUBLICLY HELD CORPORATIONS—PART I TOP 25 U.S. CORPORATIONS AS OF DECEMBER 31, 1990, at 9 (Oct. 1991) [hereinafter INSTITUTIONAL INVESTOR CONCENTRATION].

[53] *Id.* at 8.

smaller companies,[54] the comparison between the foregoing level of concentration and that level which characterizes the securities markets most closely resembling our own—i.e., the British, Canadian, and Australian securities markets—is striking. In Great Britain, the percentage of the stock held by the largest twenty shareholders has long been higher than in the United States. A study from 1936 to 1939 found that the median proportion of voting shares held by the twenty largest shareholders in the eighty-two largest nonfinancial British firms was about 40% (compared to 28% for a similar sample of 132 American corporations at that time).[55] Moreover, in 40% of these British companies, the twenty largest shareholders held an absolute majority of the voting stock (while a similar concentration then existed in only 24% of American companies surveyed).[56] Although a 1976 survey that updated this earlier study found that the level of concentration had fallen, with the result that the top twenty shareholders then typically owned between 20% and 29% of the largest British firms,[57] the most recent estimate (in 1991) suggests that the growth of institutional shareownership has now caused stock concentration in Great Britain to surpass the original levels in the 1936 study, with the top twenty-five shareholders frequently owning an absolute majority of the stock.[58] Whatever the exact level, it is clear that in Great Britain (where the level of institutional stock ownership is now around 66%[59]) ownership of the stock is more concentrated because the population of institutional investors is considerably smaller than in the United States.

Recent studies of the largest Australian corporations show an even higher level of stock concentration, with the latest such study showing that the five largest shareholders held, on average, 54% of the outstanding shares, the ten largest shareholders held 64%, and the twenty largest shareholders held 72%.[60] Canadian data shows an es-

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54 Although this is possible, institutional investors have long been known to tilt their portfolios toward the largest corporations, both to assure liquidity and to avoid risk. Because of this tendency, and because the market is necessarily thinner in companies with smaller capitalizations, institutions generally hold smaller stakes in such companies on a percentage basis.

55 P. SARGANT FLORENCE, THE LOGIC OF BRITISH AND AMERICAN INDUSTRY 189 (rev. ed. 1961).

56 *Id.* at 189, tbl. Vc.

57 JOHN SCOTT, CAPITALIST PROPERTY AND FINANCIAL POWER: A COMPARATIVE STUDY OF BRITAIN, THE UNITED STATES AND JAPAN 95-96 (1986).

58 Tony Jackson, *The Institutions Get Militant*, FIN. TIMES, June 20, 1991, at 18.

59 *Id.*

60 Ian M. Ramsay & Mark Blair, *Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies*, 19 MELB. U. L. REV. 153, 168 (1993). Earlier studies in 1978 and 1980 found that the twenty largest shareholders held 51.7% and 51.2%, respectively. *Id.* at 166.

sentially similar level of concentration, with most significant companies having a controlling shareholder.[61] In short, when we turn to those economies organized along lines and according to legal rules most resembling our own, we find that the level of shareholder concentration is vastly higher. In truth, the Berle/Means thesis[62] may have always stopped at the water's edge and not applied very accurately beyond the shores of the United States.

How many institutions would have to join to form an effective coalition able to "control" a major U.S. corporation? Here, a closer look at the U.S. data is necessary because even the foregoing figure that the twenty largest shareholders hold 21.23% may overstate the effective level of concentration. U.S. institutional fund managers often do not retain sole voting authority over the stock they own. When adjustment was made for this fact in the Columbia study, the level of concentration dropped significantly. The largest five investment managers were found to hold sole voting authority over only 7.55% (in comparison to the 10.58% that they owned) of the shares of the largest twenty-five companies; the largest ten institutions held similar authority over only 10.98% (as opposed to owning 15.21%), and the largest twenty institutional investors held 14.87% (as opposed to owning 21.23%).[63] On this basis, a coalition of even twenty or more pension funds could have comparatively little clout.

Another means by which to gauge the dispersion of institutional ownership in the United States also emerges from this study. In 1985, a total of 8,779 institutions that made Form 13F filings held stock in the largest twenty-five U.S. corporations, resulting in an average of 351 such institutions per such corporation. By 1990, this number had risen to 13,524, for an average of 541 such institutions for each corporation in the top twenty-five.[64] Although this figure of 541 institutional shareholders is for the largest U.S. corporations, it may still understate the level of dispersion because not all sizable institutions are required to report their holdings by section 13(f).

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[61] *See Liquidity Versus Control*, *supra* note 23, at 1308-09. A 1978 Royal Commission found that forty-eight out of the largest 100 nonfinancial Canadian corporations were either a subsidiary of another (usually foreign) corporation or had an absolute majority shareholder. Still more had de facto controlling shareholders. A later survey found that only twenty of the 400 largest corporations in Canada were widely held by public shareholders. *Id.*

[62] *See supra* note 4 and accompanying text.

[63] *See* INSTITUTIONAL INVESTOR PROJECT, CENTER FOR LAW AND ECONOMIC STUDIES, "INSTITUTIONAL INVESTOR CONCENTRATION OF ECONOMIC POWER: A STUDY OF INSTITUTIONAL HOLDINGS AND VOTING AUTHORITY IN THE TOP 25 U.S. PUBLICLY HELD CORPORATIONS—PART II—COMPARISONS BETWEEN 1985 VS. 1990, at tbl. 7 (Feb. 1993) [hereinafter ECONOMIC POWER—PART II].

[64] *Id.* at 4.

The implication of this data is that there will typically be a large population within which a party seeking to form a coalition must search, and search is costly. In marked contrast to the British securities market, where the largest institutions typically own between 1% and 3% of virtually every large publicly traded corporation,[65] a dissatisfied U.S. institution considering whether to form a shareholder coalition with respect to a specific corporation knows at the outset that on average 540 other institutions own stock in the subject company. Yet potentially, no single institution may own as much as 2% of the equity of the underperforming company.

In terms of the number of institutional investors owning stock in a particular company, the trend is away from concentration, and this trend is likely to continue because of developments within the most rapidly growing sector of the U.S. financial industry: mutual funds. Where once a limited number of fund "families"—i.e., Fidelity, Vanguard, Dreyfus—dominated this field, there are now over 4,300 mutual funds, and 1,000 new mutual funds came into existence last year alone.[66] Indeed, there has been a 600% increase in the number of mutual funds over the last decade, until today "there are now twice as many mutual funds in existence as there are stocks listed in the NYSE."[67] In such a marketplace where mutual funds outnumber major corporations by a two-to-one margin, the "institutionalization" of stock ownership does not necessarily imply the end of the separation of ownership and control. Indeed, within both the pension and mutual fund sectors, the same pattern appears to hold: the percentage of equity held by institutions may be growing, but its ownership is widely dispersed—and growing more so. Why? Various reasons may be given: the disintermediation of money out of the banking sector and into mutual funds and IRAs, changes in retirement savings patterns by middle class investors, and the ease with which new investment vehicles can be created today. More generally, there are few significant barriers to entry into the money management business, and new entrants, as well as products and investment vehicles, appear on almost a daily basis. Moreover, because the holdings of even a single pension fund may be allocated among a dozen or more independent external money managers, none of whom easily cooperate with their rivals, institutional coordination is a more complicated matter than data about pension fund portfolio size initially reveals.

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65 *See* Black & Coffee, *supra* note 26, at nn.8-10 and accompanying text.

66 Wayne, *supra* note 36, at A1.

67 *See* Honey Bees, Mohair, and Investor Protection for Mutual Funds, 59 Sec. Reg. ¶ 22.3, at 5 (Warren Gorham Lamont, Oct. 28, 1993) (quoting from Speech by SEC Commissioner J. Carter Beese).

All this evidence thus points toward the same general conclusion: given the current pattern of shareholdings, it is unlikely that a small coterie of institutional investors could seize control of a public corporation. At least based on existing ownership levels, it might take a coalition of several dozen participating institutions before the aggregate ownership level could approach 40% or more. As next discussed, such a dispersed coalition of several dozen participants would be infeasible to assemble and inherently unstable—particularly in the face of managerial hostility and the predictable "divide and conquer" tactics that management could employ. The difficulty of forming such a coalition is perhaps best evidenced by the fact that no example of such a coalition forming in the United States to force a showdown with management comes to mind.

C. *The Feasibility of Large Coalitions*

Kenneth Arrow, the Nobel Laureate, has hypothesized, as a "broadly valid generalization, that in [large] organizations . . . the central decisions are made by a relatively small number of individuals."[68] He suggests that this phenomenon of elite control is "explainable in terms of rational organization theory."[69] Organizations economize on the cost of communications (and, in particular, on the cost of delay in making decisions) by keeping collective decision-making bodies small. The need to do so is greatest, he suggests, as the message to be communicated becomes more complex.[70] Senior executive offices in large corporations, he notes, are relatively small, both presumably because of the complexity of the information to be communicated and the high cost of delay in reaching business decisions.

If we apply Arrow's hypothesis to institutional decision-making, it follows that elite control of institutional coalitions is a necessary condition for their effectiveness. A broad-based coalition of twenty or so institutions seems inherently cumbersome and unstable. If such a coalition were attempted, each decision, or stage in a decision-making process, would require consultations between the fund managers representing the institutions and their clients, among the participating fund managers themselves, and between the institutions and the corporation they wish to influence. Questions raised, compromises suggested, or nuances detected anywhere in this process might have to be discussed again through the same network. For the individual fund

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[68] Kenneth Arrow, *Scale Returns in Communication and Elite Control of Organizations*, 7 J.L. ECON. & ORG. 1, 1 (1991) (Special Issue).

[69] *Id.*

[70] *Id.* at 5-6.

manager (who probably is also supervising a portfolio of one hundred or more companies), this process may seem interminable. In Britain, where institutional coalitions do form, we find that they are usually small in size (four to five firms) and dominated by a well-known powerful financial institution that owns one of the largest stakes in the corporation.[71] But small coalitions will be less powerful in the United States, given the lesser level of shareholder concentration, unless institutions are willing to concentrate their investments. And this, as earlier noted, would require a sacrifice of liquidity that few institutions are willing to make.

To summarize, the feasibility of a large coalition of shareholders remains unproven. At a minimum, such a coalition would still have to negotiate with a tightly knit executive team at the corporation, which would predictably attempt to pursue "divide and conquer" tactics that separate the institutions. Conceivably, institutional coalitions could learn to delegate decision-making power to an elite leadership of respected institutions, but at a minimum this will require a gradual learning process.

D. *Pension Funds: Public Versus Private*

By general consensus, banks and insurance companies have not been active investors and rarely oppose management.[72] This passivity may be attributable to legal restrictions on them, or conflicts of interest arising from the fact that they market services and products to the corporations in their investment portfolio, or (particularly in the case of banks) the lack of economic incentive for a trustee to expend funds on corporate governance issues. Whatever the reason, the bottom line is that pension funds have been the vanguard of activist investors. Only pension funds have been willing to undertake the role of catalyst and seek to form coalitions and make proxy proposals. Yet, as noted above, there is a major division among pension funds between public funds and private corporate funds. As a result, despite the sometimes aggressive bluster of the public pension funds, corporate managements need not feel threatened by pension fund activism, except in two circumstances: (1) when the public funds are able to form cross-institutional coalitions with private pension funds and mutual funds, or (2) if a limited number of pension funds were to revise their ex-

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71 Black & Coffee, *supra* note 26.

72 Professor Black describes banks as "relentlessly passive," both as money managers of corporate pension plans and as fiduciaries for trust accounts. *Shareholder Passivity*, *supra* note 3, at 600. He finds insurance companies subject to conflicts of interest "similar in strength to bank conflicts." *Id.* at 601.

isting policies and decide to hold concentrated investments in a few selected firms with a view to improving the performance of these firms through active involvement in management. The focus in this section will be on the relative likelihood of these two scenarios for institutional activism.

1. *Public Pension Funds*

As a class, public pension funds are pressure resistant, because they have few (if any) conflicts of interest. They do not market goods or services to corporations (unlike banks and insurance companies) and so cannot be threatened with business being cut off. Thus, for corporate managements who fear the potential influence of institutional investors, the worst case scenario is that public pension funds might attempt to concentrate their holdings, most likely in underperforming firms, in the belief that through active involvement as shareholders they could improve these firms' performance. Such an idea has been proposed by a few advocates of active investing, most notably by Robert Monks, who has attempted (with only limited success to date) to organize a closed-end mutual fund to serve as a vehicle for such investing.[73] How likely is it that public or private pension funds will be attracted to such a strategy? The early anecdotal evidence is that even the public pension funds have been distinctly cool to such proposals (as shown in part by the decision of CalPERS not to invest in Robert Monks's proposed LENS Fund[74]). The one notable exception to this generalization is the recent success of Dillon, Read & Company, the investment banking firm, in securing substantial equity commitments from institutional investors for a fund that will buy 10% stakes in selected corporations and place a representative on the board of each such corporation.[75] However, the Dillon Read proposal comes with a special twist: the general partners of the fund who will sit on the portfolio boards are all prominent chief executive officers themselves and include the Business Roundtable's own spokesman on corporate governance issues.[76] In short, this looks like a very

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[73] *See* Leslie Wayne, *Money Manager's 'Reality Check,'* N.Y. TIMES, June 22, 1993, at D1 (Monks canvassed sixty pension funds without success but has raised funds from other sources).

[74] *See* Susan Pullman, *Calpers Won't Invest in Activist's Fund*, WALL ST. J., June 22, 1993, at C1; *Meaningful Relationships*, THE ECONOMIST, June 26, 1993, at 82.

[75] *See* Allen R. Myerson, *Pension Funds Join in Turnaround Venture*, N.Y. TIMES, Nov. 2, 1993, at D1, D3 (noting that CalPERS was investing some $125 million in this fund along with the General Motors Pension Fund).

[76] *See id.* (H. Brewster Atwater, Jr., CEO of General Mills).

tame experiment in "relational investing," and its real implication may be that even public funds can be co-opted.

But what explains the public funds' lack of enthusiasm for concentrated investing? One possibility is that public pension funds are risk averse and thus apprehensive about either investing in underperforming companies or accumulating large and illiquid stakes. One item of evidence supporting this hypothesis is their lower allocation of funds to equities. As of 1990, public pension funds invested only 37.7% of their assets in equities, whereas the typical private pension fund invested 54.6% of its funds in equities.[77] Although the gap between private and public funds is closing in this respect, private funds appear considerably more willing to take the risk of equity investments—and for a logical reason. The trustees of private pension funds are typically employees of the corporate sponsor and thus have an understandable desire to minimize the annual contribution that the corporate sponsor must make under a defined benefit pension plan. Higher earnings by the pension plan on its investment portfolio (through equity investments) reduce the necessary annual contribution from the corporation. In contrast, reducing the sponsor's annual contribution may be a less pressing concern for public pension plan trustees. Possibly, the trustees of the public fund are not employees of the public sponsor or they are less effectively monitored by that sponsor. Also, they may believe that in a pinch a public pension fund can rely on state funding to bail it out.[78] As a result, although the public fund's investment performance will over time affect the state's annual contribution, the connection is less visible, and the pressure is weaker on the public fund's trustees to improve performance. In addition, while private pension plans are generally "defined benefit" plans, public pension funds often employ "defined contribution" formulas, which thereby sever any connection between investment performance and the sponsor's annual contribution.

Finally, internal fund managers do not face the same active competition for their jobs as do external fund managers. Their position is akin to that of a civil servant in a large bureaucracy. Hence, they have a rational reason to be risk averse, because a visible mistake could be embarrassing (if a large investment were to fail), but a below-market performance will not cost them their jobs (as it eventually will for the external fund manager). Given this difference, investing in concentrated and illiquid stakes in underperforming companies is pre-

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[77] 1991 UPDATE, *supra* note 34, at 7.

[78] *See* Romano, *supra* note 13, at 821-22 (arguing that the state's annual contribution can be used to pay current distributions).

cisely the investment strategy that risk averse internal fund managers seem most likely to avoid.

Public funds also differ from private funds in their greater reliance on an investment strategy of passive indexation. As of September 30, 1990, of the largest fifteen pension funds with investments in indexed equities, ten were public funds and only five were private funds—a two-to-one ratio.[79] Because indexing requires the investor to invest in a broad market index that approximates the market as a whole, it precludes concentrated investments, at least with the portion of the portfolio that is indexed. Ironically, those public pension funds most heavily identified with outspoken shareholder activism have also indexed the majority of their equity portfolios: CalPERS (64.1% of total equities indexed); California State Teachers (92.0%); New York State (73.5%).[80] In contrast, the largest private pension fund (AT&T) had only 46.8% of its equity portfolio indexed, and the third largest private fund (General Electric) had only 38.8% indexed.[81] In short, despite their vocal willingness to criticize managements, public funds to date have shown relatively little inclination to "put their money where their mouth is" by making concentrated investments.[82] Of course, an indexed investor can still be an active participant in corporate governance, but it has by definition forsworn the tactic that most threatens corporate managements: namely, making concentrated investments.

2. *Private Pension Funds*

If we assume that concentrated investments are unlikely for pension funds, it follows then that to be effective they must form coalitions with other institutional investors. As a practical matter, the most likely allies of public funds are private pension funds and mutual funds. To evaluate the likelihood of such alliances, it is useful to focus in more detail on the differences between private and public funds. Several stand out: first, private funds generally have a higher portfolio turnover rate and are more active traders.[83] Thus, their desire for

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79 1991 UPDATE, *supra* note 34, at 13. These 15 funds invested at least 62% of their equities in an indexed investment strategy.

80 *Id.* at tbl. 14.

81 *Id.* The second largest private fund (General Motors) did not even appear on the list of the fifteen largest funds with domestic indexed equities, and thus would appear to have used an indexed investment strategy to a much lesser degree.

82 Recall that CalPERS, often a close ally of Robert Monks, declined to invest in his LENS Fund. *See supra* note 74 and accompanying text.

83 For example, CalPERS, the largest public pension fund, has an annual turnover rate of only 10% and holds each stock in its portfolio for an average of between 6 and 10 years. *See* Gilson & Kraakman, *supra* note 3, at 863.

liquidity seems higher and the likelihood that they will hold a stock long enough to reap the benefits of improved corporate governance is lower. Second, although both private and public funds may be internally managed, public funds are more likely to rely on in-house management for investment decision making than private funds. Private pension funds typically delegate both investment and voting discretion over portfolio shares to external fund managers. In contrast, even when public pension funds use external fund managers, they tend to retain proxy voting authority in-house.[84] A 1990 survey by Investors Responsibility Research Center ("IRRC") found that 65% of responding public funds retained all authority over proxy voting, while 44% of responding private funds delegated all or most of their voting power to the outside fund manager.[85]

The following table, prepared by the Columbia Institutional Investor Project, is even more revealing because it shows the degree to which proxy voting authority is increasingly delegated to external agents by institutional investors holding shares in the largest 25 U.S. corporations as of December 31, 1990:[86]

	Sole Voting Authority	
Investor Category	1985 Average	1990 Average
Banks	9.23%	12.11%
Investment Advisors	3.31	8.22
Insurance Companies	2.66	2.03
Corporate Pension Funds	1.04	1.27
Investment Companies (Mutual Funds)	0.85	0.66
Public and Academic Pension Funds and Foundations	0.78	5.25

The contrast between private and public funds on this point is particularly striking. By 1990, although private funds owned considerably more shares than did public funds, the public funds held voting authority over more than four times as much stock in the top twenty-five U.S. corporations than did private funds (i.e., 5.25% to 1.27%).

The superficial reason for this disparity is that private pension funds have delegated their voting power to external managers (many of whom fall either under the category of banks or investment advisers). But why has this happened? One possibility is that one delegates what one is not truly interested in. On this basis, public funds may care more about voting than private funds. Given the greater

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84 Romano, *supra* note 13, at 832.

85 *Id.* at 832 n.123.

86 ECONOMIC POWER—PART II, *supra* note 63, at tbl. 3.

exposure of private funds to conflict of interest problems and to pressure from corporate managements, it may be that delegation to external agents is a bureaucratic defense mechanism.

An alternative explanation is less cynical. Private pension administrators have suggested to me that the real economic gains in pension administration come not from stock picking, but from strategic allocation management (that is, the allocation of the fund's assets among various asset categories—i.e., stocks, bonds, derivatives, real estate, foreign securities, etc.). Hence, the in-house management of a private pension fund concentrates on this issue and delegates both stock picking and voting to others. Once one delegates stock picking to external managers, they add, it is administratively burdensome and costly to retain the voting discretion over the same shares in-house.[87]

E. *The External Fund Manager*

The implications of this external delegation of voting authority is that the key actor with whom public funds must form an alliance is not the private pension plan's trustees or internal administrator, but its external fund manager. To paraphrase Willie Sutton (who explained that he robbed banks because "that's where the money is"), students of corporate governance need to focus on fund managers, because that is where the decision-making discretion is. Put simply, fund managers control most pension fund assets.[88]

How willing will the external fund manager be to join such an alliance? The external fund manager typically differs from the internal portfolio manager in several important respects: first, he faces greater competition because he does not have an exclusive relationship with the client. Typically, the private pension fund will allocate its funds among several external managers, reviewing them periodically and replacing underperforming managers. Second, the external fund manager has (or seeks) multiple clients. It is thus constantly marketing its services to potential new clients, and this factor is widely thought to result in a pro-managerial bias with regard to issues of shareholder activism because a reputation for activism may dissuade potential new clients from hiring the fund manager. Of course, these two factors may partially offset each other. If the fund manager believes that a stock in its portfolio can be increased in value through proxy voting, there is at least an incentive to undertake such a step in order to increase portfolio return and avoid replacement in the inevi-

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[87] A senior pension administrator at AT&T estimated to me in 1993 that it would cost AT&T $2 million per year for it to retain proxy voting authority in-house.

[88] *See* Rock, *supra* note 23, at 475.

table competition among fund managers. But, if such activism will potentially displease other or future clients, then, unless this activism can be hidden from public view, there is an offsetting disincentive. Better to lose an existing client, it may feel, than to acquire an activist reputation that deters dozens of potential clients. The tradeoff between these two factors may be indeterminate, but the one certainty is that the external fund manager will want to maintain a low profile when and if it votes against a corporate management.

Another even more important factor that differentiates the external fund manager from an internal manager involves compensation. Although the in-house portfolio manager at the public pension fund will have a budget and may not expend funds on proxy activism without limit, this manager does not personally bear the costs of proxy activism. In contrast, the external fund manager is compensated under a contractual formula that typically requires it to "perform normal proxy activity" and to bear the costs thereof.[89] The concept of "normal proxy activity" is, of course, changing, but the larger point here goes beyond the drafting question. Whatever the contractual formula, there is a potential conflict of interest between the interests of the money manager and those of the pension fund: proxy activism that could produce gains to the pension fund's beneficiaries may yet result in a net loss to the fund manager. Put differently, that proxy activism is cost-justified to the pension fund does not mean that it is cost-justified to the fund manager.

This explanation for passivity becomes even more credible when we examine the current structure of compensation for fund managers. Today, it is estimated that the typical fund manager of an equity mutual fund receives an annual fee of approximately seventy basis points (possibly with an additional incentive performance fee of up to an additional ten to twenty basis points).[90] In the case of index funds, this annual fee falls to around ten basis points (without any additional incentive fee).[91] The advisory contract between the mutual fund and its external fund manager will typically require the latter to vote the shares and conduct all proxy activities at its own expense. Because the market for pension fund managers is more competitive than that for mutual fund managers (because the corporate sponsor of a pension fund is a superior monitor to the dispersed shareholders and conflicted directors of a mutual fund), the annual fee to the external fund

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89 Pozen, *supra* note 29, at 143.

90 *Id.* at 11.

91 *Id.*

manager of a pension fund is unlikely to be significantly higher and may be even lower than the foregoing seventy basis point estimate.

On this assumption, an external pension fund manager has very little incentive to become involved in any form of proxy activity or voting contest. To see this, consider the standard case of a pension fund manager handling a $100 million equity account for a major corporate pension fund. Because a basis point equals 1/100th of 1%, the fund manager handling this account will receive an annual fee of around $700,000 (with maybe up to $200,000 in additional contingent incentive compensation based on performance). The manager of a similar-sized index fund would receive only $100,000 annually. The assets in this account will be invested in possibly 100 or more stocks (at least 500 in the case of an indexed fund). Given this compensation structure, our hypothetical pension manager seems likely to be rationally apathetic about incurring any substantial expense simply to increase the value of one stock in its portfolio. Even if a successful proxy contest would enhance materially the fund's overall rate of return, a seventy basis point fee will not cover the costs of a proxy contest (which can exceed several million dollars in a contested election).[92]

Moreover, the pension manager must worry about becoming a defendant in costly securities litigation brought by a corporation in which it acquires a substantial stake over the quality and materiality of any disclosures it was arguably required to make. Once discovery begins, the corporation's suit need not be meritorious to absorb most or all of the defendant's entire annual fee from its client. In addition, the imputed costs of time spent in negotiations with other members of its shareholder coalition, with the subject corporation (which is likely to propose some token concessions to placate its shareholders), and with its clients (who will want to be kept informed as to what is happening with their stock) may represent an even greater cost.

One arguable response to this assertion that the fund manager will remain inclined towards passivity, notwithstanding the benefit to the pension fund, is to increase the compensation to the agent. That is, if there is an agency problem, then rewrite the compensation agreement. But the problems with such a glib answer are considerable. First, the fund manager, as an agent, may not want to signal to its principal that it intends to be a proxy activist, because this is exactly the profile of the money manager that activism-fearing corporate

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92 For such an estimate of the costs of a proxy contest, see Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 914-15 n.253 (1993) (providing examples).

sponsors of pension funds want to avoid. Nor in the competitive world of fund managers is it a simple thing to ask for a fee increase to cover rising expenses. To do so is to allow oneself to be underbid by precisely those fund managers who are apathetic about voting and intend to incur only those expenses required by law.

Another alternative might be to ask the pension fund to cover all proxy-related expenses, separate and apart from the fund manager's fee. But it is unrealistic to expect the pension fund to make an open-ended commitment to underwrite any expenses that the fund manager hopes will increase portfolio value. Before it agreed to any such broad indemnity, the pension fund might logically decide to reclaim voting discretion and leave the external fund manager with only stock-picking responsibilities.

The logical answer to this problem of designing the optimal compensation contract for money managers is probably to use incentive compensation: make the external fund manager incur the proxy expenses (or a major portion of them) and then reward it with an agreed portion of the gain in share value over a defined period. In theory, the fund manager is then disciplined by having to incur the costs, but motivated by the prospect of a share of the benefits; in effect, the fund manager becomes a joint venturer with the fund in a search for underperforming companies that proxy initiatives could turn around. There are, however, several problems with this answer: first, the federal securities laws severely limit the payment of incentive compensation to investment advisers.[93] In the case of private pension funds, the payment of incentive compensation to the fund's investment adviser must pass muster under both the ERISA statute regulating private pension funds and the Investment Advisers Act of 1940. Although the relevant regulations do permit the use of what is known as a "fulcrum fee,"[94] these exemptions are generally perceived to permit only modest incentive compensation—in part because the compensation must be based on the fund's performance over a multi-year period

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[93] Under section 205 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-5(*l*)(1) (1988), an investment adviser may not enter into an "investment advisory contract . . . if such contract . . . provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client." This prohibition is partially lifted by section 205, 15 U.S.C. § 80b-5(b) (1988), which permits most institutions to pay limited incentive compensation measured "in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission . . . may specify." Pursuant to this authority, the SEC has adopted Rule 205, which permits the payment of a limited "fulcrum fee." *See* 17 C.F.R. §§ 275.205-1 - 205-3 (1993).

[94] See Rule 205-2(a)(1), under the Investment Advisors Act of 1940, 17 C.F.R. § 275.205-2(a)(1) (1993).

relative to "an appropriate index of securities prices" and thus must be forfeited if the fund's performance later falls below the same index's performance.

Second, even if these regulatory barriers were lowered, severe contracting problems would remain. How is one to determine in advance whether an improvement in share price at a specific company was attributable to proxy activism or unrelated exogenous factors? The likely answer to this question is to focus not on a single company but on whether the portfolio outperformed some appropriate market index. But then, activism will be beneficial to the fund manager only if it concentrates the account's assets on the few companies it can afford to monitor closely. And, as noted earlier, this implies a sacrifice of both diversification and liquidity. Finally, it remains very questionable whether private pension funds would seek to utilize incentive compensation to encourage proxy activism by their external fund managers—until some "first mover" demonstrates clearly the actual profit potential from such conduct. The problem is not simply that corporate managers are beset by obvious conflicts of interest (and thus have little reason to encourage shareholder revolts), but also that there has been no clear demonstration to the industry that there is any significant profit potential in proxy activism. Until some upstart entrepreneur demonstrates to the market that portfolio values can be enhanced in this way, the market will probably remain skeptical.

F. *When Will Shareholder Coalitions Form?*

Those commentators who predict that deregulation would end the separation of ownership and control usually make an argument that begins with the "free rider" problem and then shows how it can be partially solved as institutions hold larger stakes.[95] Assume a shareholder owns only 1% of the outstanding stock of a company and believes that a proxy contest to oust incumbent management will result in a 10% increase in the corporation's stock value, for a total gain of $100 million for all shareholders. But such a proxy contest may cost $3 to $5 million, and this exceeds the $1 million benefit that a 1% shareholder anticipates it will individually reap. Such a shareholder is rationally uninterested in incurring costs to benefit others; it will proceed only if it can either (1) tax the "free rider" (i.e., the other share-

[95] *See* Bernard S. Black, *Institutional Investors and Corporate Governance: The Case for Institutional Voice*, 5 J. APPLIED CORP. FIN. 19, 21 (1992) [hereinafter *Institutional Investors*]. The "free rider" problem was first explicitly discussed by Mancur Olson. *See, e.g.*, MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 27-36 (2d ed. 1971).

holders)[96] or (2) find allies who will share the costs with it. If, for example, it could form a coalition with nine other 1% shareholders, then each might contribute the necessary $300,000 to $500,000 to cover the expected costs of the proxy fight. But finding nine other like-minded shareholders willing to share costs may be difficult. Thus, if our 1% investor were to increase its stake to 10%, it might become more of an activist, because now it would rationally incur costs of $3 to $5 million on its own, as the expected benefit to it is now $10 million. Also, it would need only to find one or two other similar sized shareholders to reduce its contribution to the collective fund by one-half or two-thirds.

Logical as this analysis is, it fails to "unpack" the pension fund and examine the incentives of the actual decision makers: the external fund managers. First, if we assume that the typical private pension fund will use multiple external fund managers, this premise suggests a reason why the pension fund will not easily hold 5% (or greater) stakes. Even if such a large stake would not disrupt the overall diversification level of the firm, the individual money manager may want to keep its own account fully diversified and protected against large, visible losses, because it fears that any such loss will result in its replacement. More generally, competitors do not easily cooperate. As a result, with each additional external money manager used by the pension fund, the maximum level of investment that the fund will make in a single portfolio company is likely reduced.

More importantly, the incentives for the money manager to monitor are far weaker than for the pension fund as a whole. For example, assume that the money manager has been given a $100,000,000 account to manage by a large private pension fund, which also uses three or four other external money managers, and that this money manager will receive an annual fee in the neighborhood of seventy to 100 basis points per annum (or between $700,000 and $1,000,000). Clearly, the same expected $3 to $5 cost of the proxy contest will be prohibitive if the fund manager has to bear it itself. Indeed, whether it holds a 1% stake or a 5% stake, its attitude will change little so long as it is not compensated on a performance basis. Of course, it is theoretically possible that if a large enough coalition is formed, the contribution per fund manager necessary to defray the expected proxy contest's costs would be within their respective capacities. But such a

[96] If the costs of a successful proxy campaign can be charged to the subject corporation, this is in effect a technique for prorating the expenditures among all shareholders and thus taxing the free riders. *See* Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, 292-93 (N.Y. 1955).

coalition would be an order of magnitude larger than the half-dozen or so institutions that the proponents of activism believe could "influence" a corporation (if existing regulations were relaxed).[97]

Obviously, the more practical alternative is to ask the pension fund to bear the costs of proxy activism; then, in theory, a group of a half dozen or so pension funds might rationally incur considerable expense (if the expected benefit per participating institutional shareholder covered it). Yet, there are still reasons why the external fund manager might be hesitant to approach pension funds to ask them to underwrite the costs of proxy activism: first, there is the usual problem of conflict of interest and the undesirability of a reputation as an activist. To the extent that the fund manager engages in proxy activism at its own expense, it at least maintains a low profile, but requests to the pension fund for the latter to subsidize these costs require the manager to abandon its protective camouflage.

Second, there is the problem of competition. Our external fund manager's performance is being measured periodically against that of the other fund managers used by the pension fund and against that of other potential managers. If it recommends that the pension fund make a substantial outlay on proxy activism and the effort is not successful (i.e., the share price does not rise sufficiently in the short-run to cover these costs), the fund manager may well fear that its reputation will be tarnished. Some believe that fund managers have a tendency to "follow the herd" in their investment decision in the belief that mistakes also made by others cause less reputational injury than conspicuous errors that others have not also made.[98] If so, this same pattern may carry over to voting decisions as well and produce a reluctance for the fund manager to become identified with activism on any issue where there is not a very broad consensus.

Finally, there is the problem of timing. Investments in corporate governance pay off (if at all) over the long-term, but fund managers are evaluated over a shorter cycle. Assume our fund manager is evaluated over a four year cycle (in which it is now midway). Any expenditure that it convinces its principal to make will properly be considered against the rate of return it has generated. Yet, the payoff will come only later. As a result, it is predictable that fund managers who face competitive pressure or who are currently underperforming the benchmark standards necessary for continued employment will be

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97 For such an estimate, see *Institutional Investors*, *supra* note 95, at 21.

98 *Cf.* Joseph Lakonishok et al., *The Impact of Institutional Trading on Stock Prices*, 32 J. FIN. ECON. 23 (1992) (finding that "herding" occurs primarily in small stocks and does not significantly destabilize stock prices).

hesitant about recommending investments in proxy contests or similar forms of activism—unless there is a likelihood of a short-term improvement in the share price of the portfolio company as a result of that activism.

It is important here not to seek to prove too much. The foregoing pessimistic assessment has suggested that there is an agency problem within both pension funds and mutual funds that necessarily constrains institutional activism: namely, the difficulties inherent in designing a compensation contract that adequately motivates the fund manager to incur the costs of proxy activism. But this does not mean that alliances between public funds and other institutional investors will never form. Fund managers do have an interest in improving their clients' investment performance, even at a short-term loss to themselves, both to attract new clients as well as to retain existing ones. On occasion, this may lead them even to incur a financial loss to demonstrate their fidelity to their clients.

When then are such coalitions most likely to form? Several generalizations suggest themselves: first, coalitions among institutional investors are most likely when public pension funds are prepared to assume disproportionately the costs of collective action. Put differently, the most logical strategy for private fund managers when they see managerial behavior that threatens their interests is to approach the leading public activists (CalPERS, TIAA-CREF, etc.) and ask them to lead a campaign.[99] Placing the public fund in a visible leadership role affords a measure of protective camouflage to conflict-sensitive private fund managers. Although the private fund managers are obviously "free-riding" on the public funds in such a case, the relationship may still be a symbiotic one, with reciprocal benefits. To the public fund, which wants a reputation for activism, it is at least reassuring to know that, if they lead, others will follow. Further, once the prospect of success is heightened in this manner, it is rational for the public fund to commit greater funds. Indeed, the public fund may hear informed estimates from the private fund managers as to the market's probable reaction (and the likely gain in share price) if the proposed action is successful.

Second, some recurring issues of procedure or governance involve only low costs because they are generalized issues, without any significant fact specific complications, and thus institutions can formulate a generic policy in advance. Economies of scale may exist

[99] Personnel inside major public funds have told me that they now receive such calls from private fund managers. One case in which such calls were particularly frequent and insistent involved the 1993 management succession crisis at Eastman Kodak.

with respect to such issues because they will arise predictably with regard to a number of companies over a foreseeable period.[100] Policies regarding poison pills, golden parachutes, and confidential voting fall into this class. When CalPERS and other public pension funds began to undertake proxy solicitations at the end of the 1980s, seeking to restrict the use of poison pills, other institutional investors gradually came to support them; a few such contests were successful, while others received substantial support.[101] Indeed, in such cases, it may be unnecessary in the future to seek proxy authority. The proponent could either seek to place the issue on the subject corporation's agenda by proposing a bylaw amendment under Rule 14a-8,[102] or it could announce its intention to propose a precatory resolution at the annual meeting and ask other institutions to vote for it.

Third, coalitions are more likely to form when the object is a short-term change that will yield an immediate increase in market price. Coalitions that are formed to propose a merger, sale of significant assets, spin-off, or restructuring (or to support directors committed to such policies) can meet this criterion. For short-term traders, such as mutual fund managers, such a campaign makes far more sense than one directed simply at "good governance" reforms or independent directors.[103]

Finally, coalitions are more likely to form when institutional investors fear that their market exit has been impaired. Consider, for example, a corporation that experiences a sudden and unexpected financial crisis that places it on the edge of bankruptcy. Institutional investors could recognize in such a situation that any effort to liquidate their substantial positions will only produce a panic and a greater price decline than if they jointly worked to make necessary changes in management. Another example would be a case where an institution held too large a stake to enjoy liquidity. In either case, with "exit" thus foreclosed, institutional investors are forced to rely on "voice."

The basic prediction then is that most institutional investors (other than the public pension fund) will support proxy activism if and to the extent that they can economize on their own costs—in part, by asking public funds to subsidize them. Classically, this is how the traditional proxy fight worked. The insurgent sought support from neutral or uncommitted shareholders, who even if they

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100 *See Shareholder Passivity*, *supra* note 3, at 589-91.

101 *See* Gilson & Kraakman, *supra* note 3, at 867-68, 893 & n.91 (discussing CalPERS campaign and other recent proxy proposals); *see also Agents*, *supra* note 3, at 828 & n.33.

102 17 C.F.R. § 240.14a-8 (1993). *See infra* notes 149-89 and accompanying text.

103 For a similar view, see Pozen, *supra* note 29, at 145-46.

granted a proxy to the insurgent did not expend their own funds or invest time in seeking to organize the coalition. Participation consisted solely of granting the proxy.

One implication of this hypothesis is that the institution playing the catalyst role (typically a public pension fund) will encounter little challenge to its leadership. Other institutions may or may not join with it, but their participation will be more passive than active. Instances in which private pension funds will tax themselves to create a common fund to cover proxy solicitation or legal costs are likely to remain very rare.

G. *Are Institutional Coalitions Dangerous?*

Throughout much of American history, there has been a deep populist suspicion of the supposed machinations of Wall Street financiers. Secret deals, invisible alliances, hidden self-dealing—these fears and suspicions appear to explain many of the regulatory barriers (such as Glass/Steagall's mandatory wall between investment and commercial banking) that today constrain financial intermediaries and render them relatively ineffective monitors.[104]

Given this long history, is it realistic to expect the public to tolerate the idea of coalitions of institutional investors exercising a controlling influence over corporate managements? Predictably, this fear of secret coalitions will be exploited by the Business Roundtable and others whenever further deregulation is sought.[105] But how valid is this fear? To address this question meaningfully, it is necessary to break down this fear into its constituent elements. The following more specific scenarios are possible, but, in overview, none seem persuasive:

1. *The Fear of the Diversion of Corporate Income and Assets*

Obviously, a person or group holding control can use it to its own advantage. But this is a relative truth; some control groups are better positioned to exploit their influence and divert income or assets to themselves than others. Here, there is a fundamental difference between institutional shareholders and the controlling coalitions that a J.P. Morgan or other investment bankers would knit together earlier in this century. When one looks at the dark side of the spectrum (as

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[104] *See* Roe, *supra* note 3, at 16-31.

[105] This theme has also been raised in academic articles. *See* Boyer, *supra* note 20, at 1033-38 (analogizing institutional investors to the Robber Barons of an earlier era).

Professor Rock does in his contribution to this symposium[106]), one usually identifies some non-pro-rata benefit or gain that the control group is seeking to obtain or preempt. Thus, in J.P. Morgan's day, investment bankers formed shareholder coalitions to hold control because control carried with it the ability to deal with the corporation: to be its investment banker, supplier, preferred customer—in short, it implied the ability to enjoy some benefit or opportunity not made available on an equivalent basis to the other shareholders.

But the modern institutional investor—i.e., pension funds and mutual funds—simply cannot make use of control in this way. Structurally, their capacity to engage in any form of business dealings with the corporations in their investment portfolio is limited because, put simply, they have no business of their own. To give the clearest case, pension funds produce no products or services to sell to their portfolio companies; nor do they need to buy goods or services from them. Whereas an investment banking firm has multi-lateral relationships with its clients, the relationship between pension funds and their portfolio companies is inherently isomorphic—that is, one to one. Because they can receive benefit or gain from the corporation only as a shareholder (or possibly as a bondholder as well), the potential for conflicts of interest, which was so strong earlier in this century when investment bankers organized control groups, is today largely absent in the case of most institutional investors. In short, pension funds are innocuous. Arguably, they may sometimes make poor business decisions, but such decisions will result from a lack of care or judgment, not from a lack of good faith or conflicts of interest. By definition, they are incapable of not considering what is best for all shareholders—because they are only shareholders, no more and no less.

In the case of other institutional investors—for example, mutual funds—scenarios can at least be imagined in which they could use control so as to benefit their sponsors (typically, an investment banking firm).[107] Yet, even in these cases, two additional factors must be considered before the fear of income or asset diversion can be called rational. First, the law may have changed since the era of the late 19th Century Robber Barons so that control cannot be as easily exploited as it may have been then. Some econometric studies suggest that the stock market doubts that control can be exploited and thus prices minority shares the same as it does shares in corporations with

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[106] *See* Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994); *see also* Boyer, *supra* note 20.

[107] For example, a "controlling" mutual fund could insist that the investment banking firm that was its investment advisor be used by the corporation (and at above market rates).

more dispersed shareholders.[108] Second, even if control can be exploited by an institutional investor, it is not clear that a coalition of institutional investors can carry it off. As argued earlier, a small group of three to five institutions do not seem able to make the concentrated investments in a limited number of companies necessary to achieve control.[109] Control groups involving institutional investors are more likely to form around ad hoc, fact specific issues (e.g., whether to support or oppose a management proposal or a shareholder proposed bylaw amendment). Such coalitions are transient in character and inherently unstable; hence, they cannot be as easily exploited as a means by which to secure some other advantage. Even more important than the transient character of such coalitions is the fact that they will inherently have multiple members whose own narrow economic interests will conflict. For example, if there are three mutual funds participating in the coalition, it seems unlikely that one will be able to name its investment banking sponsor as the corporation's investment bankers, while the other two watch passively. Rather, each institution is a natural monitor of the others. In short, the larger the coalition, the more there are inherent checks and balances within that tend to prevent exploitation and reduce the significance of conflicts of interest.

2. *The Fear of Insider Trading*

A control group potentially may receive non-public material information. This danger always exists, but it seems particularly unlikely in the case of institutional investors. Although the danger of insider trading is not remote, institutional investors are uniquely the one group—as opposed to corporate officials, investment bankers, lawyers, and other securities professionals—that has not been implicated in any insider trading scandal. Prophylactic measures—such as the Chinese Wall—exist that are sufficient to guard against any danger of misuse of non-public information. Equally important, the amorphous, shifting character of institutional coalitions also minimizes the danger. Where there are a dozen or more members to the institutional coalition, it will probably not be feasible for corporate management to disclose non-public information to all members of the coalition. Not only would the risk of detection for a criminal offense be unacceptably high from this form of broad disclosure, but the last recipients will gain nothing of real value. That is, because the stock

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[108] *See* Clifford G. Holderness & Dennis P. Sheehan, *Constraints on Active Investors* (Aug. 5, 1993) (unpublished manuscript, on file with the *Cardozo Law Review*).

[109] *See supra* notes 63-65 and accompanying text.

market adjusts to new information very quickly, any system of slow leakage to favored insiders will benefit the first recipients greatly—and the last not at all. Hence, many members of the coalition will rationally oppose informational favoritism where it is likely to benefit some and not all. Once again, the larger the coalition, the more likely that its own incentives will make it self-policing.

3. *The Herd Instinct and the Problem of Short-term Bias*

Some evidence suggests that the stock market does have a short-term bias[110] and other studies find some tendency for institutional investors to follow the herd.[111] Put these two tendencies together, and the fear is that a coalition of institutional investors will simply enforce and exacerbate the worst tendencies of an inefficient stock market. One cannot lightly dismiss this fear, but the impact of institutional voice on these tendencies is more debatable. Some believe institutional coalitions will tend to cure managerial myopia.[112] Only one thing is certain: institutional coalitions will permit a better dialogue between institutions and managements than exists today. Potentially, managements could explain to the institutional coalition why management's long-term investment projects will have a superior payoff than the market initially anticipated. In this light, institutions already have the ability in a fragmented way to discount the corporation's stock price for long-term projects that they consider inefficient, and management may already overrespond to these market signals. Arguably then, facilitating institutional coalitions increases the possibility of discussion and consensus.

Ultimately, because institutional coalitions will tend to be ad hoc and transient, it is not a realistic scenario that a management team will be ousted simply because of its preference for long-term investments. Only if that team consistently lags the market does such a prospect become possible as a last recourse. And probably then, it will be the board, not a shareholder-led proxy fight, that will finally administer the coup de grace. To be sure, shareholders may make mistakes, but that is the price of democracy, and the alternative—a self-perpetuating management—promises a higher risk of error.

4. *Discrimination Against Small Shareholders*

If institutional coalitions could be formed to nominate directors

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110 *See* Bronwyn H. Hall & Robert E. Hall, *The Value and Performance of U.S. Corporations*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1, 4, 18-20 (Brookings Institution 1993).

111 *See* Lakonishok et al., *supra* note 98, at 32.

112 *See Agents*, *supra* note 3, at 865.

or propose bylaw amendments without elaborate prior disclosure about their group and its intent, would small shareholders be frozen out of corporate governance? Some have recently made this claim.[113] But to speak meaningfully of shareholders being "frozen out," one must address the obvious rejoinder: compared to what? Proponents of proxy reform argue that small shareholders are already and inevitably frozen out of corporate governance.[114] Symptomatically, no complaints have yet been heard from the organizations that represent small shareholders.[115] Still, the better answer may be that if there are conflicts between large and small shareholders, management will be able to exploit them and strike an alliance with the small shareholder. In short, the capacity of the small shareholder to influence events depends in the first instance upon the existence of countervailing power in the hands of institutional shareholders. Then, and only then, does it obtain the swing vote.

The nature of the alleged discrimination also deserves a closer examination. The most realistic scenario for discriminatory treatment of small shareholders involves a shareholder targeting only the corporation's largest shareholder and not sending its communications to smaller shareholders. The United Shareholders Association has estimated that as a result of the new proxy rules, it can now write to a corporation's 1000 largest shareholders at a cost of $5,000 to $10,000, while a proxy statement would cost it around $1,000,000.[116] Interestingly, the United Shareholders Association is an organization of small shareholders, which obviously feels benefitted by this radical cost reduction. Still, the question remains: will small shareholders really be left in the dark? As a practical matter this seems unlikely, because in any contested proxy contest there will be press releases, advertisements, and fight letters that will be highly public and that will often receive independent media attention. Put differently, given that institutional coalitions have to be broad, they cannot be secret. Communications sent to the largest 1000 shareholders will not stay secret. Small shareholders may sometimes lose the benefit of the traditional full-scale proxy statement, but there is little reason to believe that they ever read it anyway.

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113 *See* Robert T. Lang & David S. Lefkowitz, *The Shareholder Communication Rules—Implications for Shareholders and Management*, INSIGHTS, Dec. 1992, at 3.

114 *Agents*, *supra* note 3, at 871-72.

115 The United Shareholders Association was the leading organization representing small shareholders, and it supported the SEC's proxy reforms.

116 *Corporate Governance*, *supra* note 18, at 83.

II. SCHIZOPHRENIA AT THE SEC: THE TWO FACES OF SEC REGULATION

Ultimately, this is a symposium about the SEC, and it is time to turn from institutional investors to the SEC, as their ambivalent regulator. As noted earlier, a number of commentators have viewed the SEC's proxy rules as a principal barrier to institutional monitoring,[117] and some believe that they have even detected indications of a political conspiracy in the way the proxy rules were gradually extended to apply more restrictively to dissident shareholders than to corporate managements.[118] But if this is the case, the SEC's significant relaxation of the proxy rules in 1992 is difficult to explain. New political forces did not suddenly emerge late in a Republican Administration to account for this reversal. Nor did they quickly vanish again, so as to explain the SEC's continuing intransigence to institutional activism, as discussed below.

A better explanation of the SEC's behavior toward institutional investors might begin from the premise that the SEC's attitude is equivocal, that it is torn between the standard impulse of a bureaucratic agency to expand its jurisdiction and defend its existing turf and the recognition that a regulatory system must have some relevant end purpose if it is to survive. Certainly, the SEC has shown during the 1980s that it is not an automatic opponent of sensible deregulation. Instead, the SEC voluntarily downsized much of its traditional registration and disclosure system under the Securities Act of 1933 with the advent of integrated disclosure and shelf registration.[119] Nonetheless, with regard to the institutional investor, the SEC's performance has been more erratic and indecisive. What it has given with one hand (in the form of liberalized proxy rules), it has taken away with the other, particularly in two respects that will next be examined. This indecision may partly be the result of political compromise, but it seems more the consequence of uncertainty at the SEC about the role of institutional investors in the SEC's traditional system of "shareholder democracy." Are they disruptive intruders bent on forming secret coalitions that disenfranchise other shareholders? Or are they the only force that can make the naive normative model of shareholder democracy actually work by serving as virtual representatives for disorganized small shareholders? The SEC today seems to vacillate between these two positions, never fully espousing either.

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117 *See* sources cited *supra* note 3.

118 *See* Roe, *supra* note 3, at 27-28.

119 RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS 152-61, 239-51 (7th ed. 1992).

Part II will next analyze two areas where SEC ambivalence toward institutional investors seems the most pronounced.

A. *Section 13(d) and the Invention of the Voting Group*

Section 13(d) of the Securities Exchange Act of 1934 requires a person or "group" that beneficially owns more than 5% of a "reporting" company's stock to file a Schedule 13D, which document must make detailed disclosures about the person or group's plans with respect to the company, its stock ownership, its financing, and related matters.[120] The Schedule 13D must be filed within ten days of a shareholder's crossing the 5% threshold, and material changes in the information so disclosed must be reported "promptly" in an amendment to the Schedule 13D.[121] However, institutions that acquire a 5% stake without "the purpose [or] effect of changing or influencing the control of the issuer" can instead file an abbreviated form—known as a Schedule 13G—on an annual basis and also avoid the requirement to amend it as promptly.[122] Thus, at the outset, there is an incentive created for institutions to promise passivity in order to minimize their regulatory burden.

The principal overreach in section 13(d) comes not from the statute, itself, but from the expansive rules that the SEC has adopted to implement it. On its face, the statute requires a Schedule 13D filing by "two or more persons [who] act as a . . . group for the purpose of acquiring, holding, or disposing of securities of an issuer."[123] By itself, this language would normally impose little burden on institutional investors who would rarely agree to act as a group in buying or selling securities because such an agreement would interfere with their liquidity. However, the SEC has cantilevered its rules well out beyond the statutory foundation afforded by section 13(d). In Rule 13d-5(b)(1), the SEC defined "group" to include "two or more persons [who] agree to act together for the purpose of acquiring, holding, *voting*, or disposing of equity securities."[124] Nothing in the legislative history or statutory context justifies this concept of a "voting group," which introduces a proxy rule concept into the foreign territory of the

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120 *See* Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (1988); Rules 13d-1 - 13d-7, 17 C.F.R. §§ 240.13d-1 - 13d-7 (1993).

121 Schedule 13D, 17 C.F.R. § 240.13d-101 (1993). *See* Rule 13d-2, 17 C.F.R. § 240.13d-2 (1993).

122 *See* Securities Exchange Act of 1934 § 13(g), 15 U.S.C. § 78g (1988); Rule 13d-1(b)(1), 17 C.F.R. § 240.13d-1(b) (1993); Schedule 13G, 17 C.F.R. § 240.13d-102 (1993).

123 Securities Exchange Act of 1934 § 13(d)(3), 15 U.S.C. § 78m(d)(3) (1988).

124 17 C.F.R. § 240.13d-5(b)(1) (1993) (emphasis added).

Williams Act. Like Minerva, the "voting group" concept appears to have leaped directly from the mind of the SEC.

The practical consequence of this extension of the statutory language to pick up any collection of persons or entities who in the aggregate own more than 5% of a class and have decided to vote together on at least one issue is three-fold: First, there is an additional disclosure burden under section 13(d), itself, because each time a new member allegedly joins the "voting group," an amendment of the Schedule 13D may be required to be filed "promptly."[125] Each new member of the group may bring with it plans, financings, or other material facts that arguably require special disclosure. Second, section 13(d)'s disclosure requirements also carry over to the reporting requirements under section 16(a), where Rule 16a-1(a)(1) defines "beneficial ownership" in terms of the rules under section 13(d).[126] Effectively, this adds a second level of complexity if the alleged consortium holds 10% or more of any class of equity security of a reporting company. Third, and most important, the "voting group" concept creates a legal risk and accompanying uncertainty. The company in whom the alleged group has invested can bring suit (and in takeover battles frequently does) in order to use litigation as a window into the group.[127] All that is usually necessary to justify broad discovery is an allegation that the group has concealed its true intent.[128] Although the risk of liability may be small, discovery is costly, both in litigation expense and lost time to the fund managers who are deposed.

This tactic may be particularly effective against institutional investors because the litigation expenses may have to be picked up by the fund manager out of its annual fee. If we assume that annual fee is typically in the range of seventy to 100 basis points, then a single law suit can exhaust it, and fund managers will rationally fear even frivolous litigation. Thus, they will avoid involvement in collective action, notwithstanding a potential for significant gains to the fund. Once again, then, a potential for a conflict of interest arises between the fund manager and the fund it represents.[129]

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125 *See* Rule 13d-2, 17 C.F.R. § 240.13d-2 (1993).

126 *See* Rule 16a-1(a)(1), 17 C.F.R. § 240.16a-1(a)(1) (1993).

127 *See* Jonathan R. Macey & Jeffry M. Netter, *Regulation 13D and the Regulatory Process*, 65 WASH. U. L.Q. 131, 151-53 (1987) (discussing the variety of disclosure violations asserted by takeover targets in § 13(d) disclosure suits).

128 *See Shareholder Passivity*, *supra* note 3, at 543.

129 Note, however, that the public pension fund is more resistant to this conflict of interest, because it typically relies on in-house fund managers or, if not, still retains voting discretion internally. *See supra* notes 84-87 and accompanying text.

To date, the courts have largely supported the SEC in its "voting group" theory (although cases involving institutional investors have not truly been presented).[130] Under these cases, it is clear that a voting group can come into existence informally, without any written agreement or documentation, and its existence can be proven by circumstantial evidence (possibly through evidence of consciously parallel actions).[131] What kind of circumstantial evidence can demonstrate that a "voting group" has been formed? Catherine Dixon, a former SEC staffer, who was significantly involved in the 1992 proxy rule reforms, recently gave the following answer:

> This circumstantial evidence may include proof of a common plan or goal among shareholders involving voting or investment of company securities, possibly inferred from a pattern of parallel action over a relatively short period in connection with an ongoing or impending solicitation, and some evidence of coordination among shareholders, activities and communications.[132]

This summary probably reflects the SEC's current thinking.[133] But note that, under this analysis, the voting group concept applies not only to a shareholder voting group formed to seek control in a hostile proxy contest, but also to one loosely organized to support a bylaw amendment that would establish confidential voting procedures at annual shareholder meetings or to a precatory shareholder resolution proposed under Rule 14a-8. The obvious difference is that these latter proposals have little or nothing to do with corporate control (which is the focus of the Williams Act). So interpreted, there is an inherent overbreadth in the "voting group" concept.

Another uncertainty with the concept involves the point at which a voting group comes into existence. Although the better line of cases recognizes that "section 13(d) allows individuals broad freedom to discuss the possibilities of future agreements without filing under the federal securities laws,"[134] this exemption for preliminary discussions

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130 *See, e.g.*, Portsmouth Square, Inc. v. Shareholders Protective Comm., 770 F.2d 866, 870-71 (9th Cir. 1985); Jacobs v. Pabst Brewing Co., 549 F. Supp. 1050, 1065 (D. Del. 1982).

131 *See, e.g.*, Wellman v. Dickinson, 682 F.2d 355, 362-63 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983) (informal nature of group discussed); SEC v. Savoy Indus. Inc., 587 F.2d 1149, 1163 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979).

132 *See* Catherine T. Dixon, Esq., Post Proxy Reform Era: Remaining Pitfalls for the Unwary Activist Shareholder, Remarks to the Executive Board of the Council of Institutional Investors (June 3, 1993, Washington, D.C.) (transcript available in Cardozo Law Review Office).

133 As Ms. Dixon also notes, "[b]oth the Commission and the staff have indicated that the [1992 proxy] amendments have not changed the scope of existing Section 13(d) requirements or the 'group' concept thereunder." *Id.* at 6.

134 Pantry Pride, Inc. v. Rooney, 598 F. Supp. 891, 900 (S.D.N.Y. 1984); *see also* Scott v. Multi-Amp Corp., 386 F. Supp. 44, 70-72 (D.N.J. 1974).

may provide little comfort for fund managers who fear less the prospect of damages[135] than the tactical use of litigation by threatened corporate managements to punish and deter institutional activism. Of course such litigation may impose even greater costs on the plaintiff corporation, but its pockets are typically deeper than those of the fund manager, and, more importantly, corporate managers are not bearing the costs of their own defense, but are passing them onto their corporations (and indirectly, of course, to their shareholders).

Beyond these litigation risks, the SEC's voting group doctrine has other specific impacts. As a practical matter, it prevents cost sharing among institutional investors, because once a common fund is created, the participants have seemingly moved well beyond preliminary discussions and now have a common objective.[136] Thus, the voting group doctrine effectively prevents pooling of resources, which is the most logical solution to the "free rider" problem. Second, the SEC staff has repeatedly suggested that an agreement to co-sponsor a shareholder resolution may result in the formation of a voting group.[137] As a result, Professor Black reports that institutional investors never co-sponsor shareholder resolutions.[138] In an even more extreme interpretation, the SEC's staff has similarly suggested that soliciting support for a shareholder proposal submitted under Rule 14a-8 may also result in a Section 13(d) voting group.[139]

What is the net impact of these constraints? An inability to co-sponsor a shareholder resolution may have relatively little consequence. But the idea that soliciting support for a resolution sponsored by another institution implies the formation of a voting group runs directly counter to the SEC's new proxy rule reforms. Effectively, the new proxy rules permit shareholders to communicate with, and recommend courses of actions to, each other provided that the soliciting shareholder does not seek proxy authority and lacks a disqualifying "substantial interest" in the subject matter of the solicitation.[140] But this immunity may be forfeited if others agree with your views and they solicit still others to support your proposal. Put differently, the

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135 Potentially, the damages for a violation of section 13(d) could include disgorgement of all profits made during a period when the voting group was not disclosed, as required by § 13(d). *See* SEC v. First City Fin. Corp., 890 F.2d 1215, 1229-32 (D.C. Cir. 1989) (ordering disgorgement for section 13(d) violations).

136 But see Gilson & Kraakman, *supra* note 3, at 897-98 for a contrary view.

137 *See* Joseph G. Connolly & David B.H. Martin, Jr., *Shareholder Communications—Legal Restrictions Governing Group Activity: Part II*, INSIGHTS, Apr. 1990, at 16, 19.

138 *See Shareholder Passivity*, *supra* note 3, at 544. However, he notes, friendly institutions may sponsor identical resolutions at different companies.

139 Connolly & Martin, *supra* note 137, at 19 (discussing SEC staff's view).

140 *See supra* notes 17-18 and accompanying text.

SEC's approach today seems to say: you can communicate freely, but your audience must stay at a distance and not indicate that they agree.

This assessment that the SEC's current policies under section 13(d) may frustrate its reforms under section 14(a) leads to an obvious question: Why did the SEC paint itself into this corner? Various answers are possible. Some believe that the refusal to adopt a narrower definition of "beneficial ownership is consistent with the agency's general disinclination to establish bright-line tests that can be circumvented easily in the context of the inherently fact-driven analyses demanded by questions of intent . . . ."[141] In short, prosecutorial discretion is important to the SEC. Historical inertia may be another factor; many SEC rules (including the definition of proxy solicitation)[142] have the widest possible breadth and begin at the earliest possible moment. The "voting group" concept under section 13(d) is consistent with that long-term tendency (but inconsistent with the more recent tendency to deregulate innocuous activity by shareholders not seeking control).

Yet, both these reasons seem overshadowed by the Commission's more basic fear of "secret combinations of voting power."[143] The legitimacy of this fear depends, in turn, on the empirical validity of its premise: that institutional investors can easily and quickly assemble into powerful groups. As Part I of this Article has already argued, this fear may be greatly exaggerated. Institutional investors are too heterogeneous and their holdings too decentralized for this to happen easily. Such loose consortiums that do form are more likely to be ramshackle, jerry-rigged affairs with little stability.

What then should be done so that the rules under section 13(d) do not frustrate the SEC's reforms under section 14(a)? Arguably, the best reform would be simply to strike the word "voting" from Rule 13d-5(b)(1),[144] so that disclosure of voting groups would not be required under section 13(d). However, any proposal to cut the Gordian Knot with such a single stroke of the deregulatory sword will encounter predictable resistance. The case for disclosure under section 13(d) is usually rested on an example, much like the following: assume that a group of institutional investors is approached by a takeover raider, and they agree to support its proxy contest to unseat the

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141 *See* Dixon, *supra* note 132, at 6-7.

142 Rule 14a-1(*l*), 17 C.F.R. § 240.14a-1(*l*) (1993).

143 *See* Dixon, *supra* note 132, at 6.

144 17 C.F.R. § 240.13d-5(b)(1) (1993). The current language says: "When two or more persons agree to act together for the purpose of acquiring, holding, *voting* or disposing of equity securities of an issuer . . ." (emphasis added).

incumbent board at Lackluster, Inc. The proxy contest will be publicly announced in one month, and it is anticipated that its announcement will produce an immediate increase in Lackluster's stock price. Armed with this knowledge, the institutions begin buying significant amounts of Lackluster's stock. Such purchases would probably not constitute insider trading as no fiduciary duty to Lackluster has been breached by these mere shareholders and (let us assume) none has misappropriated information from the investor group. Thus, proponents of "voting group" disclosure can argue that this example shows the need for a Schedule 13D filing to inform the market of material developments.

At most, however, this argument for market transparency supplies a justification for disclosure of a voting group that is truly seeking corporate control. Less significant plans by this same group are unlikely to be material to other investors. Thus, at a minimum, the voting group concept should be cut back to exclude shareholders who are engaged in organizing support for a non-control-related vote. For example, a shareholder proposal under Rule 14a-8—whether concerned with South African investments, confidential shareholder voting, or redemption of poison pills—is not within the legitimate scope of section 13(d), even if shareholders establish a collective fund or solicit others to vote for their proposal. Beyond this first step, the definition of a voting group should also be shrunk so that it does not apply to a negative solicitation—that is, one in which the participants solicit others simply not to vote for a particular candidate or slate and make no positive recommendation.[145] Finally, it is arguable that a solicitation intended to elect only a minority of the seats up for election might be similarly excluded.[146] The common denominator to these proposals is that the Williams Act should be limited to requiring early disclosure by persons who constitute a "voting group" only when the collective aim of their voting agreement is to acquire control. Part III of this Article will return to this theme with a specific proposal that could be implemented without legislative action.[147]

B. *Shareholder Proposals and Bylaw Amendments*

Only as a last resort are institutional investors likely to run a slate of candidates for the board of a portfolio company. The costs of

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[145] Others have elaborated on this "Just Vote No" concept. *See* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993).

[146] *See* Gilson & Kraakman, *supra* note 3, at 897.

[147] *See infra* notes 194-210 and accompanying text.

such an effort (probably several million dollars at the least) are too high, the liabilities too risky, and the prospect of controlling person liability, if successful, too forbidding. Instead, their more likely resort will be to less drastic means, including the making of proposals at the annual shareholder meeting. During the 1970s and 1980s, shareholder proposals were typically an activity of church groups and other charitable and educational institutions concerned about "social justice" issues: South Africa, discrimination, Vietnam, etc.[148] At the end of the 1980s, however, the constituency most likely to use the SEC's shareholder proposal rule (Rule 14a-8)[149] shifted from charitable and educational institutions to institutional investors. Institutional investors began to make "precatory" shareholder proposals seeking a variety of objectives: (1) redemptions of poison pills,[150] (2) restrictions on special targeted issuances of preferred stock to "white squires,"[151] and (3) a majority of independent directors, and similar objectives. These proposals were typically non-binding or "precatory" in character because the SEC had indicated that proposals that "mandate or direct the board to take certain action may constitute an unlawful intrusion on the board's discretionary authority under the typical statute."[152] Thus, they could be excluded under Rule 14a-8(c)(1) as "not a proper subject for action by security holders."[153] However, at the same time that it said mandatory proposals could be improper under state law, the SEC also found that "proposals that merely recommend or request that the board take certain action would not appear to be contrary to the typical state statute . . . ."[154] This judgment that shareholders had a legal right to address precatory recommendations to the board was largely rested on a forty-year-old New York decision.[155]

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148 The impetus for this movement came in substantial part from the broad reading given to Rule 14a-8 in Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), *vacated*, 404 U.S. 403 (1972).

149 17 C.F.R. § 240.14a-8 (1993).

150 Some 32 companies were selected for anti-pill proposals in 1987 based on their high institutional ownership levels. The average vote for these proposals was 29%. *See* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 278 (Supp. 1992).

151 During 1990, TIAA-CREF initiated this tactic with a shareholder proposal directed to Pfizer, requesting that shareholders vote on proposals representing an issuance of 10% or more of the corporation's stock. *See* Rock, *supra* note 106, at 1024.

152 Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 80,812, at 87,128 (Nov. 22, 1976).

153 17 C.F.R. § 240.14a-8(c)(1) (1993).

154 *Id.* (Note to Rule 14a-8(c)(1)).

155 *See* Auer v. Dressel, 118 N.E.2d 590 (N.Y. 1954).

Yet, even if mandatory shareholder proposals are normally improper, shareholders clearly have at least one source of statutory authority under which they may bind the board. In virtually every jurisdiction, shareholders may amend the bylaws.[156] Although this power to amend the bylaws also can be (and almost invariably is) given to the board pursuant to a provision in the certificate of incorporation, most state statutes contain a provision similar to that in the Delaware General Corporation Law, which states that such a certificate provision authorizing the board to amend the bylaws "shall not divest the stockholders . . . of the power, nor limit their power to adopt, amend or repeal bylaws."[157]

Obviously, the attraction of a shareholder proposal to amend the bylaws is that the substantive instruction contained in the bylaw amendment can be made mandatory, rather than precatory, without offending the "proper subject" for shareholder action test of Rule 14a-8(c)(1). To illustrate, although a shareholder resolution asking the board not to pay any officer more than $5,000,000 per year without prior shareholder approval would have to be precatory to constitute a "proper subject" for shareholder action under Rule 14a-8(c)(1), the same instruction set forth in a bylaw amendment could seemingly be made mandatory. Still, even such a mandatory bylaw amendment could be excluded from the corporation's proxy statement if it fell within any of the other twelve cumulative subcategories under Rule 14a-8(c) that justify management's exclusion of a shareholder proposal from its proxy statement. For example, managements frequently rely upon Rule 14a-8(c)(7)'s exclusion for matters "relating to the conduct of the ordinary business operations of the registrant."[158] Thus, to be successful, a shareholder proposing a bylaw amendment under Rule 14a-8 had to establish both (1) that the proposal was a proper subject for shareholder action under Rule 14a-8(c)(1) and (2) that it did not fall under any other exclusion, such as Rule 14a-8(c)(7)'s exclusion for "ordinary business matters." So matters stood until 1992, with shareholders sometimes winning and sometimes losing.[159]

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156 *See, e.g.*, DEL. CODE ANN. tit. 8, § 109(a) (1991); N.Y. BUS. CORP. LAW § 601(a) (McKinney 1986).

157 DEL. CODE ANN. tit. 8, § 109(a) (1991). For a discussion of the scope of this provision, see ERNEST L. FOLK, III ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 109, at 1-18 (3d ed. 1992). *See also* Rogers v. Hill, 289 U.S. 582, 589 (1933).

158 17 C.F.R. § 240.14a-8(c)(7) (1993). For a good review of the long history of SEC vacillation on excludability of shareholder proposals under this "ordinary business" provision, see Fisch, *supra* note 2, at 1148-62.

159 For reviews of the SEC's performance and lists of proposals that it had at times excluded and at other times refused to exclude, see Lesser, *supra* note 42; *Shareholder Proposals to*

Then, in 1992, Robert Monks, a well-known shareholder activist, submitted a proposal to Exxon to create a three-member shareholder advisory committee ("SAC") that would review the management of Exxon's business and affairs and advise the directors of both its views and those of other shareholders.[160] As proposed, this SAC would have a unique and frankly extraordinary scope of power: it could engage outside advisors; could incur expenses of up to $12 million per year (or one penny per outstanding Exxon common share); could include a 2,500-word report and evaluation in the corporation's annual proxy statement; and its members would be elected annually by Exxon shareholders through the Exxon proxy statement.[161] Not unfairly, critics saw it as a "shadow board." More importantly, the proposal was presented in the form of a bylaw amendment. Although a number of earlier shareholder proposals for SACs had been made and in some cases the SEC had refused to allow the corporation to exclude them,[162] the Monks proposal appears to have been the first attempt to present the SAC concept in the form of a mandatory bylaw amendment.

To the surprise of many, the SEC found that Exxon could not exclude the Monks proposal.[163] Despite the broad scope of the Monks proposal and the obvious counterargument that it invaded the realm of the board's authority by permitting the SAC to become involved in "ordinary business matters," the SEC still refused to permit its exclusion under Rule 14a-8(c)(7). Even more importantly, the SEC staff's decision seems to signal that the "proper subject" test of Rule 14a-8(c)(1) no longer represented an important obstacle because bylaw amendments now offered a new low-cost technique by which shareholders could seemingly constrain corporate managements.[164]

Amend Bylaws: Issues Surface as Investors Ponder New Weapon to Advance Activist Goals, BNA'S CORP. COUNSEL WEEKLY, Mar. 18, 1992, at 8; Richards & Foster, *supra* note 42, at 1509 & n.3.

160 *See* Lesser, *supra* note 42, at 1, 11.

161 *Id.* at 11.

162 *See* TRW, Inc., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 247, at *1 (Feb. 12, 1990); McDonald & Co. Inv., Inc., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 692 (May 6, 1991). In its *McDonald* no-action letter, the SEC required the proposal (which did not involve a bylaw amendment) to be recast in precatory form in order to avoid exclusion under Rule 14a-8(c)(1).

163 Exxon Corp., SEC No-Action Letter, 1992 No-Act. LEXIS 281, at *1 (Feb. 28, 1992) [hereinafter Exxon No-Action Letter].

164 The Monks proposal was by no means the first instance in which the bylaw amendment mechanism was used by institutional investors. The tactic dates back to the 1940s and was used by shareholder activists of an earlier day. *See* SEC v. Transamerica Corp., 163 F.2d 511, 517 (3d Cir. 1947), *cert. denied*, 382 U.S. 847 (1948). More recently, CalPERS successfully used this technique to propose compensation committees and had obtained General Motors' consent to a bylaw amendment requiring a majority of independent directors on its board. *See*

Doctrinally, no clear limits emerged from the SEC's rejection of Exxon's position. In rebuffing Exxon's argument that the shareholders' right to amend the bylaws had to yield to the board's statutory authority to manage the business and affairs of the corporation, the SEC staff replied with Delphic ambiguity that it could not conclude that New Jersey law precluded a shareholder advisory committee whose functions were limited to advising the board.[165] Similarly, the SEC staff rejected Exxon's claim that the SAC, as proposed, would interfere with "ordinary business operations" of Exxon by noting that the SAC was intended only to review and evaluate the directors' performance in managing Exxon and to communicate the shareholders' views on matters under the board's consideration. In that light, it said, "the nature and scope of that communication would appear as not involving matters concerning the conduct of the Company's ordinary business operations."[166] Whatever this response meant, its equivocal character invited others to test and stretch the boundaries still further.

In overview, what is most striking about the Exxon episode is that the SEC was forced to make up answers, itself, to such basic substantive questions as the proper scope of the bylaws. Neither side seemed able to cite any dispositive authority. Indeed, neither statutory law nor case law has dealt with either concept extensively. As a result, fundamental issues of state corporate governance were being decided as a matter of first impression by a federal administrative agency. Nor should this have been surprising. When, decades earlier, the SEC decided that precatory proposals were a proper subject for shareholder action, it then also had little more than a single New

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Marcia Parker, *GM Bylaw Revision Hailed as a Victory*, PENSIONS & INVESTMENTS, Feb. 4, 1991, at 6. But most of these recent instances resulted in a negotiated resolution between the institutions and the corporation, and the corporation did not make a "no-action" request to the SEC to omit the proposal. Also, the shareholder advisory committee contemplated by the Monks proposal was considerably more far-reaching than anything proposed in earlier uses of this technique. *See* Lesser, *supra* note 42.

165 In obvious anticipation of this argument that the bylaw would invade the board's authority, the Monks proposal artfully provided: "Nothing herein shall restrict the power of the directors to manage the business and affairs of the corporation." Exxon No-Action Letter, *supra* note 163, at *20.

166 *Id.* at *3. If the Exxon No-Action Letter is to be reconciled with other SEC no-action letters issued almost simultaneously, then the critical point may have been that the shareholder advisory committee's proposed assigned task was to review the directors' performance. Exclusion of similar proposals to establish advisory committees to review specific areas of corporate performance has regularly been permitted by the SEC staff. *See, e.g.*, GTE Corp., SEC No-Action Letter, 1992 No-Act. LEXIS 131 (Feb. 4, 1992) (precatory resolution to establish Employee Advisory Council to discuss issues of employee concern was excludable under Rule 14a-8(c)(7)).

York decision to support its position.[167] In all likelihood, the Commission's decision to permit precatory shareholder proposals was probably based less on the legal authority supporting the shareholders' right to advance precatory proposals than on the underlying purpose of the proxy rules: namely, to promote shareholder democracy.

The SEC's current commitment to shareholder democracy is, however, open to more question, because the SEC's position on shareholder bylaw amendments underwent a strange flip-flop in 1992. Having decided to promote shareholder monitoring in the Exxon episode in early 1992, the Commission reversed itself a few months later in a similar case in late 1992. In November, 1992, CalPERS, the largest U.S. public pension fund, proposed a bylaw amendment for inclusion in the proxy statement of Pennzoil Company, which amendment would have established a similar three-member shareholder advisory committee.[168] The CalPERS proposal largely paralleled the Monks proposal, except that it also provided that the proposed bylaw could not be "altered or repealed without the approval of shareholders."[169] In response, Pennzoil predictably sought a no-action letter from the SEC that the SEC would take no action if Pennzoil omitted the CalPERS proposal from its proxy statement. Disdaining any Rule 14a-8(c)(7) argument about "ordinary business operations," Pennzoil focused its attack squarely on the inconsistency between the proposed bylaw and its board's authority to manage the business and affairs of the corporation under Delaware law.[170] Pennzoil's Delaware counsel argued broadly that under Delaware law, once stockholders have elected the directors, they "have exhausted their ability to dictate the direction of the business and affairs of the corporation by vesting that power in those elected board members."[171] CalPERS replied, equally broadly, that "Delaware Law does not create a restriction or other limitation on the power of a company and its shareholders to form and implement mechanisms for the marshalling and communication of shareholder input and advice."[172] In short, so long as the share-

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167 *See supra* note 155 and accompanying text.

168 *See* Richards & Foster, *supra* note 42, at 1511-12.

169 *Id.* at 1512 (quoting Proposal of California Public Employees' Retirement System to Pennzoil Co.).

170 Delaware law, much like the New Jersey statute in the Exxon case, provides that the corporation "shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE ANN. tit. 4, § 141(a) (1991).

171 Richards & Foster, *supra* note 42, at 1513 (quoting Opinion Letter from Richards, Layton & Finger to Pennzoil Co. (Jan. 7, 1993)).

172 *Id.* at 1514-15 (quoting Letter from David B.H. Martin, Jr. to SEC (Feb. 3, 1993)).

holder committee functioned strictly in an advisory capacity, it would not intrude upon the statutory role of the board.

In early 1993, the SEC staff announced that it would take no action if Pennzoil excluded the CalPERS proposal, because, it said, "[t]here appears to be some basis for your view that the proposal may be omitted from the Company's proxy material under Rule 14a-8(c)(1)."[173] What appears to have most troubled the SEC was a provision in the CalPERS proposed bylaw that authorized "the expenditure of corporate funds, effected by shareholders without any concurring action by the Board of Directors . . . ."[174] Arguably, the SEC staff has thus accepted a theory that bylaw amendments overstep their boundaries (at least in Delaware) and intrude impermissibly on the role of the board when they authorize expenditures without the board's concurrence. Yet, this premise cuts a wide swath, because virtually anything a shareholder advisory committee does will result in some expenditure of corporate funds (if only to clean the meeting room, reimburse travel expenses, or provide the committee with a hot lunch).

But the story continues. Desiring at least a symbolic vote, CalPERS responded to the SEC's no-action letter by refashioning its proposal into a precatory request and resubmitting it.[175] Again, Pennzoil objected, this time principally on the ground that the proposal violated Delaware corporate law by providing that the bylaw it proposed for shareholder adoption could be amended only by the shareholders (and not the Pennzoil board). After further debate among the parties and the SEC staff, the SEC announced that it had "determined that even if the proposal is made precatory, there is a *substantial question* as to whether, under Delaware law, the directors may adopt a by-law provision that specifies that it may be amended only by shareholders."[176]

Although the Pennzoil opinion does not wholly reverse the Exxon letter of a year earlier,[177] the result may be largely to trivialize it.

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[173] *Id.* at 1515 (quoting Letter from William E. Morley to C. Michael Watson (Feb. 24, 1993 [hereinafter Morley Letter])).

[174] *Id.* (quoting Morley Letter, *id.*).

[175] CalPERS requested reconsideration of its no-action letter on February 25, 1993, the day following the SEC's announcement of its no-action letter to Pennzoil. *See id.* at 1515-16.

[176] *Id.* at 1518 (emphasis added) (quoting Letter from William A. Morley to David B.H. Martin (Mar. 22, 1993)). As Richards and Foster note, this letter seems to conflict with the Exxon letter which stated that "the staff is unable to conclude that the applicable state law prohibits a bylaw." Exxon No-Action Letter, *supra* note 163, at *1. *See* Richards & Foster, *supra* note 42, at 1518 n.59.

[177] *See supra* notes 163-67 and accompanying text. Presumably, a bylaw amendment that did not preclude the board from reversing it would be valid (if, for example, it required a

Presumably, if the SEC staff is to be consistent, shareholders can still propose a mandatory bylaw amendment establishing a shareholder advisory committee, but the committee cannot expend funds and the bylaw adopted by shareholders cannot (at least in the SEC's view) be protected from immediate revocation by a board-passed bylaw rescinding it. The result is effectively to neuter not only the idea of a shareholder advisory committee, but, more importantly, the efficacy of shareholder-adopted bylaws.

In truth, the shareholder advisory committee is a strange procedural mongrel, which few institutional investors are likely to support.[178] But, in its Pennzoil letter, the SEC staff went well beyond disfavoring an unlikely reform, in three respects: First, it has at least tacitly endorsed the principle that shareholder-passed bylaws may not authorize the expenditure of corporate funds without invading the authority of the board. Second, it has similarly accepted the idea that shareholder-adopted bylaws may not be protected from immediate board modification or rescission. Finally, it seems to be adopting a new burden of proof rule: if the corporation that wishes to omit the proposal can raise a "substantial question" of state law—i.e., that the proposal is not a proper subject for shareholder action because in some respect it allegedly violates state law—then the SEC will not object to the proposal's omission.

The significance of each of these steps dwarfs the issue of shareholder advisory committees. For example, if shareholders cannot use a bylaw amendment to authorize funds because it infringes upon the board's authority, can they use bylaw amendments to restrict the adoption of poison pills or to prevent targeted issuances of preferred stock to "white squire" allies of management? Although distinctions can be drawn between expending funds and limiting stock issuances, they are not persuasive. The board's control over the corporate treasury is not more sacrosanct than its control over authorized, but unissued, shares.

Symptomatically, persuasive Delaware authority is simply lacking that draws boundaries between the shareholder's right to amend the bylaws and the board's right to manage. No Delaware decision deals directly with either (1) whether shareholder-adopted bylaws can authorize corporate expenditures or (2) whether they can preclude

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majority of independent directors). Also, when the board does reverse the shareholders who elected it, the result is likely to be a public relations nightmare for the corporation.

178 For example, the Monks proposal at Exxon drew only an 8% favorable vote. *See* Richards & Foster, *supra* note 42, at 1511.

subsequent board modifications or amendments.[179] Indeed, in related contexts, rather than reconcile tensions, Delaware has developed the doctrine of "independent legal significance" to hold that what cannot be done by one route can be done quite easily by another.[180] Here, however, the SEC seems to believe that this tension must be reconciled—in favor of the board's authority. Yet, the limited Delaware authority on this issue hints that the appropriate reconciliation should be to permit shareholders to deny the board power to amend a shareholder-approved bylaw. In *American International Rent A Car, Inc. v. Cross*,[181] the Chancery Court noted that stockholders "could cause a special meeting of the stockholders to be held for the purpose of amending the bylaws and, as part of the amendment, they could remove from the Board the power to further amend the provision in question."[182] This parenthetical statement may well prove to be incorrect,[183] but it seems out of character for the SEC, as the proponent of shareholder democracy, to conclude that state law does not afford shareholders a right to make their bylaw amendments effective when the closest state decision (admittedly in dictum) suggests otherwise.

Perhaps, the Pennzoil no-action letter is best explained as reflecting a new caution at the SEC, under which it will not rule if there is a "substantial question" under state law. Yet, such an approach seems

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179 A number of Delaware decisions do, however, cast a degree of doubt over the ability of the board to repeal immediately a shareholder-adopted bylaw, even when the certificate of incorporation authorizes the board to amend the bylaws. These decisions hold that the board may not use even powers that it legitimately holds to inequitably entrench itself in office. *See, e.g.*, Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971); Lerman v. Diagnostic Data, Inc., 421 A.2d 906 (Del. Ch. 1980); Steinkraus v. GIH Corp., 1991 Del. Ch. LEXIS 8, at *13 (Jan. 16, 1991). This does not mean that a board could never (or even seldom) reverse a shareholder-adopted bylaw, but, as Chancellor Allen suggested in Stahl v. Apple Bancorp, Inc., 579 A.2d 1115 (Del. Ch. 1990), some special justification for the board's action may be necessary. In this light, activist shareholders might be better advised to propose a bylaw amendment that could be amended or revoked by the board, but only if the board could advance some "compelling justification." In effect, this form of shareholder bylaw amendment would attempt to specify the standard of judicial review with regard to the board's attempt to repeal the shareholder-passed bylaw. Other variations on this theme are easy to imagine.

180 The doctrine of "independent legal significance" holds that the validity of a transaction that may be accomplished by one statutory route is not to be implicitly limited by restrictions (or tested by the standards applicable to) another alternative statutory route (even if the two are parallel and the result is thus to permit precisely the outcome under one that is forbidden under the other.) *See* Nixon v. Blackwell, 626 A.2d 1366, 1380-81 n.21 (Del. 1993). The doctrine traces back to Federal United Corp. v. Havender, 11 A.2d 331 (Del. 1940); *see also* Hariton v. Arco Elecs., Inc., 188 A.2d 123 (Del. 1963).

181 No. 7583, 1984 WL 8204 (Del. Ch. May 9, 1984).

182 *Id.* at *3.

183 The problem is that the board's authority to amend the bylaws is set forth in the certificate of incorporation, which presumably controls over any bylaw, including a shareholder adopted one. For a further discussion of this case, see Rock, *supra* note 106, at 1017 n.141 (discussing differing views of Delaware practitioners).

inconsistent with the SEC's past commitment to an expansive interpretation of the shareholder's voting rights. Indeed, in *SEC v. Transamerica*,[184] the SEC convinced the Third Circuit that the board could not apply its bylaws according to their technical language in a way that would block a shareholder bylaw amendment. The Third Circuit both read the shareholders' power to amend bylaws under Delaware law broadly and even held in the alternative that the corporate bylaw, if truly applicable, would be invalid because it "frustrated" the intent of Rule 14a-8.[185] The SEC's new caution may be the product of its defeat in the *Business Roundtable* case, in which a panel of the D.C. Circuit rejected the SEC's attempt to impose a modified "one share, one vote" standard on NASDAQ and the stock exchanges.[186] In so holding, the D.C. Circuit panel found that section 14(a) of the Securities Exchange Act of 1934 did not authorize the SEC to determine when a shareholder vote was required or otherwise to interfere with traditional state law norms regarding the allocation of power within the corporation.[187]

Even if we assume that the *Business Roundtable* decision denies the SEC any substantive power under section 14(a) to override state corporate law, how should the SEC respond in cases where the underlying state law is also unclear? For example, should the SEC have deferred to Pennzoil's claim that shareholders lack the authority to limit the board's power to repeal a shareholder-passed bylaw amendment? Long ago, in *Rogers v. Hill*,[188] the Supreme Court responded to a similar claim that shareholders lacked the power to amend the bylaws once a similar power had been granted to the board by saying: "It would be preposterous to leave the real owners of the corporate property at the mercy of their agents, and the law has not done so."[189]

In truth, the law has never really faced the issue, but it is difficult to understand why the agent should be deemed to have unqualified authority to reverse the principal. Neither the SEC staff nor the coun-

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184 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 382 U.S. 847 (1948).

185 163 F.2d at 517-18. In *Transamerica*, the corporation had adopted a bylaw that denied shareholders the ability to vote on any bylaw amendment notice of which had not been set forth in the notice of the annual meeting. Effectively, this gave the board a veto power over the bylaws that could be adopted at the shareholders' annual meeting.

186 *See* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (invalidating SEC Rule 19c-4).

187 *Id.* at 411-12. There has, of course, been a substantial debate over the extent of the substantive power accorded the SEC under § 14(a). *See* Fisch, *supra* note 2, at 1173-94; Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97 (1988).

188 289 U.S. 582 (1933).

189 *Id.* at 589.

sel's opinions on which it relied provide a satisfactory rationale for permitting shareholders to be overruled in this fashion. To be sure, the Delaware courts may reach a similar position when and if the issue arises. But, as a practical matter, the substantive law on this point is likely to remain obscure in most jurisdictions for some time to come. Thus, the critical issue is the presumption that the SEC uses in the interim. In the past, in assuming that *Auer v. Dressel* applied broadly,[190] the SEC has assumed shareholder power existed, unless forced by clear authority to a contrary position. This approach makes sense. When conflicts arise between the agent and principal, it is not too much to ask of the SEC that it remember its history and side with shareholders, unless the law is clearly to the contrary.

III. AN AGENDA FOR THE SEC: ENCOURAGING INSTITUTIONS TO BE PATIENT CAPITALISTS

Up to this point, this Article has made an easy argument: The SEC has been inconsistent and equivocal in its approach to institutional investors. This should not be surprising; in a world of political pressures, powerful lobbies, and rapid change, consistency is the exception, not the rule, for administrative agencies.

Easy as it is to criticize the SEC, the more important questions are: What should it do? What is a sensible policy? How do we get there from here? Here, a basic policy premise needs to be advanced. All investors confront a choice between "exit" and "voice." That is, they can participate in corporate governance (thereby "exercising voice") or they can rely on market liquidity (i.e., "exit").[191] For small investors, the choice is easy: their "voice" will be weak in any event, and attempts to exercise it are costly and are confounded by the usual problems of collective action. For institutional investors, however, the choice is more complex. Their large holdings often mean that they lack the same degree of market liquidity that the small shareholder possesses, and for indexed investors, there simply is no escape into the market. Thus, unlike the small investor, institutional investors' relative illiquidity (plus the potential gains or averted losses on the substantial stakes they hold) could lead them to exercise voice and play a serious monitoring role in corporate governance.

But if their potential willingness to exercise "voice" is chilled by SEC overregulation, institutional investors will continue to rely principally on "exit." To the extent that "exit" is valued above "voice,"

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190 118 N.E.2d 590 (N.Y. 1954). *See also supra* note 155 and accompanying text.

191 For a more detailed exposition of this theme, see *Liquidity Versus Control, supra* note 23, at 1281-89.

the public policy implications include a securities market characterized by higher volatility and heavier trading, one in which institutions will hold smaller stakes in individual companies and turn over these stakes more rapidly. All this contributes to a short-term horizon, which places greater pressure on corporate managers to maximize value over the short-run. Although the alleged short-term bias of institutional investors is far from an established fact, recent commentators have repeatedly detected such a tendency.[192]

How can this asserted tendency be alleviated? As a policy prescription, the basic answer must be to encourage institutional investors to rely on "voice," and thus to hold larger stakes longer. To this end, public policy could follow two general approaches: (1) it could make "voice" less costly, or (2) it could make "exit" more expensive. Transaction taxes or a differential tax rate based on the investor's holding period could obviously chill exit. This Article, however, will explore only the first policy approach, which could be implemented using one or both of two basic techniques: (a) the SEC could seek to reduce the expected costs and liabilities associated with institutions holding large equity stakes; and, (b) similarly, it could seek to increase the shareholders' access to the corporate proxy machinery in order to increase the potential payoff from the exercise of "voice."

This general policy outline does not, however, describe in detail the specific steps that need to be taken or what the trade-offs are. To provide such an outline, four specific proposals for the deregulation of existing barriers to the exercise of institutional "voice" will next be examined.

A. *Downsizing Section 13(d): Reducing the Burden on Shareholders Not Seeking Control*

The overbreadth latent in the SEC's concept of "voting group" has already been analyzed.[193] Although the SEC could simply delete the word "voting" from its existing rules under section 13(d),[194] it is hard to defend secrecy if a group truly does intend to oust the incumbent board and take control of a corporation. A better compromise may then be to limit the concept of voting group to a group organized to seek a change in control of the corporation. Thus, a voting group

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[192] For representative examples of this common critique, see COUNCIL ON COMPETITIVENESS AND HARVARD BUSINESS SCHOOL, CAPITAL CHOICES: CHANGING THE WAY AMERICA INVESTS IN INDUSTRY (1992); TIME HORIZONS, *supra* note 14; THE TWENTIETH CENTURY FUND, THE REPORT OF THE TWENTIETH CENTURY FUND ON MARKET SPECULATION AND CORPORATE GOVERNANCE (1992).

[193] *See supra* notes 120-47 and accompanying text.

[194] *See supra* note 144 and accompanying text.

organized to obtain a non-control related vote should be excluded from section 13(d)'s coverage. For example, shareholder proposals relating to bylaw amendments, executive compensation, preemptive rights, and the other mundane matters of everyday corporate governance would be excluded. Similarly, any group organized to oppose a managerial initiative should also be excluded, because opposition to a management proposal (such as an overly generous stock option plan or a leveraged buyout proposal) will not, by itself, result in a change in control.

Inevitably, the most important cases fall between the foregoing polar examples and requires us to define more carefully what is meant by a "change in control." If institutional investors are to take a long term perspective, they need to be encouraged to seek board representation. Ideally, major institutional investors—a CalPERS or a TIAA-CREF—might wish to elect an officer, employee, or other representative to the boards of at least some companies in their portfolio. But before this scenario of minority representation on the board becomes realistic, the section 13(d) rules clearly need to be relaxed to clarify that a group supporting a single candidate is not a "voting group" that should fall within section 13(d)'s scope.

What would a sensible rule look like? Existing Rule 13d-5(b)(1)[195] could be revised to substitute the following italicized language for the existing word "voting":

> When two or more persons agree to act together for the purpose of acquiring, holding, [voting] or disposing of equity securities of an issuer, *or for the purpose of changing the control of the corporation by electing directors*, the group formed thereby shall be deemed to have acquired beneficial ownership for purposes of Sections 13(d) and 13(g) of the Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons. *For purposes of this Rule, a group seeking to elect a single director to the board at any election of directors shall not on that basis alone be deemed to be a group having the purpose of changing the control of the corporation.*

Essentially, this revision of the existing rule would assure institutions that so long as they did not attempt to elect more than a single director at any election, they would not be a section 13(d) voting group. Closer questions (such as whether an attempt to elect a larger slate of directors constitutes an attempt to change control) would be left for case-by-case determination.

The above proposal with respect to the definition of voting group

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[195] 17 C.F.R. § 13d-5(b)(1) (1993).

logically carries over to a second issue under section 13(d). Currently, investors who acquire a 5% stake without "the purpose . . . of changing or influencing the control of the issuer"[196] may file a Schedule 13G, instead of Schedule 13D. The former involves less information and need not be filed (or amended) as promptly. Again, the issue of the availability of the Schedule 13G alternative depends on how we define the nebulous concept of "influencing control." Without redrafting the above proposal for the Schedule 13G context, it is obvious that the same safe harbor (i.e., one is not seeking to influence control if one is not seeking to elect more than a single director) could be applied to this context as well. If necessary, additional conditions—such as a 20% maximum ownership level—could easily be added.

Finally, because section 16(a) (discussed below) utilizes and works off the section 13(d) "voting group" concept, whatever is done to reform Rule 13d-5(b)(1) will also automatically carry over to alleviate the reporting burden under section 16(a).[197] Much more, however, must be done under section 16(b), as next discussed.

B. *Section 16(b): The Need for a Safe Harbor from "Deputization" Theory*

Section 16(b) of the Securities Exchange Act of 1934 requires a 10% holder of any class of equity securities of a "reporting" company to turn over to the corporation any profits made on a purchase and sale or sale and purchase sequence within six months.[198] Effectively, this rule barring "short swing" profits keeps institutional investors below the 10% level, because they face a six-month period of illiquidity on purchase or sales made once they cross the 10% threshold. Although some may argue that the need for section 16(b) has been eclipsed by the subsequent development of insider trading law (particularly under Rule 10b-5), repeal of section 16(b) would only aggravate the tendency for institutions to rely on exit rather than voice. Not only are rapid "in and out" trades by a 10% holder inherently suspicious, but they are also inconsistent with the longer time horizon that public policy should seek to encourage both on the part of corporate managers and investors.[199]

However, section 16(b) also imposes a quite distinct and less justifiable burden on institutional investors: even if they stay below the

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196 *See* Rule 13d-1(b)(1)(i), 17 C.F.R. § 240.13d-1(b)(1)(i) (1993).

197 *See* Rule 16a-1(a)(1), 17 C.F.R. § 240.16a-1(a)(1) (1993).

198 *See supra* note 48 and accompanying text.

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

10% threshold, they may still be subject to its recapture provisions if they have a representative on the corporation's board. The theory is that the institution becomes a constructive director based on its agency relationship with its nominee. Thus, an institution owning only 1% may be subject to section 16(b) (and hence illiquid with regard to its stock in the subject company) if it belongs to a shareholder group that has elected a director to the corporation's board. In the SEC's view, any person or entity that has "expressly or impliedly 'deputized' an individual to serve as its representative on a company's board of directors"[200] is subject to both the reporting and recapture provisions of section 16.

The scope of deputization theory is unclear, in part because few cases have construed the SEC's ambiguous pronouncements in the area.[201] Thus, one does not know whether the mere act by an institution of seeking to elect an individual who is not directly affiliated with that institution will cause the individual, if elected to the board, to be deemed a "deputy" of the group that elected him. But the prospect of liability is real (and private litigation is virtually certain, given the profit-motivated bar that enforces section 16(b)). Nonetheless, the SEC has refused to provide a bright-line standard, insisting instead that a fact-intensive analysis is necessary and that determinations must be made on a case-by-case basis.[202] This turf-guarding behavior comes, however, at a high cost. Instances in which an officer or employee of a mutual fund or a pension has gone on the board of a portfolio company are extraordinarily rare. In the few instances in which they have occurred, extreme precautions have been thought necessary. For example, when Peter Lynch, the well-known manager of the Fidelity Magellan mutual fund, went on the board of W.R. Grace, Fidelity required that Magellan sell its Grace stock.[203]

If it is desirable that institutional investors have the ability to obtain board representation, then deputization theory under section 16(b) is an even greater obstacle than section 13(d)'s overbroad "voting group" concept. Its consequence is to emasculate institutional investors as shareholders, denying them the practical ability to place their own personnel on corporate boards. The most logical source of

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200 *See* Exchange Act Release No. 26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,343 (Dec. 2, 1988) [hereinafter Release No. 26,333].

201 Most of the case law in this area is not recent. *See, e.g.*, Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); Lowey v. Howmet Corp., 424 F. Supp. 461 (S.D.N.Y. 1977).

202 Release No. 26,333, *supra* note 200.

203 *See Shareholder Passivity*, *supra* note 3, at 546-47.

truly independent directors—i.e., institutional investors—is thus effectively placed off-limits.

What, then, should be done? If the concern underlying section 16(b) is the fear of insider trading, one obvious compromise would be to create a safe harbor under which deputization could not be found based only on the presence of a single director who was an institution's agent or employee provided that a Chinese Wall was maintained between the director and the institution employing the director. Specifically, the safe harbor would require that (1) the investor group or individual institution had established "written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information,"[204] and (2) the director executed and complied with an undertaking that the director filed with the subject corporation and the SEC under which the director agreed not to disclose material, nonpublic information to the institution (at least without the prior consent of the subject corporation). In effect, this compromise would simply extend to institutional investors with a representative on a corporate board the legislative command in section 15(f) of the Securities Exchange Act of 1934 that already applies to broker dealers.

The doctrinal premise of this proposed safe harbor rule would be that one is not a deputy of another if the director could not share confidential information with the party nominating the director. Rather, the director so nominated should be seen as, in effect, an independent contractor. Put differently, in ordinary usage a "deputy" is a loyal assistant, and thus one separated by a "Chinese Wall" informational barrier that both sides have established should not be deemed a "deputy." Although this safe harbor would not apply if in fact there was information sharing, the proposed standard represents a bright line test that reduces uncertainty. Of course, under this test, trading desk employees and fund managers of the institutional investor could still not serve on the board of portfolio companies, but others divorced from the institution's trading activities could.

C. *Controlling Person Liability*

The willingness of institutions to place representatives or employees on corporate boards is equally chilled by the broad definition of a "controlling person" under the federal securities laws. If an institution is deemed to be a "controlling person" of a portfolio company because it has an officer, agent or employee on the board of a portfolio

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[204] This language is already mandated for broker dealer firms. *See* Securities Exchange Act of 1934 § 15(f), 15 U.S.C. § 78o(f) (1988).

company, two adverse consequences follow. First, the institution faces an illiquidity problem because controlling persons are legally permitted to sell shares of the controlled company only through a registered public offering or if an exemption from registration (such as, most notably, Rule 144) is applicable.[205] Second, a controlling person faces liability for the controlled company's securities law violations, unless it can satisfy an uncertain statutory affirmative defense which requires the institution to prove that it "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[206] For an institution such as a pension fund with special fiduciary responsibilities, a serious question arises as to whether it can justifiably accept this risk of vicarious liability if, by placing a representative on the controlled company's board, it becomes a controlling person.

At present, the SEC's definition of control is both broad and vague. Securities Act Rule 405 defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities . . . or otherwise."[207] In short, the potential to influence control is sufficient; one need not actively exercise that power to be a controlling person. Arguably, the very fact that an institutional investor is successful in placing a representative or nominee on the corporation's board shows that it has the potential "power to direct or cause the direction of the management and policies of" the corporation.

If one wants to encourage institutional investors to become involved in corporate governance and to rely on "voice" rather than "exit," then the impact of controlling person liability is particularly perverse because the risk of liability increases in direct proportion to the shareholder's involvement in monitoring management. The best answer would again seem to be a safe harbor rule. Because "controlling person" liability is a statutory creation, a safe harbor rule cannot simply eliminate this liability, but it can define who is *not* a controlling person.

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205 Under the last sentence of section 2(11) of the Securities Act of 1933, persons who buy from a controlling person are deemed "underwriters." Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1988). Thus, controlling persons are forced to register their shares or find an exemption. Rule 144 provides such an exemption, but requires a two-year holding period. *See* Rule 144(d), 17 C.F.R. § 230.144(d) (1993).

206 *See* Securities Act of 1933 § 15, 15 U.S.C. § 77o (1988); *see also* Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (1988).

207 Securities Act Rule 405, 17 C.F.R. § 230.405 (1993). *See also* Rule 12b-2, 17 C.F.R. § 240.12b-2 (1993).

Traditionally, the SEC has taken the view that "the ownership of 20% . . . of the voting power in a widely held company in most instances constitutes control,"[208] and practitioners have warned that levels as low as 10% could create a rebuttable presumption of control "if such holdings are combined with executive officer, membership on the board, or wide dispersion of the remainder of the stock."[209] On this basis, a safe harbor rule could be defended as simply codifying the prevailing understanding if it provided, for example, that:

> A person shall not be deemed to control another person (the "controlled person") within the meaning of [Section 15 of the Securities Act of 1933] [Section 20(a) of the Securities Exchange Act of 1934] based on the fact that such person, alone or with others, has an employee, officer, agent or other representative on the board of directors of the controlled person, or that it nominated or otherwise helped cause the election of one or more directors to the board of the controlled person, if (1) such person and its affiliates do not own more than 15% of any class of equity security of the controlled person; (2) such person, either individually or with others, has not filed (a) a Schedule 13D that discloses in response to Item 4 thereof an intent to seek control of the controlled person or (b) a Schedule 14D-1 with respect to the controlled person; and (3) such person does not have employees, agents, or other representatives on the board of directors of the controlled person exceeding [20]% of the total members of the board.

This proposal meshes with the earlier proposed revision to the rules under section 13(d) of the Securities Exchange Act, because it allows an institution (or, more likely, a group of institutions) to run a "short slate" and elect a minority of the directors, provided that the individual institution (and its affiliates) holds less than 15% of any class of equity security.

The proposed rule (or any similar variant) would also solve the illiquidity problem that arises when an institution reaches the point where it may hold "control" over a corporate issuer. Under this proposal, greater certainty results because an institutional investor would know that, so long as it kept its stock ownership below the 15% level, it would not have to rely on an exemption from registration to sell shares, as it would not hold "control."[210]

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208 *See* Exchange Act Release No. 27,035, 1989 SEC LEXIS 1352 (July 14, 1989).

209 A.A. Sommer, Jr., *Who's In Control?—S.E.C.*, 21 BUS. LAW. 559, 568 (1966); *see also* Raymond A. Enstam & Harry P. Kamen, *Control and the Institutional Investor*, 23 BUS. LAW. 289, 315 (1968) (10% ownership is SEC's "rule of thumb" for existence of control).

210 Thus, it would not need to rely on Rule 144 (or some other exemption) and would not have to hold the securities for the two-year holding period required by Rule 144. *See supra* note 205.

D. *Section 14(a): Access to the Corporation's Proxy Statement*

The common denominator in the foregoing proposals is that they reduce potential sources of liability and related costs of litigation. But an alternative means of inducing institutions to take a longer-term perspective is to reduce the direct costs of exercising "voice," in particular by facilitating the ability of institutions to elect a representative or nominee to a portfolio's company's board. Today, a proxy contest is expensive; in a truly contested proxy fight, the insurgent can expect to spend millions. Obviously, an institutional investor (with possibly a thousand or more companies in its portfolio) will not incur such costs where it has neither the desire nor, probably, the capacity to take actual control of the portfolio company. Thus, to facilitate board representation by institutional investors, it is essential to reduce radically the costs of electing a single director (or a minority slate of directors).

One means of reducing the costs of a proxy fight is obvious and has a long and largely successful history in related contexts: allow the insurgent to make its proposal as an addendum to the corporation's own proxy statement. Then, rather than having to prepare, clear with the SEC, and circulate its own proxy statement at its own expense, the shareholder can simply free-ride on the corporation's proxy statement. In addition, because management is required by SEC rules to vote the proxies that it solicits from its shareholders as the shareholders instruct it with regard to the insurgent's shareholder proposal, these rules eliminate the need for the shareholder to solicit proxies.[211] However, at present, SEC Rule 14a-8 permits shareholders to use the corporation's proxy statement for some purposes, but not for others. Thus, shareholders can today propose bylaw amendments or make precatory recommendations to management, but they may not make a shareholder proposal that (1) "relates to an election to office;"[212] or (2) "is counter to a proposal to be submitted by the registrant at the meeting."[213] Both exclusions seem overbroad. When one or more shareholders holding a significant equity stake in the corporation wish to propose a single nominee for the board, there is no discernible reason why they should be required to incur the several million dollars in campaign expenses necessary to file their own proxy statement and conduct their own proxy solicitation. Nor do other shareholders need the same disclosure about the intent and plans of such a minority

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211 Rule 14a-4(e) requires management to vote proxies as instructed. *See* Rule 14a-4(e), 17 C.F.R. § 240.14a-4(e) (1993).

212 Rule 14a-8(c)(8), 17 C.F.R. § 240.14a-8(c)(8) (1993).

213 Rule 14a-8(c)(9), 17 C.F.R. § 240.14a-8(c)(9) (1993).

nominee as they do when a contest is being fought for control of the board.

Once, in 1942, the SEC proposed a rule that would have required corporations to include shareholder-nominated candidates in the corporation's proxy statement.[214] But it retreated from this proposal in the face of management opposition and a sense that during the middle of World War II, there were more pressing priorities than corporate governance reform. Nonetheless, management's original objections that unqualified candidates or an excessive number of candidates would be nominated now seem quaint and unpersuasive in an era when institutional shareholders dominate the shareholder population. Multiple slates are unlikely (given the weak incentives of most institutions to become involved in corporate governance), but even in theory the problem can be easily addressed by requiring some minimal level of shareholder support to obtain access to the corporation's proxy statement for one's nominees.

The exclusion for counter-proposals (Rule 14a-8(c)(9)) is similarly overbroad. By denying shareholders the right to make counter-proposals, Rule 14a-8 also denies them the ability to include their statement of justifications for their proposal in the corporation's proxy statement. Viewed this way, counter-proposals are not simply redundant, because they come with a 500 word "supporting statement" in which the proponent explains its case.[215] By excluding counter-proposals, the SEC thus effectively denies shareholders the opportunity to hear the other side of the argument. As a result, the playing field becomes unlevel, because management can, of course, comment critically in its proxy statement on any shareholder proposal, but shareholders cannot reply to management's proposals.

Any proposal that urges reconsideration of the exclusions under Rules 14a-8(c)(8) and (9) will face predictable opposition. One claim will be that, absent these exclusions, corporations would be inundated with proposals having no real support among shareholders; another will be that the proposal discriminates against small shareholders. The answer in both cases is to condition access to the corporation's proxy statement for these purposes upon some showing of shareholder support. For example, Rule 14a-8 could require that an eligible proponent have the support of 1% of the shares or, say, one thousand shareholders. It is not necessary in this Article to resolve where this

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214 *See* Securities Exchange Act Release No. 3347, 1942 SEC LEXIS 44 (Dec. 18, 1942). *See also* Mortimer M. Caplin, *Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage*, 39 VA. L. REV. 141 (1953); Fisch, *supra* note 2, at 1163-64.

215 *See* Rule 14a-8(b)(1), 17 C.F.R. § 240.14a-8(b)(1) (1993).

threshold should be set, but at some level of shareholder support the inundation scenario clearly becomes unrealistic.

Another objection will be that the corporation should not, in effect, pay the election expenses of any one faction's nominee for office. As a practical matter, the corporation's costs will largely stem from management's seeking to oppose this nominee, but as a matter of principle, it should not be conceded that the director so elected will be a representative of any one faction or group. Indeed, if the director is separated by a "Chinese Wall" from the group that elected him (which will probably be a precaution that actively trading institutional investors will want for their own protection), the director will function largely independent of any one faction's views or advice. As here contemplated, the director so nominated and elected would be a representative of the shareholders generally. Thus, one plausible condition to the use of Rule 14a-8 to nominate a single nominee to the board could be conditioned on the existence of an informational barrier between the nominee and those nominating the candidate. On this basis, it seems fairer to ask the corporation to grant access to its proxy statement where the nominee will be relatively isolated from those who nominated him.

If institutional investors had such a right, how often would it be exercised? The best answer seems to be: rarely. Although some public funds might make liberal use of such access at first, they would soon find that support from private pension funds was lacking. When would private funds make use of such a rule? Here, the most likely scenario is that they would use it indirectly. If so armed, most institutional investors, as sophisticated repeat players, would "bargain in the shadow of the law"—that is, they and the corporations they faced would both discount in advance their respective legal positions. In this light, instead of actually exercising their rights to elect a minority director to the board, institutions are more likely to reach compromises with management, agreeing on other reforms or consensus candidates, rather than enforcing the letter of the law. So viewed, access to the corporate proxy machinery may occasionally be used in extreme situations, but, more commonly, its significance will lie in the additional leverage that it gives institutional investors. As a practical matter, this leverage would be traded off for more valuable concessions in very fact-specific cases. Thus, rather than lead to factionalized boards or meaningless minority directors, the legal right to access to the corporate proxy machinery is likely to yield institutions specific, but unpredictable, concessions from management across a host of issues and settings.

E. *Incentive Compensation*

Although the elimination of legal barriers to collective action by shareholders is a necessary condition for effective shareholder monitoring, it may not be a sufficient condition. Particularly in the case of the vast majority of institutional investors that rely on external money managers, monitoring must be performed by external agents who currently receive only trivial compensation for performing monitoring services. Today, the typical equity mutual fund manager receives an annual fee in the range of seventy to one hundred basis points of the assets under its management (considerably less if the fund is indexed).[216] This annual fee compensates the fund manager both for its investment services (i.e. stock picking) and its monitoring services. Out of this fee the fund manager is typically expected to cover the costs of voting the shares and any proxy expenses it decides to incur. But because the fund manager incurs the costs of proxy activism without directly sharing in the benefits, the fund manager may remain rationally apathetic about corporate governance and proxy contests. Of course, the fund manager will receive an indirect benefit from proxy activism if such activism increases the value of its portfolio companies *and* thereby attracts new assets into the fund. But if each new dollar of assets means less than a penny of increased annual fees (as the standard seventy basis point formula implies), then this incentive may be insufficient to encourage costly monitoring and may leave the fund manager interested only in short-term gains from takeovers, LBOs, and the like.

That fund managers do not charge more for their voting and monitoring services testifies in part to the limited importance that they or their clients currently attach to such activities. Monitoring is costly, and in those contexts where investment managers do monitor intensively, they charge considerably higher fees. Indeed, the contrast is striking between the compensation formulas used today with regard to equity fund managers (both at mutual and pension funds) and those that apply to the venture capitalist or the hedge fund operator. The latter may receive annual fees equal to one or two percent of the assets under management plus a share of the profits (up to 25% of the gains over a specified multi-year period for some hedge funds).

Such an incentive-based "performance fee" is, however, legally restricted by the federal securities laws and ERISA. Under section 205 of the Investment Advisers Act of 1940, an investment adviser may not enter into an investment advisory contract that "provides for

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216 *See supra* note 90 and accompanying text.

compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client."[217] This provision is then relaxed for mutual funds by section 205(b), which permits an investment adviser in certain instances to charge a "fulcrum fee" under which compensation to the investment adviser may be

> based on the asset value of the . . . fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the . . . fund over a specified period in relation to the investment record of an appropriate index of securities prices or such other measure of investment performance as the Commission by rule, regulation, or order may specify.[218]

The key to this "fulcrum fee" concept is that there must be a corresponding and equal decrease in the advisory fee if the portfolio underperforms the benchmark index.

In addition to the fulcrum fee, the Commission adopted in 1985 another exemptive rule, Rule 205-3,[219] which also permits limited incentive compensation. However, this exemption is limited to clients having at least $500,000 under management with the adviser or a net worth exceeding $1,000,000. This rule effectively applies to pension funds, but not to mutual funds (except in the unlikely event that each equity owner of the fund meets the foregoing wealth test[220]). Many states also impose additional advisory and performance fee restrictions on investment advisers.

The case for incentive compensation faces a practical difficulty: Neither fulcrum fees nor Rule 205-3 appear to have encouraged fund managers to form small portfolio funds that, through intensive monitoring, would seek to outperform some benchmark index in order to earn incentive compensation. Relatively few funds actually use the fulcrum fee device, and it is reportedly not popular within the industry.[221] What explains this apparent market failure? A partial explanation may be that the mutual fund industry's apathy toward incentive compensation simply reflects the industry's distaste for a new and unexplored form of competition. Competitors often jointly seek to preclude precisely those forms of competition that might attract new entrants into their industry. Another possibility is that the technology of monitoring was underdeveloped. Prior to the SEC's

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217 Investment Advisers Act of 1940 § 205(a)(1), 15 U.S.C. § 80b-5(a)(1) (1988).

218 *Id.* § 205(b)(2), 15 U.S.C. § 80b-5(b)(2) (1988).

219 17 C.F.R. § 275.205-3 (1993).

220 *See* Rule 205.3(b)(2), 17 C.F.R. § 275.205-3(b)(2) (1993).

221 I rely here on private conversations with mutual fund officials.

deregulation of the proxy rules in 1992, there was arguably little that active investors (who did not intend to acquire control) could do to persuade a stubborn management to change its course. From this perspective, incentive compensation makes sense only if one has a strategy to outperform the market index. In principle, in an efficient market, one can hope to outperform the market index in one of two ways: (1) by assuming a higher level of risk, or (2) by seeking to change the behavior and performance of the companies in which one invests. The first technique may have required investment managers to take a larger gamble on their compensation than they were prepared to do, and the second required an ability to intervene and influence management decisions that did not yet exist (and still is only emerging). Hence, incentive compensation may be an idea whose time has not yet come—but could come soon.

For the future, however, the issue is how to lure into the money management market new entrepreneurs who will offer monitoring services in return for incentive compensation. Arguably, a new investment vehicle may need to be designed that would hold a large-stake portfolio in a limited number of companies. Today, any investment company having more than one hundred beneficial owners must register under the Investment Company Act of 1940.[222] Hedge funds, which do use incentive compensation formulas to compensate their investment advisers, must stay under this one hundred shareholder limit in order to avoid regulation. But, as a result, this one hundred shareholder limitation imposes a capital constraint that may make it infeasible for most of them to take large stakes in even a limited number of companies. One possibility that at least deserves consideration might be to raise this one hundred beneficial owner limit to some higher level (possibly two hundred) if all the individuals met some minimal test of wealth or sophistication. Such a test might resemble the SEC's existing concept of "accredited investor."[223] Exempt from the Investment Company Act and able to pay incentive compensation to its fund managers, such an investment vehicle could pursue a strategy of intensive monitoring with respect to a limited number of companies. Yet, such an investment vehicle does not currently exist.

Ironically, this suggestion brings us full circle to our starting point: to create a truly activist institutional investor, it may be necessary to invent a new one.

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222 *See* Investment Company Act of 1940 § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (1988).

223 *See* Securities Act of 1933 § 4(b), 15 U.S.C. § 77b(15) (1988); Regulation D, Rule 501(a), 17 C.F.R. § 230.501(a) (1993) (defining "accredited investor").

CONCLUSION

Three different conceptions of the institutional investor battle for supremacy today:

(1) The first conception sees institutional investors as dangerous, short-term oriented, and inclined toward fads and "herd" behavior. Proponents of this view have already begun to argue that institutional investors should themselves be the subjects, rather than the beneficiaries, of a fiduciary duty.[224]

(2) A second conception sees institutional investors as having been regulated into passivity. Fragmented by legislative restrictions, institutional investors are unable to assume their natural role as the efficient monitors of management, unless deregulation liberates them.[225]

(3) A third and final view doubts the strength of the incentive to monitor and suggests that it may be significantly undercut by a preference for liquidity and agent passivity. Fund managers market their services in a highly competitive market where their relative performance against their peers determines their success or failure. In this light, the problem with expenditures on corporate governance is two-fold: (1) the payoff can be long delayed; and (2) even when there is a payoff, it benefits the free riding shareholder and fund manager as well. Thus, even when successful, the fund manager does not necessarily outperform its rivals. As a result, competitive fund managers have rational reasons not to invest in corporate monitoring, even when there is a positive payoff to their clients. Given these problems, deregulation alone is not the answer, and positive incentives may be necessary if greater monitoring is desired.[226]

The first view of institutions as financial adolescents is currently popular within the business community; the second, which sees politics as the cause of passivity, now is in vogue within the academic community; while the third view is still little understood. Nonetheless, the fundamental claim of this Article is that the first view is wrong and the second overstated. Structurally, historically and culturally, institutional investors are not natural monitors of management; rather, they are natural traders, inclined to rely more on exit than voice. Within the financial environment in which they exist, competitive forces have induced them to acquire skills in noise trading, hedging, and portfolio management, but not the management

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224 *See, e.g.*, Boyer, *supra* note 20, at 1039.

225 For representative statements of this view, see sources cited *supra* note 5.

226 Obviously, the Author is a proponent of this third view, although he does not deny that there is validity to the second view as well.

consulting skills that an ideal monitor would possess. To acquire these skills would require substantial organizational change within fund managers (and the investment advisory industry) and probably awaits some visibly successful "first mover."

The dependence of institutional investors on external fund managers aggravates these short-term trading tendencies, because for both reputational and fee-based reasons, these agents will willingly become involved in corporate governance only in fairly unusual circumstances (such as where a lucrative takeover looms or a change in management appears necessary to stave off disaster).[227] Although deregulation can marginally increase monitoring by institutions, the comparative evidence from Great Britain suggests that even in an unregulated market the incentive to monitor is modest.[228]

Pessimistic as these conclusions may sound, they also explain why deregulation may eventually become a reality. Because institutional investors are not inclined (for the most part) to be activist shareholders, they are not the dangerous conspirators that the business community perceives them to be. Indeed, they are highly vulnerable to co-option. In time, as managements learn this, the current paranoia over the rise of the institutional investor may subside.

Meanwhile, the SEC remains on the fence, both supporting a traditional (if unrealistic) model of shareholder democracy and resisting any effort at coalition formation among institutional investors. Although the SEC is no doubt subject to Congressional and lobbying pressures and legitimately fears that courts will impose jurisdictional limits on any attempts by it to expand its authority over shareholder voting, the SEC must ultimately decide which of the foregoing models of the institutional investor it accepts. If it opts for the second or third models, it could adopt virtually all the proposals discussed in this Article without legislation. But first, the SEC must choose.

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227 Public pension funds are, of course, an exception to this generalization, but they are the exception that proves the rule.

228 *See supra* notes 55-59 and accompanying text.