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## THE FUTURE OF SHAREHOLDER ACTIVISM

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### ABSTRACT

*Activist hedge funds do not hold a sufficiently large number of shares to win proxy battles, and their success in driving corporate change relies on the willingness of institutional investors to support their cause. Against this background, this Article advances three claims about the interaction of activist hedge funds and institutional investors' stewardship. First, this Article argues that the rise of activist hedge funds and their dramatic impact cannot be reconciled with the claim that institutional investors have systemic conflicts of interest that lead them to favor management. One cannot celebrate the achievements of activist hedge funds and at the same time argue that institutional investors systemically desire to appease managers. Second, this Article explains that the rise of money managers' power is changing the nature of shareholder activism. Large money managers' size and influence mean that they need not resort to aggressive tactics to influence companies' management. In today's marketplace, management initiates contact with large institutional investors to learn about any concerns that could trigger activist attacks. Finally, this Article argues that even well-incentivized institutional investors are unlikely to pursue some activist interventions—specifically, those that require the appointment of activist directors to implement complex business changes. This Article analyzes the role activist directors play and show that it might require changes too dramatic to money managers' business model and regulatory landscape. Institutional investors are therefore unlikely to displace activist hedge funds.*

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## CONTENTS

INTRODUCTION .....	973
I. TOO BIG NOT TO BE ACTIVISTS .....	977
A. <i>Hedge Fund Activism and Institutional Investors' Conflicts</i> .....	977
B. <i>Size, Incentives, and Conflicts</i> .....	979
II. THE NEW KINGMAKERS .....	983
A. <i>Management Incentives</i> .....	984
B. <i>Engagement</i> .....	985
III. MONEY MANAGERS AND ACTIVIST DIRECTORS .....	992
A. <i>Activism and Board Appointments</i> .....	993
B. <i>The Role of Activist Directors</i> .....	994
C. <i>Money Managers and Activist Directors</i> .....	997
CONCLUSION .....	999

## INTRODUCTION

Two major developments are shaping modern capital markets: the dramatic increase in the size and influence of institutional investors, mostly mutual funds; and the rising influence of activist hedge funds.

Institutional investors today collectively own 70-80% of the entire U.S. capital market,<sup>1</sup> and a small number of money managers hold significant stakes at each public company.<sup>2</sup> A typical large public corporation has between three to five money managers, each holding approximately 5-10% of the corporation's stock. Other institutional investors (mutual funds, pension funds, insurance companies, etc.) hold smaller percentages, comprising together up to an additional 50% of the corporation's shares.<sup>3</sup> In Pepsico, for example, institutional investors collectively hold 70.47% of the stock.<sup>4</sup> Out of that stake, Vanguard holds 12.03%, BlackRock holds 9.53%, and State Street holds 6.31%.<sup>5</sup> The rest of the institutional investors have much smaller stakes.<sup>6</sup>

The other important development is the rise of activist hedge funds, which use proxy fights and other tools to pressure public companies into making business and governance changes.<sup>7</sup> In 2018, for example, 131 activist investors targeted 226 companies and won 161 board seats.<sup>8</sup> As explained below, the rise

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<sup>1</sup> See Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 69, 74 (2017) ("The growth of institutional investors has been extraordinary: their current 70-80% share compares to 7% in 1950.")

<sup>2</sup> This Article refers to those that make investment decisions on behalf of the funds as "asset managers" or "money managers."

<sup>3</sup> See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: HISTORICAL ANNUAL TABLES 2005 TO 2013, at 98 tbl.L.213 (Dec. 2014), <https://www.federalreserve.gov/releases/z1/20141211/z1.pdf> [<http://perma.cc/7A29-78S7>].

<sup>4</sup> *Pepsico, Inc. Ownership Summary*, NASDAQ, <https://www.nasdaq.com/symbol/pep/ownership-summary> (last visited Apr. 3, 2019) (stating 70.47% of Pepsico is held by institutional investors).

<sup>5</sup> *Id.* (calculating percentages of ownership of Pepsico's institutional holdings). The percentage mentioned in the text above is computed out of the joint stake of all institutional investors in Pepsico, and not out of Pepsico's entire market cap. *See id.*

<sup>6</sup> *Id.* (indicating that other than Blackrock, State Street, and Vanguard, no institutional investor holds over 3% of Pepsico).

<sup>7</sup> For an early review of activist hedge funds, see generally Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007). *See also* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1378-81 (2007). For more recent reviews, see generally Ajay Khorana, Anil Shivdasani & Gustav Sigurdsson, *The Evolving Shareholder Activist Landscape (How Companies Can Prepare for It)*, 29 J. APPLIED CORP. FIN. 8 (2017); and C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296 (2016).

<sup>8</sup> LAZARD S'HOLDER ADVISORY GRP., 2018 REVIEW OF SHAREHOLDER ACTIVISM 1 (2019) [hereinafter LAZARD 2018 REVIEW], <https://www.lazard.com/media/450805/lazards-2018-review-of-shareholder-activism.pdf> [<https://perma.cc/Y24P-8PNG>].

of hedge fund activism has a dramatic effect even on public companies that are not the direct targets of activist campaigns.

An extensive body of literature addresses each development. One strand of literature debates whether activist hedge funds alleviate managerial agency costs and improve long-term company performance or, in contrast, pressure companies to focus on short-term profits.<sup>9</sup> Another strand of literature focuses on the corporate governance role of institutional investors. Dating back to the early 1990s, this literature celebrates the promise of institutional investors but then carefully analyzes their shortcomings in improving corporate performance.<sup>10</sup> The literature focuses on the many reasons—ranging from conflicts of interest to collective action problems and suboptimal fee structure—that undermine money managers’ incentives to monitor management.<sup>11</sup>

This Article focuses on the interaction of these two important developments. It addresses the overlooked implications of the rise of activist hedge funds for the debate on institutional investors’ stewardship incentives. The success of activist hedge funds, this Article argues, cannot be reconciled with the claim that institutional investors have conflicts of interest that are sufficiently pervasive to

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<sup>9</sup> See, e.g., Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1085 (2015) (discussing whether activist hedge funds have detrimental effect on long-term interests of companies and their shareholders); Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 822 (2017) (“[A]ctivist campaigns could generate both positive and negative externalities.”); Alessio M. Paces, *Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance*, 9 ERASMUS L. REV. 199, 202 (2016) (depicting debate over hedge fund activism as debate over the vision for leading company).

<sup>10</sup> See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 886-87 (1992) [hereinafter Black, *Agents Watching Agents*] (discussing case for legal reform to facilitate institutional shareholder voice); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 525 (1990) (arguing whether shareholder monitoring is desirable); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 452 (1991) (analyzing potential promise of institutional investors).

<sup>11</sup> See, e.g., Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1024 (1994) (arguing that, because its competitors are able to free-ride on institutional investor’s monitoring, cost of monitoring “diminishes the institutional investor’s returns relative to the market as a whole”). A recent body of literature focuses on the rise of passive investment through mutual funds. See generally Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. (forthcoming 2019); Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, U. PA. L. REV. (forthcoming 2019); Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018); Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* (N.Y. Univ. Sch. Law, Working Paper No. 18-39, 2018).

have a substantial market-wide effect.<sup>12</sup> Activist hedge funds do not hold a sufficiently large number of shares to win proxy battles, and their success to drive corporate change therefore relies on the willingness of large money managers to support their cause. Thus, one cannot celebrate—or express concern over—the achievements of activist hedge funds and at the same time argue that institutional investors systemically desire to appease managers.

But if money managers are the real power brokers, why do money managers not play a more proactive role in policing management? One set of answers to this question focuses on the shortcomings of money managers—their suboptimal incentives to oversee companies in their portfolio and conflicts of interest.<sup>13</sup> Another answer focuses on the regulatory regime that governs institutional investors and the impediments that it creates for shareholder activism.<sup>14</sup>

This Article offers a more nuanced account of the interaction of activists and institutional investors. It argues that the rise of money managers' power has already changed and will continue to change the nature of shareholder activism.<sup>15</sup> Specifically, large money managers' size and clout mean that they can influence companies' management without resorting to the aggressive tactics used by activist hedge funds.<sup>16</sup> Yet, this Article argues that some activist interventions—those that require the appointment of activist directors to implement complex business changes—cannot be pursued by money managers without dramatic changes to their respective business models and regulatory landscapes.<sup>17</sup>

This Article's analysis unfolds in three parts. Part I addresses money managers' incentives and conflicts. It first considers the claim that conflicts of interest might systemically lead money managers to be too deferential to management. This view, this Article argues, cannot be reconciled with the widespread success of activist campaigns.<sup>18</sup> Money managers might have

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<sup>12</sup> See *infra* Section II.A.

<sup>13</sup> See, e.g., Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 892 (2013) (explaining that “benefit-cost calculation typically will point to de minimis governance expenditures by the diversified intermediary institution”).

<sup>14</sup> See generally John Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. (forthcoming 2019).

<sup>15</sup> See *infra* Part I.

<sup>16</sup> See *infra* Part I.

<sup>17</sup> See *infra* Part III.

<sup>18</sup> For similar reasons, proxy advisory firms, and especially the Institutional Shareholder Services (“ISS”), became so effective. If asset managers' conflict of interests were so severe, ISS could achieve nothing with its recommendations that disfavor management. The effective policy against poison pills or bylaws restricting golden leashes are good examples. See Matthew D. Cain et al., *How Corporate Governance Is Made: The Case of the Golden Leash*, 164 U. PENN. L. REV. 649, 652 (2016) (discussing ISS impact on restrictions against so-called “golden leashes”); Zohar Goshen & Sharon Hanes, *The Death of Corporate Law*, N.Y.U. L.

conflicts that have some effect on their willingness to openly challenge management. Yet, the rising influence of activist hedge funds casts a significant doubt over the extent to which those conflicts translate into a systemic and substantial effect on money managers' willingness to support management of underperforming companies. Next, this Article evaluates the claim that money managers' fee structures provide insufficient oversight incentives in light of the changes in the size of investors' holdings. This Article points out that size matters for incentives. When holdings are substantial, even seemingly small fees (in terms of percentage of assets under management) could create substantial gains from activism.<sup>19</sup>

Part II explains how the rising influence of money managers is shaping and is likely to shape the relationships among corporate insiders, money managers, and activist hedge funds. Money managers' increasing clout allows them to influence companies without resorting to the aggressive tactics that are typical of activist hedge funds. With money managers holding the key to their continued service at the company, corporate insiders today are likely to be more attentive to the wishes of their institutional investors, especially the largest ones.

In fact, in today's marketplace, management initiates contact with large money managers to learn about any concerns that could trigger an activist attack. Money managers—especially the large ones—can thus affect corporations simply by sharing their views with management. This sheds new light on what is labeled today as “engagement.”<sup>20</sup> Moreover, the line between institutional investors' engagement and hedge fund activism could increasingly become blurred. To be sure, the authors do not expect institutional investors to develop deeply researched and detailed plans for companies' operational improvement. Yet, institutional investors' engagement is increasingly likely to focus not only on governance, but also on business and strategy issues.

Part III explains why the rising influence of money managers is unlikely to displace at least some forms of activism. Specifically, this Article argues that money managers are unlikely to be effective in leading complex business interventions that require director appointments. Its analysis starts with the observation that activists often appoint directors to target boards. Such appointments may be necessary to implement an activist campaign when the corporate change underlying the intervention does not lend itself to quick fixes, such as selling a subsidiary or buying back shares. In complex cases, activist

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REV. (forthcoming 2019) (manuscript at 16-21) (discussing ISS impact on “poison pill’s” adoption rates).

<sup>19</sup> See, e.g., Jonathan Lewellen & Katharina Lewellen, *Institutional Investors and Corporate Governance: The Incentive to Be Engaged 2* (Tuck Sch. of Bus., Working Paper No. 3265761, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3265761](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3265761) (estimating that “a one percentage point increase in an institution’s benchmark-adjusted quarterly return predicts 1.29 percentage point (standard error of 0.12) increase in net inflow over the subsequent ten quarters”).

<sup>20</sup> See *infra* Part II.

directors are required not only in order to continuously monitor management, but also to further refine the activist business plan for the company.

This insight, however, only serves to reframe this Article's basic question. Given the rising power of institutional investors, why can they not appoint such directors to companies' boards? The answer lies in the need of such directors to share nonpublic information with the fund that appointed them.<sup>21</sup> As explained below, sharing such information with institutional investors would create significant insider trading concerns and would critically change the role of institutional investors as relatively passive investors with a limited say over company affairs.

### I. TOO BIG NOT TO BE ACTIVISTS

This Part offers some insights about the implications of recent market developments for the continuous debate over the extent to which institutional investors have incentives to actively monitor management.

Section I.A focuses on the overlooked implications of the rise of activist hedge funds for the debate on institutional investors' stewardship incentives. This Article argues that the success of activist hedge funds cannot be reconciled with the claim that institutional investors have systemic conflicts of interest that lead them to favor management. Section I.B explores the link between the increasingly large stakes owned by large money managers and their stewardship incentives. Professor John Morley recently explained that the growing size of the large money managers creates conflicts of interest and regulatory constraints, thereby making the largest money managers "too big to be activists."<sup>22</sup> But as this Article explains, size also pushes in the other direction—towards more activism on behalf of large institutional investors. With their growing size, money managers can gain more from activism, are more likely to be pivotal in votes, and have fewer reasons to fear managerial retaliation.

#### A. *Hedge Fund Activism and Institutional Investors' Conflicts*

Critics of institutional investors point to money managers' conflicts of interest as distorting their incentives to oversee corporate insiders.<sup>23</sup> Under this view, potential conflicts, such as business ties with corporate managers, would lead money managers to be excessively deferential to corporate insiders.<sup>24</sup>

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<sup>21</sup> Another reason is the need for someone to identify the right candidate for the right board seat.

<sup>22</sup> See Morley, *supra* note 14 (manuscript at 1).

<sup>23</sup> See, e.g., *id.*

<sup>24</sup> See Bebchuk & Hirst, *supra* note 11 (manuscript at 23-25) (discussing conflicts of interest between BlackRock, State Street, and Vanguard, the "Big Three," and corporate managers, leading the Big Three to pay close attention to how corporate managers perceive them).

Activist hedge funds have had a dramatic impact on modern capital markets. This Section argues that the widespread success of hedge fund activists tells us something important about large money managers. Specifically, it suggests that money managers' conflicts are unlikely to be sufficiently pervasive to have a systemic governance effect.

Hedge fund activism's success depends on the support of large asset managers.<sup>25</sup> Hedge funds commonly buy slivers of equity in the companies they target.<sup>26</sup> Without the potential or actual support of institutional investors, activist hedge funds would not be able to win proxy fights and would therefore lose their most potent threat against underperforming managers. In other words, they would be no more than paper tigers.

The dependence of activists on institutional investors creates an inevitable tension between the claim that asset managers face severe conflicts of interest and the widespread success of activist hedge funds.<sup>27</sup> If large money managers suffered from pervasive conflicts of interest that led them to support management, they would often vote against activist hedge funds. Moreover, under this view, the rise in the percentage of public companies' shares held by institutional investors would be expected to make incumbent managers more secure against the threat of intervention by activist hedge funds.

The evidence, however, runs in the opposite direction.<sup>28</sup> Each year, for example, many settlements between activists and public corporations take place.<sup>29</sup> Activists are able, through these settlements, to place directors on the targets' boards of directors and force major corporate reform.<sup>30</sup> Managers would not routinely settle with activists if they knew they could count on major

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<sup>25</sup> See Gordon & Gilson, *supra* note 13, at 867 ("These activists gain their power not because of their equity stakes, which are not controlling, but because of their capacity to present convincing plans to institutional shareholders, who ultimately will decide whether the activists' proposed plan should be followed.").

<sup>26</sup> See Martijn Cremers, Saura Masconale & Simone M. Sepe, *Activist Hedge Funds and the Corporation*, 94 WASH. U. L. REV. 261, 319 (2016) ("Most activists, however, do not aim at accumulating large blocks of a target's stock, as smaller stakes (usually at around 5 to 10 percent) may be enough to wage an effective proxy contest for director elections, especially if an activist can count on the support of institutional investors, as has frequently been the case.").

<sup>27</sup> See Goshen & Hanes, *supra* note 18 (manuscript at 18) ("Over the past two decades, hedge fund activism has emerged as a viable, and prominent, corporate governance mechanism.").

<sup>28</sup> See, e.g., Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1, 13 (2015) ("Over the past decade, though, the support mainstream institutional shareholders have increasingly afforded to 'activist' hedge funds specializing in buying up sizeable stakes in target companies and agitating for change has meant that the activist agenda has had an increasingly pronounced influence in the boardroom.").

<sup>29</sup> See *infra* Section III.A.

<sup>30</sup> See *infra* Section III.A.



institutional investors' support in case of a proxy fight. Moreover, the role of activist hedge funds in driving change seems to have grown with the rise of institutional investors' ownership.

To be sure, this Article does not argue that money managers do not suffer from conflicts of interest or that their incentives are perfectly aligned with those of their beneficiaries.<sup>31</sup> Money managers might have conflicts that could affect their voting on specific issues, their general tendency to support management, or their willingness to openly challenge management. Yet, the rising influence of activist hedge funds casts a significant doubt over the extent to which those conflicts translate into a systemic and substantial effect on institutional investors' willingness to support management of underperforming companies. More importantly, the rise of activist hedge funds questions the claim that the concentration of ownership, which may have harmful side effects on other fronts,<sup>32</sup> suppresses activism.

#### B. *Size, Incentives, and Conflicts*

The rise of the large asset managers' ownership stake has a substantial effect on their incentives to invest in costly measures to improve the value of companies in their portfolio. Others have recently conducted a thorough examination of the effect of the size of investors' holdings on their stewardship incentives.<sup>33</sup> Therefore, the analysis here will be relatively short.

As explained above, institutional investors collectively own approximately 70-80% of the market.<sup>34</sup> Mutual funds are especially dominant with holdings that total about 30% of the market cap of all public corporations.<sup>35</sup> These holdings are concentrated in few hands. Especially powerful are the Big Three fund families:<sup>36</sup> BlackRock, the largest asset manager in the world, controls

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<sup>31</sup> See Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds* 20 (Feb. 14, 2018) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3124039](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3124039) (showing that biggest passive managers, including Big Three, support management significantly more than other funds families do); see also Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 3, 42 (Columbia Bus. Sch., Research Paper No. 18-16, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3101473](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101473) (detailing study from 2008 to 2015 which evidences "that passive funds are significantly more 'pro-management' than active funds in proxy contests").

<sup>32</sup> See José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513, 1558 (2018) ("This paper presents evidence of large anticompetitive incentives due to common ownership links at the market level, and of a causal link between common ownership concentration and higher product prices.").

<sup>33</sup> See Kahan & Rock, *supra* note 11, at 12-21 (analyzing effect of size of investors' holdings on their incentives to engage with portfolio companies).

<sup>34</sup> See Posner, Morton & Weyl, *supra* note 1, at 74.

<sup>35</sup> *Id.*

<sup>36</sup> See, e.g., Stephen Choi, Jill Fisch & Marcel Kahan, *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 55 (2013) (stating that three

funds with an estimated \$6.3 trillion of assets under management.<sup>37</sup> Vanguard controls \$5.1 trillion and State Street controls \$2.7 trillion.<sup>38</sup> BlackRock controls 5% blocks or more in over half of all listed companies, while Vanguard holds such blocks in over 40% of public firms.<sup>39</sup> The Big Three combined are the “largest holder” in at least 88% of the S&P 500.<sup>40</sup> Although they hold the stock of a single company through many investment vehicles, these large fund complexes tend to vote all their funds uniformly.<sup>41</sup>

With such sizable holdings, money managers stand to enjoy substantial fee increases when they take measures to improve the value of their portfolio companies, especially those with a relatively large market value. Even when management fees, in percentage of assets under management, are very small, a strategic decision for a portfolio company can have a substantial impact, in dollar terms, on their size. Moreover, the large stakes increase the likelihood that each major money manager’s decision will be pivotal in corporate votes. The ability to influence the outcome, along with the expected financial gain in management fees, produces incentives to influence and intervene.<sup>42</sup>

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specific mutual funds dominate other mutual funds in terms of size of assets under management).

<sup>37</sup> See BLACKROCK, 2017 ANNUAL REPORT 3 (2018), <http://ir.blackrock.com/Cache/1500109547.PDF?O=PDF&T=&Y=&D=&FID=1500109547&iid=4048287> [<https://perma.cc/GS53-5PY6>].

<sup>38</sup> See Press Release, State Street, State Street Reports First-Quarter 2018 EPS of \$1.62, up 41%, and ROE of 12.8%, up 2.9 Percentage Points, Compared to the First-Quarter of 2017 (Apr. 20, 2018, 7:00 AM), <https://newsroom.statestreet.com/press-release/corporate/state-street-reports-first-quarter-2018-eps-162-41-and-roe-128-29-percentage> [<https://perma.cc/5FKS-AVAS>]; *Fast Facts About Vanguard*, VANGUARD, <https://about.vanguard.com/who-we-are/fast-facts/> [<https://perma.cc/YMF2-H5HZ>] (last visited Apr. 3, 2019).

<sup>39</sup> See Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 311-12 (2017) (stating “BlackRock holds 5 percent blocks in more than one-half of all listed companies in the United States” and that Vanguard holds 5% blocks in 1,750 U.S. listed companies, which is approximately 40% of all U.S. listed companies).

<sup>40</sup> *Id.* at 322.

<sup>41</sup> See Sean J. Griffith & Dorothy S. Lund, *Conflicted Shareholder Voting in the Age of Intermediated Capitalism* 16 (Nov. 12, 2018) (unpublished manuscript), [https://ecgi.global/sites/default/files/working\\_papers/documents/griffithlundconflictedshareholdervotinginageofintermediatedcapitalismnov122018.pdf](https://ecgi.global/sites/default/files/working_papers/documents/griffithlundconflictedshareholdervotinginageofintermediatedcapitalismnov122018.pdf) [<https://perma.cc/8YCM-UN9Q>] (“[N]early all large mutual fund complexes have a policy encouraging uniform voting, and some refuse to allow individual fund managers any discretion to depart from it.”). Consequently, Professor John Coates argues that twelve individuals will soon control the fate of most public companies in corporate America. See John C. Coates IV, *The Future of Corporate Governance Part I: The Problem of Twelve 2* (Harvard Pub. Law, Working Paper No. 19-07, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3247337](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337) (explaining that “control of most public companies—that is, the wealthiest organizations in the world, with more revenue than most states—will soon be concentrated in the hands of a dozen or fewer people”).

<sup>42</sup> See Fisch, Hamdani & Solomon, *supra* note 11, at 18.

Money managers can enjoy a sizable fee increase, in absolute terms, even for passively managed funds that typically carry very low management fees in percentage terms.<sup>43</sup> And because funds invested in passively managed funds are usually invested for a long duration, the annual increase in management fees should be multiplied by the funds' investment horizon.<sup>44</sup>

Additional gains from increased management fees flow when the money manager holds stock of the corporation in its actively managed funds.<sup>45</sup> These holdings are typically smaller, but the management fees, as a fraction of the assets under management, are an order of magnitude larger.<sup>46</sup> In some cases, the asset managers of the actively managed funds have so-called fulcrum management fees that fluctuate with the performance of the portfolio; for example, Fidelity is strongly pushing in this direction.<sup>47</sup> Such fees can amplify the direct gain from improved performance of portfolio companies.<sup>48</sup>

Superior returns of a given active fund also may attract the attention of investors and yield new fund inflows, in turn generating additional management fees.<sup>49</sup> Additional indirect benefit may flow from using monitoring efforts as a marketing tool.<sup>50</sup> Asset managers that work hard to improve shareholder value

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<sup>43</sup> See *Investment Funds*, BLACKROCK, <https://www.blackrock.com/investing/products/investment-funds#tab=averageAnnualReturnNAV&type=mualFunds&style=all&search=inde> [<https://perma.cc/AJR2-9KWH>] (last visited Apr. 3, 2019) (indicating BlackRock's average annual return per investment fund).

<sup>44</sup> See Kahan & Rock, *supra* note 11, at 39-40 (discussing factors relevant in how long funds stay invested in funds).

<sup>45</sup> See BLACKROCK, *supra* note 37, at 3 (stating BlackRock has significant portion of its \$6.3 trillion in assets under management invested in actively managed funds).

<sup>46</sup> See *id.*; Chris Flood, *BlackRock's Rivers of Gold from Active Management*, FIN. TIMES (Oct. 15, 2017), <https://www.ft.com/content/f62ed0c2-ada1-11e7-beba-5521c713abf4>.

<sup>47</sup> Chris Flood, *Fidelity Says Fund Companies Need to 'Fundamentally Rethink' Fees*, FIN. TIMES (Oct. 26, 2017), <https://www.ft.com/content/4bdbe5a4-b447-11e7-aa26-bb002965bc e8> (“[Fidelity] believes so-called fulcrum fees should be used more widely. Fulcrum fees, which rise when the fund outperforms and decline during periods of underperformance, have existed since the 1970s, but they remain uncommon in the US . . . .”); see also Assaf Hamdani et al., *Incentive Fees and Competition in Pension Funds: Evidence from a Regulatory Experiment*, 2 J.L. FIN. & ACCT. 49, 54 (2017) (advocating performance fees for retirement savings funds).

<sup>48</sup> See Flood, *supra* note 47.

<sup>49</sup> See, e.g., Lewellen & Lewellen, *supra* note 19, at 2; see also Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, 2019 U. ILL. L. REV. 223, 227 (arguing that “voting behavior of institutional investors is affected by their connections with other institutional investors and more generally with the agents that populate their networks”).

<sup>50</sup> See Nikolai Roussanov, Hongxun Ruan & Yanhao Wei, *Marketing Mutual Funds 1* (Nat'l Bureau of Econ. Research, Working Paper No. w25056, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3250602](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3250602) (discussing importance of marketing in determining fund size).

may stand out as loyal stewards.<sup>51</sup> Recognition of these faithful efforts by the public may attract additional investments.<sup>52</sup> The public manner in which some of the largest asset managers discuss their investor stewardship function is quite telling.<sup>53</sup>

To summarize, the increase in size of the stakes owned by large institutional investors suggests that money managers may capture substantial gains from improved share value at portfolio companies.<sup>54</sup> These incentives are not perfect but they surely exist, and they grow with the size of the stake held by the money manager.

The relationship between the size of the stake that institutional investors hold and the degree of their conflicts is a complex one. In some cases, substantial holdings by institutional investors can alleviate conflicts of interest.<sup>55</sup>

Consider one potential source of conflict that arguably arises for an actively managed fund. The buy-side analysts working for the asset manager need direct contact with portfolio companies in order to improve the investment decisions of the funds and, therefore, mutual funds' families must arguably maintain good relationships with the managers of the companies they invest in.<sup>56</sup> Another oft-mentioned source of conflict—even for passive funds—is money managers' other business activities, and especially providing services for corporate pension plans; for example, BlackRock derives approximately 40% of its assets under

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<sup>51</sup> *Id.* (recognizing performance is important in determining fund size.)

<sup>52</sup> *See id.* (noting marketing can increase fund size). Similar to any other product or service that is sold to the public, marketing efforts and good public relations are important for success. *See, e.g., id.* (estimating that marketing is nearly as important as performance and fees for determining mutual fund capital inflows and fund size).

<sup>53</sup> *See, e.g., Investment Stewardship*, BLACKROCK, <https://www.blackrock.com/corporate/about-us/investment-stewardship> [<https://perma.cc/P8HX-8M9F>] (last visited Apr. 3, 2019); *Vanguard's Investment Stewardship*, VANGUARD, <https://about.vanguard.com/investment-stewardship/> [<https://perma.cc/YPE7-RUQ>] (last visited Apr. 3, 2019).

<sup>54</sup> This Article's analysis therefore leads to a different result than Professors Gilson and Gordon's. *See Gilson & Gordon, supra* note 13, at 894 (“[T]here would be a powerful incentive to engage in activism if it delivered returns that would improve the relative performance of the fund. The dearth of this activity suggests that while potential gains from activism may exist—there is ample evidence of managerial slack—the institutional investor's business model makes it an unlikely candidate to pursue those gains.”).

<sup>55</sup> The argument in the text concentrates on conflicts of interest that stem from the asset managers' business ties with managers. Other types of conflict require separate analysis. Conflict may arise, for instance, when an asset manager invests in a company's debt in one fund and company stock in another. “If a Blackrock activist hedge fund invested in a company's equity, for example, while a Blackrock mutual fund invested in the company's debt, then if the company ever approached insolvency, Blackrock would face a direct conflict of interest.” Morley, *supra* note 14 (manuscript at 5). For a discussion of this type of conflict, see Fisch, Hamdani & Solomon, *supra* note 11, at 40-43. Such conflict, however, certainly does not impact the motivation for all types of activism.

<sup>56</sup> *See, e.g.,* Bebcuk & Hirst, *supra* note 11 (manuscript at 58) (discussing importance of fund managers' relationships with portfolio companies).

management from corporate 401(k) plans.<sup>57</sup> Corporate management can control the flow of these assets, and therefore has leverage on money managers.<sup>58</sup>

But what happens when money managers control a significant percentage of the company's shares? When a money manager holds a sufficiently large stake in a portfolio company, corporate managers might become the ones that cannot risk their relationship with the mutual funds complex, especially when all funds of the same fund family tend to vote together.<sup>59</sup> Corporate managers may have the power to deny some business benefits from asset managers, but asset managers have the power, directly or indirectly, to replace corporate managers.<sup>60</sup> If Professor John Coates is correct and twelve individuals control the votes of all major U.S. companies,<sup>61</sup> would corporate managers be able to exert pressure on these individuals by denying them business?

## II. THE NEW KINGMAKERS

This Part explains that the activism landscape has already changed and will continue to change with both the rising influence of institutional investors and the presence of activist hedge funds. A common critique of money managers is that they are not as proactive as activist hedge funds in pushing for changes, especially business-related changes, at their portfolio companies.<sup>62</sup> Large money managers, however, need not resort to the same tactics as hedge funds. Both institutional investors and corporate managers have an interest in getting results in a softer way. Therefore, with the rise of large money managers, engagement

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<sup>57</sup> See BLACKROCK, *supra* note 37, at 6 (indicating BlackRock's pension plan assets total \$2.403 trillion, or 38.14% of its assets).

<sup>58</sup> See Kahan & Rock, *supra* note 7, at 1055 ("For many mutual fund complexes, the management of corporate pension plans is an important source of revenues. Governance activism could lead to a loss of such business, not just with respect to the activist fund, but for the complex as a whole.").

<sup>59</sup> See Morley, *supra* note 14 (manuscript at 28) ("In interviews, investment management professionals insist that when a corporate voting officer from Fidelity shows up in the boardroom of an operating company like Delta Airlines, Delta's directors will presume that the Fidelity officer speaks on behalf of *all* Fidelity clients . . ."); Bubb & Catan, *supra* note 31, at 2 (empirically showing that funds that share a manager all tend to vote almost exactly the same).

<sup>60</sup> The effect is magnified by outside directors' career concerns and opportunities at other companies, since they are likely to meet the same money managers at other public companies. See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1488 (2007) ("[I]ncentive effects of reputation consist not merely in the director's subjective distaste for embarrassment and his preference for respect, but also in the business opportunities, including other directorships, that are affected by reputation.").

<sup>61</sup> See Coates IV, *supra* note 41, at 2.

<sup>62</sup> See Gilson & Gordon, *supra* note 13, at 890 ("Investment managers thus have little private incentive to address proactively strategy and performance problems at portfolio companies.").

and other forms of institutional investors' actions are likely to occupy an increasingly influential role. More importantly, this Article predicts that large money managers will increasingly focus their engagement efforts on business issues, in contrast to mere governance and public policy matters.

A. *Management Incentives*

First, consider the incentives of management and boards of directors. In a market environment where activists with a compelling claim for increasing value are likely to get support from influential investors, boards have an incentive to avoid costly and public fights with activists.

To begin, boards might pursue business or operational moves that would make their companies less attractive as targets for activists.<sup>63</sup> Advisors today urge boards to “think like an activist” and take measures that would mitigate the risk of an activist attack.<sup>64</sup> A recent study found that an increase in the perceived threat of activist attacks leads firms that were not targeted by activists to implement changes that are favored by activists, such as increasing leverage or decreasing capital expenditures.<sup>65</sup>

More important for this analysis, boards and management have powerful incentives to communicate with their largest investors.<sup>66</sup> First, management has an interest in learning what its investors, and especially the large ones, think about the company's performance and its management strategy.<sup>67</sup> After all, managers who lose their investors' support increase their chances not only of being targeted by an activist, but also of losing the fight.<sup>68</sup> The same logic applies to managers of activist hedge funds, because to secure the backing of the large

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<sup>63</sup> See FRIED, FRANK HARRIS, SHRIVER & JACOBSON LLP, M&A/PRIVATE EQUITY BRIEFING: SHAREHOLDER ACTIVISM 7 (2018), <https://www.friedfrank.com/siteFiles/Publications/FFMAPE1H2018DevelopmentstheImpactandtheFutureofActivism092418.pdf> [<https://perma.cc/9MH5-JR5V>].

<sup>64</sup> *Id.* (“Companies, together with outside advisors, should ‘think like an activist’ to identify and (where appropriate) address potential vulnerabilities that may attract activist scrutiny.”).

<sup>65</sup> See Nickolay Gantchev, Oleg Gredil & Chotibhak Jotikasthira, *Governance Under the Gun: Spillover Effects of Hedge Fund Activism* 3 (European Corp. Governance Inst., Working Paper No. 562, 2018).

<sup>66</sup> See David R. Beatty, *How Activist Investors Are Transforming the Role of Public-Company Boards*, MCKINSEY & CO. (Jan. 2017), <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/how-activist-investors-are-transforming-the-role-of-public-company-boards> [<https://perma.cc/U9GG-MB4U>].

<sup>67</sup> *See id.*

<sup>68</sup> *Id.* (“Today, as a direct consequence of shareholder activism, boards and executives frequently review lists of the largest shareholders in order of percentage of holdings. They then decide on a consultation strategy that may well include a visit from an independent director without any management being present.”).

money managers, it is wise to engage with them in advance.<sup>69</sup> Otherwise, a large investment by the hedge fund may be in vain.

Second, good communication with investors may allow managers to win battles against activists. The victory of DuPont in a fierce battle against activist hedge fund Trian Partners serves as a good example. Trian Partners, Nelson Peltz's reputable and successful hedge fund, led a proxy fight to replace four DuPont directors at the peak of a long activist campaign.<sup>70</sup> However, direct communication between the management and asset managers, especially the Big Three, saved the day for DuPont incumbents, as it was the pivotal votes of BlackRock, State Street, and Vanguard that gave DuPont the victory.<sup>71</sup> As the legal counsels for DuPont later explained, "DuPont took its case directly to the index funds, traditionally 'passive' investors and other governance and voting professionals throughout the campaign."<sup>72</sup>

### B. *Engagement*

Money managers constantly increase their engagement with corporate managers and recruit staff for this purpose.<sup>73</sup> The term "engagement" is used by money managers to describe various types of communications and discussion with portfolio companies, including meetings, e-mails, and phone

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<sup>69</sup> See Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Activism: The State of Play*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 10, 2018), <https://corpgov.law.harvard.edu/2018/10/10/activism-the-state-of-play-2/> [<https://perma.cc/Z8TD-7XEJ>]. This argument is in line with Lipton's interpretation of certain puzzling steps taken by activist hedge funds in attempts to raise their profile among passive institutional investors and other investors. *See id.* A prime example, according to Lipton, is JANA Partners' request that Apple address overuse of its devices among youth. *See id.*

<sup>70</sup> David Benoit & Jacob Bunge, *Nelson Peltz Launches Proxy Fight Against DuPont*, WALL STREET J. (Jan. 8, 2015, 9:07 PM), <https://www.wsj.com/articles/nelson-peltz-launches-proxy-fight-against-dupont-1420761264>.

<sup>71</sup> Stephen Gandel, *DuPont Nearly Lost Its War with Activist Nelson Peltz*, FORTUNE (June 4, 2015), <http://fortune.com/2015/06/04/dupont-nelson-peltz-vote/> [<https://perma.cc/P26U-QC7H>] ("[I]t is believed, and has been reported, that Blackrock, Vanguard, and State Street, DuPont's fourth largest shareholder, voted to keep the chemical giant's board in place, and not add Peltz or his other nominees.").

<sup>72</sup> Andrew R. Brownstein et al., Wachtell, Lipton, Rosen & Katz, *Winning a Proxy Fight—Lessons from the DuPont-Trian Vote*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 18, 2015), <https://corpgov.law.harvard.edu/2015/05/18/winning-a-proxy-fight-lessons-from-the-dupont-trian-vote/> [<https://perma.cc/SU5X-VPWB>]. A unique aspect of this proxy fight, evidencing the pivotal role of the Big Three fund families, is that DuPont defeated Nelson Peltz even though the major proxy advisory firms, ISS and Glass-Lewis, supported the activist. *Id.*

<sup>73</sup> Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 389 (2016) (defining engagement as strategy used "by asset managers and institutional investors to influence the actions of directors and management").

conversations.<sup>74</sup> As explained above, engagement takes place not only because money managers wish to be involved, but also because corporate managers have a strong interest in learning about money managers' views.<sup>75</sup>

These discussions between management and money managers are private, thereby making it difficult to reliably track the number of meetings or the nature of the topics raised by money managers. Moreover, money managers have a clear interest in presenting a picture of substantial investment in engagement. Yet, the available sources suggest that the rise in engagement intensity in recent years is notable. While in 2010 merely 6% of S&P 500 companies reported engagement with major investors, the number swelled to 72% in 2017.<sup>76</sup> The majority of the large asset managers currently engage in direct discussions with the management of their portfolio companies,<sup>77</sup> and many of them hold private meetings with board members without management's presence.<sup>78</sup>

The Big Three lead this engagement trend. BlackRock reported that in 2017 it had over sixteen hundred engagements with portfolio companies, and Vanguard participated in more than eight hundred engagements.<sup>79</sup> State Street announced that its staff "engages with companies to provide insight on the principles and practices that drive [its] voting decisions," and "also conduct[s] proactive engagements to address significant shareholder concerns and environmental, social and governance ('ESG') issues in a manner consistent with maximizing shareholder value."<sup>80</sup> And Vanguard states that in 2016,

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<sup>74</sup> *Id.* at 390 (explaining that "investors may define engagement as any communication with a company that enhances mutual understanding").

<sup>75</sup> See *supra* Section II.A (describing corporate managers' interest in communicating company management strategies to investors).

<sup>76</sup> ERNST & YOUNG, 2017 PROXY SEASON REVIEW 4 (2017), [http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/\\$File/ey-2017-proxy-season-review.pdf](http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/$File/ey-2017-proxy-season-review.pdf) [<https://perma.cc/FDK8-SDZ4>].

<sup>77</sup> See, e.g., Mallow & Sethi, *supra* note 73, at 395 (reporting that T. Rowe Price, large asset manager that concentrates on actively managed mutual funds, "holds hundreds of short, direct conversations with companies owned in portfolios it manages throughout the year on issues that fall beyond the normal due diligence meetings with the companies").

<sup>78</sup> A recent survey found that 63% of the large asset managers had discussions with managers of their portfolio companies, and 45% had meetings with board members without managers present. Joseph A. McCahery, Zacharias Sautner & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2906 (2016) ("[Sixty-three percent] of respondents state that in the past five years they have engaged in direct discussions with management, and 45% state that they have had private discussions with a company's board outside of management's presence.").

<sup>79</sup> Sarah Krouse, *At BlackRock, Vanguard and State Street, 'Engagement' Has Different Meanings*, WALL STREET J. (Jan. 20, 2018, 7:00 AM), <https://www.wsj.com/articles/at-blackrock-vanguard-and-state-street-engagement-has-different-meanings-1516449600>.

<sup>80</sup> 2018 Proxy Voting and Engagement Guidelines: North America (United States & Canada), ST. STREET GLOBAL ADVISORS (Mar. 16, 2018), <https://www.ssga.com/our-insights/viewpoints/2018-proxy-voting-and-engagement-guidelines-north-america.html> [<https://perma.cc/HY6A-8BR4>].



engagements covered investments of one trillion dollars, which represents an almost 70% increase in engagement activity over a three-year period.<sup>81</sup>

Currently, money managers seem to concentrate their interventions on governance and market wide policy matters. As BlackRock's managers described, "For the most part, the focus of investment stewardship activities is governance-related (e.g., board composition, the board's oversight role)."<sup>82</sup> This Article holds, however, that money managers will increasingly focus their engagements on business matters. Money managers' focus on governance makes sense as they enjoy economies of scale when dealing with issues they repeatedly encounter in many companies in which they invest.<sup>83</sup>

Engagement, however, creates an important channel of communication between money managers and corporate insiders. This channel may be used to discuss not only governance concerns, but also company performance and the need for strategic changes. First, as explained above, it is management that has an incentive to learn about money managers' view of the company's strategy. Thus, management might use this channel to initiate discussions about the company's business plan. Second, money managers, and especially the largest ones, have an interest in improving the performance of companies in their portfolio, and engagement provides them with a relatively cheap way of doing so.

To be sure, unlike hedge funds, money managers might lack incentives that are sufficiently strong to formulate complicated business plans for portfolio companies,<sup>84</sup> and their staff devoted to engagements are perhaps not savvy in

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<sup>81</sup> VANGUARD, OUR ENGAGEMENT EFFORTS AND PROXY VOTING: AN UPDATE 1 (2016), [https://pcg.law.harvard.edu/wp-content/uploads/2016/09/8-Proxy-voting-and-engagement-efforts\\_-An-update\\_-Vanguard.pdf](https://pcg.law.harvard.edu/wp-content/uploads/2016/09/8-Proxy-voting-and-engagement-efforts_-An-update_-Vanguard.pdf) [<https://perma.cc/VA9M-XA2F>] (describing growth in engagement and reasons behind increase).

<sup>82</sup> Barbara Novick, Michelle Edkins & Tom Clark, BlackRock, Inc., *The Investment Stewardship Ecosystem*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 24, 2018), <https://corpgov.law.harvard.edu/2018/07/24/the-investment-stewardship-ecosystem/> [<https://perma.cc/7UFK-XM58>].

<sup>83</sup> For passive investors, the focus on governance can also be explained by the competition with active funds. See Fisch, Hamdani & Solomon, *supra* note 11, at 20.

<sup>84</sup> Others believe that asset managers' business models prevent them from crafting any business plan for portfolio companies. See Gilson & Gordon, *supra* note 13, at 893 ("The process by which the portfolio manager acquires and uses information is not focused on identifying opportunities when the activist exercise of governance rights can improve company strategy. The portfolio manager's mission is to determine how the current stock price matches his or her best estimate of the future stock price; that judgment determines a decision to buy, sell, or hold. Information comes in continuously; the comparative evaluation occurs continuously. A diagnostic thought process—what sort of shareholder intervention would improve performance—is simply a different inquiry."). As explained in the next Part, non-complex business planning is within the reach and expertise of traditional asset managers.

strategic business planning.<sup>85</sup> But asset managers have the expertise to sense problems in company performance and are the ones who, once an activist arises, analyze solutions offered by the portfolio companies' managers. In fact, the matters that may cause an activist hedge fund to enter the arena and launch an activist campaign are the same matters that may be discussed in these engagements, whether or not any activism campaign is in sight. Moreover, with the rise of economic incentives to improve portfolio company value, large money managers may hire more expert staff to enhance company performance.<sup>86</sup> When necessary then, money managers' representatives may display concern or dissatisfaction and urge corporate managers to offer an alternative strategic plan for their review.

Indeed, there are some hints for a broader focus of money managers' engagements. One of the reasons for engagement that BlackRock mentions is "an event at the company that has impacted its performance or may impact long-term company value," and it continues to explain that "[w]here [BlackRock's managers] believe a company's business or governance practices fall short, [they] explain [their] concerns and expectations."<sup>87</sup> This sounds like more than mere discussion over governance. Moreover, in his most recent annual letter to the CEOs of public companies, Larry Fink, BlackRock's CEO, noted that the second engagement priority for 2019 is "corporate strategy and capital allocation."<sup>88</sup>

If corporate managers do not respond to money managers' concerns, money managers' dissatisfaction could become louder, thereby reaching the ears of activist hedge funds. Large money managers' dissatisfaction may serve as a fertile ground for the operation of hedge funds. Even today, money managers do not always take the back seat in initiating activism, and in some cases they even issue an informal "Request for Activism."<sup>89</sup> Although large asset managers are

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<sup>85</sup> See Bebchuk & Hirst, *supra* note 11, at 5 ("[T]he Big Three devote an economically negligible fraction of their fee income to stewardship, and . . . their stewardship staffing enables only limited and cursory stewardship for the vast majority of their portfolio companies.").

<sup>86</sup> This is in fact how today's asset managers decide how to vote on complicated business matters. See Griffith & Lund, *supra* note 41, at 9 ("[C]orporate governance groups rely on active fund managers to provide information about portfolio companies in advance of a vote.").

<sup>87</sup> Novick, Edkins & Clark, *supra* note 82 (listing BlackRock's main reasons for engagement with companies).

<sup>88</sup> Larry Fink, *Larry Fink's 2019 Letter to CEOs: Purpose & Profit*, BLACKROCK, <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter> [<https://perma.cc/JP5U-4JB2>] (last visited Apr. 3, 2019).

<sup>89</sup> Merritt Moran, *Ten Strategic Building Blocks for Shareholder Activism Preparedness*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 20, 2016), <https://corpgov.law.harvard.edu/2016/12/20/ten-strategic-building-blocks-for-shareholder-activism-preparedness/> [<https://perma.cc/ZM9W-CNFP>] ("Today, major institutions have frequently

hesitant to admit this practice, some activist hedge funds are quite open about it.<sup>90</sup>

Bill Ackman, the founder of the hedge fund Pershing Square, has stated, “Periodically, we are approached by large institutions who are disappointed with the performance of companies they are invested in to see if we would be interested in playing an active role in effectuating change.”<sup>91</sup> And Jeff Smith, the CEO of the activist hedge fund Starboard, explained that this is an evolving practice: “Mutual funds and passive investors have come not only to appreciate what we do but encourage us. It used to be they would wait and hope. Over the past five years they have added another choice: they call us and want us to get involved.”<sup>92</sup>

BlackRock describes an analogous, although much less demanding, development that took place in response to the flourishing practice of Rule 14a-8 shareholder proposals.<sup>93</sup> BlackRock’s managers explain that “[w]here management demonstrates a willingness to address the material issues raised [by the shareholder proposal], and [BlackRock management is] satisfied with the progress being made, [they] will generally support the company and vote against

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sided with shareholder activists, and in some cases privately issued a ‘Request for Activism’, or ‘RFA’ for a portfolio company, as it has become known in the industry.”).

<sup>90</sup> See David Gelles & Michael J. De La Merced, *New Alliances in Battle for Corporate Control*, N.Y. TIMES: DEALBOOK (Mar. 18, 2014, 9:40 PM), <https://dealbook.nytimes.com/2014/03/18/new-alliances-in-battle-for-corporate-control/> [<https://perma.cc/96TT-2RCR>] (“In certain circles, T. Rowe Price, an institutional investor with \$614 billion in assets under management, has gained a reputation for pursuing hedge funds and encouraging them to take up an activist campaign. The firm denies it suggests certain targets for activists but acknowledges it is in regular dialogue with other investors about the companies in its portfolio. . . . [For] BlackRock, which manages \$4.3 trillion, the lines are more blurred. BlackRock denies that any of its portfolio managers pursue hedge funds with ideas, but some portfolio managers are said to pass on certain ideas.”).

<sup>91</sup> See Simi Kedia, Laura Starks & Xianjue Wang, *Institutional Investors and Hedge Fund Activism 11* (Sept. 2017) (unpublished manuscript), <https://www.aeaweb.org/conference/2018/preliminary/paper/bFre7SK7>.

<sup>92</sup> Chris Dieterich, *Activist Hedge Funds Now Fielding Calls from Fund Companies*, BARRON’S (May 7, 2015, 10:07 AM), <https://www.barrons.com/articles/activist-hedge-funds-now-fielding-calls-from-fund-companies-1431007632> (providing examples of increased engagement by funds and institutional investors).

<sup>93</sup> See 17 C.F.R. § 240.14a-8 (2018); ELIZABETH ISING, RONALD O. MUELLER & LORI ZYSKOWSKI, GIBSON DUNN, *SHAREHOLDER PROPOSAL DEVELOPMENTS DURING THE 2016 PROXY SEASON 4* (2016), <https://www.gibsondunn.com/wp-content/uploads/documents/publications/Shareholder-Proposal-Developments-2016-Proxy-Season.pdf> [<https://perma.cc/AQZ4-DHW4>]; Brian JM Quinn, *14a-8—Shareholder Proposals*, H2O: HARV. L. SCH. (May 22, 2017), <https://h2o.law.harvard.edu/collages/7687> [<https://perma.cc/7EHS-SQ8V>] (defining shareholder proposals in context of proxies). For 2017, see Ronald O. Mueller & Elizabeth Ising, *Shareholder Proposal Developments During the 2017 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 12, 2017), <https://corpgov.law.harvard.edu/2017/07/12/shareholder-proposal-developments-during-the-2017-proxy-season/> [<https://perma.cc/772A-7JU6>].

the shareholder proposal.”<sup>94</sup> And they continue to suggest, “Our interpretation of the gradual decline in the number of shareholder proposals and levels of support over the past few years is that direct engagement is building mutual understanding between companies and their long-term investors on emerging issues . . . .”<sup>95</sup> Money managers’ direct access to managers allows this development.

To summarize, the description of institutional investors as “arbiters” between activist hedge funds and corporate managers is somewhat misleading.<sup>96</sup> It may imply that money managers are passive actors, like judges, who wait until an activism campaign starts and then decide its fate. This Article prefers to describe their role, and especially the role of the Big Three, as “kingmakers.” Kingmakers, unlike judges or arbiters, need not be passive or reactive and have much leeway to decide how active they wish to be. They will never take the throne themselves, but they may play a dramatic role. As long as asset managers are satisfied with management efforts or results, they can prevent a successful hedge fund activism campaign, and vice versa.

It is therefore expected that in the future, engagements will displace many but not all forms of activism. Indeed, when more managers become responsive to institutional investors’ wishes, the need for an activist hedge fund’s intervention becomes smaller. Engagements with large asset managers would achieve many of the goals currently achieved through more severe measures and by other agents. This process has not fully matured yet, but this Article predicts that it will gradually take place. Money managers today are careful in exerting their power, and large-scope engagement is a relatively new phenomenon. But both money managers and corporate managers have the incentive to develop the capabilities to work out mechanisms that ensure money managers’ satisfaction with management’s performance and strategy without the need for aggressive forms of activism.

This understanding is the right reading of two recent developments. First, consider BlackRock CEO Larry Fink’s famous 2017 letter to the hundreds of CEOs of BlackRock’s portfolio companies. Fink wrote,

As we seek to build long-term value for our clients through engagement, our aim is not to micromanage a company’s operations. Instead, our primary focus is to ensure board accountability for creating long-term value. However, a long-term approach should not be confused with an infinitely patient one. When BlackRock does not see progress despite ongoing engagement, or companies are insufficiently responsive to our

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<sup>94</sup> Novick, Edkins & Clark, *supra* note 82.

<sup>95</sup> *Id.* (footnote omitted).

<sup>96</sup> See Gilson & Gordon, *supra* note 13, at 917 (“The interaction between shareholder activists and institutional investors—one proposing, the other disposing—gives value to the institutions’ low-powered governance capacities . . .”).

efforts to protect our clients' longterm economic interests, we do not hesitate to exercise our right to vote against incumbent directors . . . .<sup>97</sup>

There is a promise here as well as a threat. When Fink emphasizes BlackRock's "long-term approach," he hints that BlackRock may be willing to be more patient than activist hedge funds, often accused of "short-termism."<sup>98</sup> Fink offers corporate managers more leeway than hedge funds typically do, and he encourages discussions aimed to convince BlackRock that it is worthwhile to be patient. However, there is a gun on the table. For those who fail to candidly engage ("companies [who] are insufficiently responsive") or those that consistently fail to deliver ("[w]hen BlackRock does not see progress despite ongoing engagement"),<sup>99</sup> the replacement of the management team may result.

The second illustration of activism's center of gravity changing from hedge funds to the traditional money managers lies in certain institutional investors' responses to settlements with activists. Many companies choose to settle quickly with activist hedge funds and give activists board seats rather than engage in a protracted activist campaign or proxy fight.<sup>100</sup> During 2017, large money managers expressed frustration with the growing number of rapid settlements over the previous couple of years, "viewing them as a usurpation of their right to elect directors."<sup>101</sup> The Big Three, representing more than eight trillion dollars of assets under management, publicly urged portfolio companies to solicit their

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<sup>97</sup> Larry Fink, *Larry Fink's 2017 Letter to CEOs*, BLACKROCK, <https://www.blackrock.com/corporate/investor-relations/2017-larry-fink-ceo-letter> [<https://perma.cc/P9P5-MKWD>] (last visited Apr. 3, 2019).

<sup>98</sup> See, e.g., Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1885 (2017) ("[I]nfluenced by stock market forces such as hedge fund activism[,] a short-term increase in productivity and stock price at the expense of long-term reinvestment and wage growth will likely harm the overall 'portfolio' of the human investor."); Martin Lipton, Wachtell, Lipton, Rosen & Katz, *No Long-Term Value from Activist Attacks*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 4, 2018), <https://corpgov.law.harvard.edu/2018/10/04/no-long-term-value-from-activist-attacks> (finding that activist interventions provide effectively no long-term returns).

<sup>99</sup> Fink, *supra* note 97.

<sup>100</sup> See Jay Frankl & Steve Balet, FTI Consulting, *The Rise of Settled Proxy Fights*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 22, 2017), <https://corpgov.law.harvard.edu/2017/03/22/the-rise-of-settled-proxy-fights/> [<https://perma.cc/38EF-B8HD>] ("Of the 110 proxy fights in 2016, 50 ended in settlement, the most we have ever seen in a given year."); see also LAZARD 2018 REVIEW, *supra* note 8, at 5 (showing that activists won eighty-six board seats through settlements and fourteen through proxy fights in 2017).

<sup>101</sup> J.P. MORGAN, THE 2017 PROXY SEASON 3 (2017), <https://www.jpmorgan.com/jpmpdf/1320739681811.pdf> [<https://perma.cc/3F4U-4LTV>] (describing index investors' frustrations arising from recent proxy seasons); see John C. Coffee, Jr., *The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* 14 (Eur. Corp. Governance Inst., Working Paper No. 373, 2017) (explaining that three large investment managers have criticized hedge fund activists and settlement process).

feedback before settling with activists.<sup>102</sup> These large investors also warned that failure to do so risks investors voting against incumbent directors following any unacceptable settlement.<sup>103</sup> Such a warning is nothing less than reclaiming money managers' powers and demanding to take part in reviewing and deciding activism outcomes. Hedge funds and boards alike are reminded that the fate of activism hinges on the power of the large asset managers.

### III. MONEY MANAGERS AND ACTIVIST DIRECTORS

This Article has argued that money managers are increasingly likely to engage with management and that money managers' rising influence incentivizes management to become more attentive to investor wishes. This Part argues that even powerful and well-motivated money managers cannot displace certain forms of shareholder activism—those that require the appointment of directors to drive complex business changes.<sup>104</sup>

Section III.A explains that some forms of activist intervention depend on the appointment of directors to the target company board. Section III.B outlines its explanation of the role of activist directors. These directors, it argues, rely on their ability to share nonpublic company information with the fund that appointed them. Section III.C explains that institutional investors are limited not only in their ability to nominate directors, but also in their ability to continuously receive nonpublic information from these directors.

This Article's analysis does not address another dimension of activist engagements: the regulatory constraints on money managers' ability to run a costly proxy fight. To be sure, proxy fights are not too common, and many activist engagements end with a settlement.<sup>105</sup> Moreover, the rising power of large fund sponsors makes management more responsive to shareholder wishes, thereby reducing the need for costly proxy fights. Yet, the credible threat of a proxy fight drives many companies to settle with activists,<sup>106</sup> management resistance can require activists to take costly measures,<sup>107</sup> and successful

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<sup>102</sup> Coffee, Jr., *supra* note 101, at 14 (describing reactions of BlackRock, State Street, and Vanguard).

<sup>103</sup> *Id.* at 23-25 (recounting large investment managers' warnings about investment risks associated with chasing activist hedge funds' short-term results).

<sup>104</sup> These permanent forms of activism also include activism directed at controlled companies and others that are less likely to be attentive to their investors' demands.

<sup>105</sup> Coffee, Jr., *supra* note 101, at 9 (stating that in 2016, most activist campaigns ended in settlements).

<sup>106</sup> See Travis L. Johnson & Nathan Swem, Reputation and Investor Activism 6 (Apr. 4, 2018) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2658765](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2658765) (stating that activists threaten proxy fights to achieve their goals).

<sup>107</sup> See Nicole M. Boyson & Pegaret Pichler, *Hostile Resistance to Hedge Fund Activism*, REV. FIN. STUD. (forthcoming 2019) (describing how trends in hedge fund counter-resistance change depending on institutional ownership levels).

activists develop expertise in running proxy fights.<sup>108</sup> However, even to the extent that a costly proxy fight becomes necessary—say, because management believes it has sufficient investor support—the obstacles identified in this Part would discourage large institutional investors from nominating candidates to the board.

A. *Activism and Board Appointments*

Some activist campaigns include the appointment of activist-nominated directors to the target's board. In 2018, for example, activists appointed 161 directors to the boards of sixty-eight public companies, and in 2017 they appointed one hundred directors to the boards of fifty companies.<sup>109</sup> While some “activist directors” are appointed by a shareholder vote after a proxy fight, most are appointed as the result of a settlement between the board and activists (sometimes even before the announcement of a proxy fight). In 2018, for example, only thirty-five out of 161 directors won their seats through a proxy contest.<sup>110</sup>

While some of these activist directors are partners or employees of the activist fund, most of them are not fund employees. Only thirty-six of the 161 activist directors appointed in 2018 were activist fund employees.<sup>111</sup> Moreover, activist directors normally do not control the board; that is, they compose less than a majority of board members.<sup>112</sup>

Given the rising power of institutional investors, can they take the role of activist hedge funds and nominate directors to the board? In the early 1990s, when institutional investors started to become more powerful, Professors Ron Gilson and Reinier Kraakman envisioned them in such a role.<sup>113</sup> Under their proposed regime, institutional investors would use their rising clout to appoint professional outside directors to company boards, thereby significantly

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<sup>108</sup> See Krishnan, Partnoy & Thomas, *supra* note 7, at 297 (noting launch of proxy fights contributes to activists' success).

<sup>109</sup> See LAZARD 2018 REVIEW, *supra* note 8, at 8 (showing record number of board seats won in 2018 at 161 in sixty-eight companies); LAZARD'S S'HOLDER ADVISORY GRP., 2017 ACTIVISM YEAR IN REVIEW 5 (2018) [hereinafter LAZARD 2017 REVIEW], <https://www.lazard.com/media/450414/lazards-review-of-shareholder-activism-q4-2017pdf.pdf> [<https://perma.cc/Z8H4-5KXA>] (showing number of board seats won in 2017 as one hundred in fifty companies).

<sup>110</sup> See LAZARD 2018 REVIEW, *supra* note 8, at 8. In 2017, only fourteen percent of board seats were won through a proxy fight. LAZARD 2017 REVIEW, *supra* note 109, at 5 (showing proportions of board seats won through proxy fights or settlements).

<sup>111</sup> LAZARD 2018 REVIEW, *supra* note 8, at 8 (comparing activist employees and non-activist employees within activist directors appointed in 2018).

<sup>112</sup> See *id.* at 14 (looking to future opportunities to increase activist investors' control over boards).

<sup>113</sup> See generally Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

improving the market for directors. These directors, so their argument goes, would develop a reputation for leading change at companies and would therefore be appointed by fund sponsors whenever the need arises. Their vision, however, has only been partially realized. The rise of institutional investors' influence has led to activist directors' appointment to public company boards. These directors, however, have been nominated by activist hedge funds, and not by mutual funds and other institutional investors.

More recently, Professor Jack Coffee, Jr. proposed that institutional investors form a steering committee and assemble a team of outside directors (i.e., not their employees) they could then place on corporate boards.<sup>114</sup> Under his view, such an initiative would be superior to the current regime, where activists and companies privately decide to appoint activist directors without a shareholder vote.<sup>115</sup>

To assess the extent to which institutional investors can displace activists in appointing directors, the next Section takes a closer look at the role that activist directors play on the board and their interactions with the shareholders that appoint them.

#### B. *The Role of Activist Directors*

While activist directors are increasingly present on public company boards, few academic studies explain why activists seek to appoint directors and the role that activist directors play on boards. These questions are especially puzzling, since activists appoint only a minority of board members and therefore rely on the cooperation of incumbents to implement their plan.<sup>116</sup> This Article does not offer a full account of the governance role of activist directors. Rather, it addresses the interaction between activist directors and the funds that appoint them.

Focusing on directors appointed in settlement agreements between boards and activists, Professors Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch explain that "incomplete contracting" prevents activists and boards from specifying in the settlement agreement all future actions that management should take.<sup>117</sup> In other words, activist directors are appointed to ensure that

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<sup>114</sup> Coffee, Jr., *supra* note 101, at 26 ("[I]nvestors . . . who fear they are being disenfranchised by private settlements[] could form . . . a steering committee and assemble a team of outside directors . . . that they could seek to place on corporate boards in the event of an activist attack.").

<sup>115</sup> *See id.* at 28 (arguing that adopting such a regime gives diversified investors flexibility and leverage).

<sup>116</sup> *See* Lucian A. Bebchuk et al., *Dancing with Activists* 23 (Columbia Bus. Sch., Research Paper No. 17-44, 2017) ("The activists, even if successful, are not able to dominate the boardroom or to dictate corporate policy. Instead, they aim at persuading other shareholders to support their candidates, and then influencing decision-making inside the boardroom.").

<sup>117</sup> *See id.* at 15 (arguing that director appointment is necessary because "incomplete contracts" prevent companies and activists from specifying actions that companies should



management complies with the activist's demands that cannot be specified in contract. This view assumes that, when appointing their representatives to the board, activists know what actions the company should take, but specifying these actions in contract might be too costly.

Professors Kobi Kastiel and Yaron Nili focus on the need to improve the board's competence to challenge management.<sup>118</sup> As they explain, directors appointed by activist hedge funds continuously rely on the fund's resources and expertise to collect information and analyze it independent of management.<sup>119</sup> Thus, activist directors overcome the "informational capture" that often undermines independent directors' ability to monitor management.<sup>120</sup> Under this view, activist directors improve the monitoring function of the board.

This Article offers a somewhat different account that focuses on the role of activist directors in implementing strategy or operational changes.<sup>121</sup> Implementation of these activist agendas, this Article argues, requires directors that would not only monitor management, but also play an active role in making strategic business decisions and refining the fund's vision for the company. This in turn requires directors with access to the company's nonpublic information and the ability to share this information with the activist fund for deeper analysis and consultation.

As explained in Part II, in most companies, management is likely to have addressed preemptively all the "low-hanging fruit" for successful activist interventions. Thus, activist engagements are increasingly likely to focus on sophisticated changes to the company's strategy. Changes of this type often cannot be implemented simply by incumbents' willingness to concede past

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take). Coffee, Robert Jackson, Jr., Joshua Mitts, and Robert Bishop criticize this reasoning. See John C. Coffee, Jr. et al., *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board?* 11-12 (Columbia Bus. Sch., Research Paper No. 18-15, 2018) (arguing that Bebchuk's assertion that "incomplete contracting" explains settlement agreement structure is only true in theory but not in reality).

<sup>118</sup> Kobi Kastiel & Yaron Nili, "Captured Boards": *The Rise of "Super Directors" and the Case for a Board Suite*, 2017 WIS. L. REV. 19, 63-64 (citing Delaware General Corporate Law in arguing that directors are encouraged to rely on outside expertise).

<sup>119</sup> *Id.* at 27 ("As outsiders who do not engage in the daily affairs of the corporation, independent directors rely heavily on company insiders, and, in particular, on the CEO, as the source of information.").

<sup>120</sup> *Id.* at 23 (arguing that independent directors do not have enough time, resources, or industry-specific knowledge to understand complexities modern board members are tasked with evaluating). Jack Coffee, Jr., in contrast, has recently focused on the private benefits that activist funds can capture from appointing their representatives to the board and the risk of information leakage. See Coffee, Jr., *supra* note 101, at 2, 17-22 (discussing private benefits unique to activists, including subsidies provided by information leakage).

<sup>121</sup> As explained above, activist campaigns are not limited to measures that reduce agency costs (such as enhancing board independence). See *supra* note 117 and accompanying text (arguing that, for example, appointing activist directors allows activists to more effectively steer management toward activist agenda).

mistakes or accept investors' demand for change. Rather, they require an ongoing process of implementing the activist's vision for the company's future direction. This is consistent with evidence that time horizons of activists have become longer.<sup>122</sup>

The existing literature assumes that activist directors are required to continuously monitor management in order to ensure that the company is on track and indeed changes its direction.<sup>123</sup> Activists, however, may need board representation not only to exercise oversight over management, but also to further refine their own agenda and their plan for the company. In other words, it may be the case that activists themselves do not have a well-defined, step-by-step plan for improving the company's performance at the outset; rather, they need to work with management, through their trusted board representatives, to shape the company's strategy and execute it.<sup>124</sup>

This ongoing process also requires access to the company's nonpublic information. It is difficult to make the many specific business or operational decisions required to implement a new vision for the company based solely on the information available to outside investors. This is true even if these investors are sophisticated funds that spend considerable resources on researching the company and devising a detailed plan to improve its performance. The directors appointed by activists gain access to management and the company's nonpublic information.

Moreover, to be effective, activist directors may need to share the company's nonpublic information with the fund itself in a back and forth process. First, as Professors Kastiel and Nili explain, activist directors often rely on the fund's analysts, expertise, infrastructure, and resources to make business decisions. Activist funds offer their directors a "back office" of analysts and experts that help these directors to become more effective (again, not only in monitoring management, but also in developing business strategies).<sup>125</sup>

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<sup>122</sup> See, e.g., SULLIVAN & CROMWELL LLP, REVIEW AND ANALYSIS OF 2017 U.S. SHAREHOLDER ACTIVISM 22 (2018), [https://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_Review\\_and\\_Analysis\\_of\\_2017\\_US\\_Shareholder\\_Activism.pdf](https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Review_and_Analysis_of_2017_US_Shareholder_Activism.pdf) [<https://perma.cc/ZEE3-M2S9>] ("Activist funds are now holding investments longer, regularly up to five years, and focusing initially on operational turnarounds. It is possible that activists have had no choice but to adapt to a longer time frame as companies susceptible to quick fixes have largely disappeared due to preemptive actions by boards.").

<sup>123</sup> See Kastiel & Nili, *supra* note 118, at 23 (emphasizing importance of board's ability to monitor management).

<sup>124</sup> But see Bebchuk et al., *supra* note 116, at 14-17 (describing "incomplete contracting" and activist involvement on boards with regard to specific, defined actions and goals).

<sup>125</sup> See Kastiel & Nili, *supra* note 118, at 36 (stating that activist directors "enjoy the full resources of their fund, can process and verify the information that is provided to the board by management quickly, and are often presenting the board with their own analysis of the company's underlying data").

Second, sharing nonpublic information with the fund helps the fund itself to refine its vision for the company. Note that activists and investors form their initial proposals for the company without having formal access to nonpublic information. Access to the company's nonpublic information may be instrumental in refining the activist's agenda.

Finally, the authors believe that funds' access to nonpublic company information significantly improves their ability to monitor the directors they nominate to public company boards. Such monitoring is required not only to ensure these directors remain faithful to them and are not captured by management, but also to ensure these directors are indeed sufficiently qualified to perform their role. Without access to nonpublic information, including information about board dynamics, shareholders are left to evaluate directors based only on proxies such as stock performance. Activist funds, in contrast, have superior access to information that significantly improves their ability to evaluate director performance.<sup>126</sup>

Unsurprisingly, therefore, activist funds sometimes insist on the right of activist directors to share information with the fund.<sup>127</sup> Moreover, Delaware law generally does not prevent directors from sharing information with the shareholder that appointed them.<sup>128</sup>

### C. *Money Managers and Activist Directors*

This Article has thus far argued that some forms of activist intervention depend on the appointment of directors with the ability to share nonpublic company information with the party that nominated them to the board. This understanding, this Article argues, sheds a new light on institutional investors' limited ability to displace some forms of shareholder activism. If activist directors' ability to share nonpublic information with the fund is indeed critical to their success, then money managers might be significantly constrained in their ability to displace activists when the need arises for appointment of activist directors.

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<sup>126</sup> See Gilson & Kraakman, *supra* note 113, at 890 (“[T]his disciplinary mechanism could only function as an incentive if institutional investors could monitor the performance of professional directors.”).

<sup>127</sup> See Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA L. REV. 1246, 1286 (2017) (“As part of the process by which they place an investment and nominate directors to the board of a company, hedge funds, private equity firms, and other funds commonly secure the right to receive confidential information from the designated director.”).

<sup>128</sup> See *id.* at 1287 (stating that under Delaware law, “director’s requests for corporate information are presumed valid notwithstanding any relationship he may have with a particular stockholder”).

Legal scholars have highlighted the obstacles that a large asset manager would face if it were to nominate a director on its behalf.<sup>129</sup> Specifically, under section 13(d) of the Securities and Exchange Act, an institutional investor nominating directors to a public company's board will be subject to extensive and costly filing requirements in connection with its trading of the company's stock.<sup>130</sup>

This Article's analysis, in contrast, points to the difficulties associated with directors' need, *after* appointment to the target company board, to share nonpublic information with the shareholder that appointed them. Several major constraints might prevent institutional investors from fully implementing the activist method of operation on this front. While section 13(d) applies only in the United States, activist hedge funds—and not money managers—take the lead in nominating directors in Europe and other countries. Moreover, if policymakers wished to encourage activism by institutional investors, they could remove section 13(d) obstacles by changing the rules that apply to institutional investors. The challenges identified below, however, apply even outside the United States and are harder to overcome.

First, directors' sharing of nonpublic information with institutional investors would subject these investors to prohibitive insider trading problems. Funds that receive inside information might be prohibited from trading the company's shares. While it may not be a significant obstacle for an activist hedge fund with relatively concentrated holdings, this constraint could create significant compliance risk for a large fund family with numerous mutual funds and other investment products. Appointing directors who are not employees of the asset manager cannot overcome this constraint.<sup>131</sup> As long as activist directors rely on sharing information with the fund that appointed them, such funds would be subject to the risk of insider-trading liability.

Second, a regime under which directors appointed by large institutional investors share information with the funds and rely on their advice in performing their duties would be a radical departure from institutional investors' traditionally passive role in company affairs. Consider, for example, the recent debate over the antitrust concerns raised by the increasing influence of large asset managers that own a significant stake of virtually any large public company in the United States.<sup>132</sup> Skeptics of these antitrust concerns point to the limited

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<sup>129</sup> See Morley, *supra* note 14 (manuscript at 13-25) (discussing legal challenges of activism that "make it difficult for any shareholder to become an activist"); see also Bebchuk & Hirst, *supra* note 11, at 38 (arguing that index managers' failure to nominate directors reduces effectiveness of private engagements).

<sup>130</sup> See 15 U.S.C. § 80a-8 (2012).

<sup>131</sup> Cf. Coffee, Jr., *supra* note 101, at 26 (suggesting formation of steering committees of institutional investors that would appoint outside directors who are not fund employees).

<sup>132</sup> See generally Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016); Martin C. Schmalz, *Common-Ownership Concentration and Corporate Conduct* (Annual Review of Fin. Econ, Working Paper Series No. 6908, 2018).

influence that institutional investors have on their portfolio companies.<sup>133</sup> A regime in which large money managers with significant holdings in all large public companies not only appoint directors but also regularly communicate with them regarding companies' operations and strategy might subject the large money managers to significant political backlash.<sup>134</sup>

Such a regime would also create second-order problems for large money managers. Large fund complexes, for example, are complex organizations with numerous funds. Some functions are centralized; others are executed at the fund level. These fund families would be required to create the infrastructure for providing support to activist directors which does not exist today. Moreover, it may be difficult for money managers affiliated with fund complexes that are otherwise competitors to agree on which fund complex (BlackRock or Vanguard, for example) will appoint a director to a specific company. On the one hand, a money manager that appoints a director would enjoy superior access to nonpublic information. On the other hand, that money manager would incur the cost of providing support for such a director while all other money managers benefit from the increase in the company's value.

This Article's analysis, therefore, explains why even well-incentivized money managers cannot displace activist hedge funds in driving complex business changes that require activist directors. To be effective, activist directors need to share the company's nonpublic information with the funds that appointed them. For institutional investors, however, access to such nonpublic information would be prohibitively costly.

#### CONCLUSION

This Article has offered several insights concerning the interaction of activist hedge funds and institutional investors' stewardship. First, the rise of institutional ownership and growing influence of activist hedge funds. First, this Article argues the rise of activist hedge funds and their dramatic impact cannot be reconciled with the claim that institutional investors have systemic conflicts of interest that lead them to favor management. Activist hedge funds are unable to drive corporate change without the support of institutional investors. This dependence casts doubt on the claim that money managers' conflicts of interest are sufficiently pervasive to create a systemic bias in support of corporate insiders.

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<sup>133</sup> See Edward B. Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors* 17-18 (N.Y. Univ. Sch. of Law, Law & Econ., Research Paper No. 17-23, 2017) (noting that institutional investors can influence companies through voting on directors, voting on management's compensation, lobbying, and exit).

<sup>134</sup> One may argue that nothing prevents money managers (BlackRock, for example) from establishing a hedge fund that would nominate its directors to company boards. If the fund has absolutely no communication with the rest of BlackRock, such a structure may resolve the insider trading problem for BlackRock. But if this is true, then why should BlackRock establish such hedge funds that will not be able to communicate and coordinate with them in the first place?

Second, this Article explains that the rise of money managers' power is changing the nature of shareholder activism. To be sure, institutional investors and activist hedge funds do not have the same incentive structure. Unlike activist hedge funds, even large money managers lack sufficiently strong incentives to formulate complicated business plans for portfolio companies. Yet, money managers have the expertise to sense problems in underperforming companies and assess proposals for strategic reform. After all, when a proxy fight takes place, money managers are those that analyze proposals offered by the activist hedge funds as well as the ones offered by portfolio companies' managers.

Thus, this Article argues that so-called "engagements" between money managers and corporate insiders, which are on the rise, create an important channel of communication. This channel may be used to discuss not only governance concerns, but also company performance and the need for strategic changes. The management of a portfolio company has an incentive to learn about money managers' views of the company's strategy. Thus, management might use this channel to initiate discussions about the company's business plan with its major shareholders. Furthermore, money managers, and especially the largest ones, do have an interest in improving the performance of companies in their portfolio, and engagement provides them with a relatively cheap way of monitoring. This Article presents evidence that the market is moving in this direction.

Alas, we explained that institutional investors are unlikely to displace the role played by hedge fund activism. Activist campaigns are increasingly likely to focus on sophisticated changes to the company's strategy. Such corporate reforms often cannot be implemented simply by incumbents' willingness to concede past mistakes or accept investors' demand for change. Rather, they require an ongoing process of implementing the activist's vision for the company's future direction.

Implementation of sophisticated and evolving activist agendas, this Article argues, requires nomination of activist directors that would not only monitor management, but also play an active role in making strategic business decisions and refining the fund's vision for the company. This in turn requires directors with access to the company's nonpublic information and the ability to share this information with the activist fund for deeper analysis and consultation. A prolonged back-and-forth process, involving such inside information, seems absolutely necessary. As this Article explains, large money managers, are a poor fit for this mission that activist hedge funds are free to perform.