ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES: AN ALTERED SHAREHOLDER ACTIVIST PARADIGM

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ABSTRACT

Within capital markets, institutional investors' nascent focus on environmental, social, and governance (ESG) issues is transforming the market for corporate control. Using their ever-increasing ownership of public companies as leverage, these voting blocs color their interactions with two other key players: management and shareholder activists. Institutions are now integrating non-financial ESG risks into traditional quantitative metrics to form optimal strategies for long-term value. The result is that other stakeholders are forced to respond, adapt, and alter their thinking and approaches. Activist hedge funds have responded by incorporating ESG into their campaigns as a means to garner voting support. The corollary is that former short-term investment plays are giving way to longer-term horizons and a wider spectrum of considerations. In response, management must increase its shareholder engagement and appease ESG concerns, or risk facing activist intervention. But engagement cannot always prove a panacea. As a consequence, ESG is changing the power dynamic between management, institutional investors, and hedge funds activists. These groups are being forced to adjust long-established behaviors, thus collectively altering the shareholder activist paradigm.

* I am thankful for discussions with Michigan Law faculty, specifically Professors Laura Nyantung Beny, Vikramaditya Khanna, and J.J. Prescott. I am also grateful to Shaun Mathew. I can be reached at alextkraik@gmail.com.

INTRODUCTION

In matters of corporate governance, institutional investors have become a formidable presence. Over the past several decades, they have increasingly gained power and influence through their consolidated ownership of public equity markets,[1] so that they now control over 80% of shares comprising the S&P 500.[2] Not content to simply remain passive, these institutional investors instead seek to influence corporations and steer corporate governance—all of which challenges conventional notions of the shareholder franchise.[3] Recently, under the rubric of investment due diligence and stewardship, these entities have expanded their analyses to prioritize non-financial matters—namely environmental risks, social issues, and governance reforms.[4] Styled environmental, social, and governance factors (ESG), these same focuses are now increasingly regarded as integral to investment decision-making[5] and as

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1. Marshall E. Blume & Donald B. Keim, Institutional Investors and Stock Market Liquidity: Trends and Relationships 4 (Aug. 21, 2012) (unpublished manuscript), http://finance.wharton.upenn.edu/~keim/research/ChangingInstitutionPreferences_21Aug2012.pdf; *see* MATTEO TONELLO & STEPHAN RABIMOV, THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 22 (The Conference Board, No. R-1468-10-RR, 2010) (showing how institutional holdings of outstanding equity increased from 6.1% in 1950 to 50.6% in 2009).

2. Jacob Greenspon, *How Big a Problem Is It that a Few Shareholders Own Stock in So Many Competing Companies?*, HARV. BUS. REV. (Feb. 22, 2019), https://hbr.org/2019/02/how-big-a-problem-is-it-that-a-few-shareholders-own-stock-in-so-many-competing-companies (discussing the increasing prevalence of common ownerships and their potential harms).

3. *See* Donald E. Farrar & Lance Girton, *Institutional Investors and Concentration of Financial Power: Berle and Means Revisited*, 36 J. FIN. 369, 370, 379 (1981) (showing increasing stock concentration in the hands of institutional investors); Joshua R. Mourning, *The Majority-Voting Movement: Curtailing Shareholder Disenfranchisement in Corporate Director Elections*, 85 WASH. U. L. REV. 1143, 1149–69 (2007) (discussing the institutional shareholder-led effort for corporations to have majority voting over cumulative voting); Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 J. Fin. Econ. 111, 134 (2016) (describing other governance changes brought about by institutional investors). *But see* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688–711 (arguing that shareholders do not have the power to effect change and suggesting corporate election reforms to increase director accountability).

4. *See* Mathew Nelson, *The Importance of Nonfinancial Performance to Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 25, 2017), https://corpgov.law.harvard.edu/2017/04/25/the-importance-of-nonfinancial-performance-to-investors/ (showing how investors see long-term financial benefits in companies with high environmental and social awareness and strategies).

5. *See, e.g.*, Viraj Patel, *2018 Investor Corporate Governance Report*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 17, 2018), https://corpgov.law.harvard.edu/2018/07/17/2018-investor-corporate-governance-report/ (showing the increased importance of ESG factors in investment decisions); MATTEO TONELLO, THOMAS SINGER & CHARLES MITCHELL, THE CONFERENCE BD., THE BUSINESS

new determinants in the framing of fiduciary duties.[6] In the search for long-term share value and the pursuit of positive financial returns, these evolving considerations and approaches have complicated the already complex dynamic between firm managers, institutional investors, and shareholder activists. With their high levels of share ownership, institutional investors often function as management bulwarks against shareholder activists.[7] They are able to lever their influence, thereby determining the success or failure of activist campaigns.[8] The result is that social issues in governance are now entwined with matters involving the market for corporate control, especially when framed within the ongoing long-term versus short-term value debate. As a consequence, management and activists must now routinely appease institutional investors by prioritizing ESG issues in their deliberations and respective strategies.[9] Few companies have been immune to ESG-related issues. Recently, Apple, Amazon, and ExxonMobil have all been beset by criticism.[10] Companies must now view ESG as central to the ongoing operations of firms and their shareholder groups within public markets.

CASE FOR CORPORATE INVESTMENT IN SUSTAINABLE PRACTICES (2015), http://cecp.co/wp-content/uploads/2016/12/2016_Business_Case_for_Sust_Invest.pdf (arguing that businesses should invest in ESG initiatives); U.S. SIF FOUND., REPORT ON U.S. SUSTAINABLE, RESPONSIBLE AND IMPACT INVESTING TRENDS 2018 (2018) (tracking the expansion of sustainable investments in the United States).

6. *See infra* Part III. *See also* RORY SULLIVAN ET AL., U.N. PRI, FIDUCIARY DUTY IN THE 21ST CENTURY (2015), https://www.unpri.org/download?ac=1378 (arguing that fiduciary duties include considering ESG factors); Susan N. Gary, *Values and Value: University Endowments, Fiduciary Duties, and ESG Investing*, 42 J. OF C. & U.L. 247, 259–60 (2016) (explaining how the fiduciary includes ESG factors); STATE STREET GLOBAL ADVISORS, PERFORMING FOR THE FUTURE 17, 22 (2017) https://www.ssga.com/investment-topics/environmental-social-governance/2017/esg-institutional-investor-survey-us.PDF (attributing the rise of ESG investors to changes in corporate culture that frame these factors as part of corporate fiduciary duty); Brian Tomlinson, *ESG and Fiduciary Duties: A Roadmap for the U.S. Capital Market*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 1, 2016), https://corpgov.law.harvard.edu/2016/11/01/esg-and-fiduciary-duties-a-roadmap-for-the-us-capital-market/ (showing that a number of governmental agencies and other policy instruments interpret corporate fiduciary duties to include ESG factors).

7. *Cf.* Farrar & Girton, *supra* note 3, at 370–75 (using recent data to support Adolph Berle's concern that institutional investors' concentration of stock shares gives them "power countervailing that of corporate management[]").

8. *See* Paula Loop et al., *The Changing Face of Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 1, 2018), https://corpgov.law.harvard.edu/2018/02/01/the-changing-face-of-shareholder-activism/ (explaining that institutional investors have the most impact in driving corporate change and governance practices).

9. *See* Nelson, *supra* note 4 (increasing the call from institutional investors for corporate managers to incorporate ECG factors because of a belief that this will maximize long-term profits).

10. *See infra* text accompanying notes 437–38 and 452–58 (describing activist campaigns aimed at Apple and ExxonMobil); Sandra Flow et al., *Navigating the ESG Landscape*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 31, 2020), https://corpgov.law.harvard.edu/2020/01/31/navigating-the-esg-landscape/ (showing how Amazon was recently pressured by employees and shareholders to change its environmental policy).

This Article explores institutional investors' increasingly heightened focus on ESG in the pursuit of long-term value and the attendant ramifications for stakeholders in the market for corporate control. I explain how the combination of this nascent focus with institutional ownership concentrations affects three crucial players and their interrelations: institutional investors, activist hedge funds, and firm management. In this, hedge funds and management have been forced to respond and adapt to institutions. ESG is transforming approaches to fundamental analysis in decision-making. And though these players are driven by different incentives, ESG influences these key stakeholders' behaviors and how they think about corporate governance.[11]

For institutional investors, a heightened focus on ESG invites a progressive view of financial fundamental analysis; views of long-term value are made more dimensional. While the law is still unsettled on whether fiduciary duties compel or even forbid ESG considerations, de facto institutional orientations are already shaping corporate governance.[12] Decisions made and priorities enunciated by these investors are establishing bright lines around long-term strategies for public companies. In effect, this influence might be likened to effects that normally inhere to control blocs of shareholders.

Separately, for shareholder activists, ESG greatly expands the axes along which they can claim underperformance. Since ESG is non-quantitative, it invites more subjective views and considerations into valuations and investment approaches. Increased ambiguity creates opportunity, in turn increasing the potential for activist involvement. As a result, these hedge funds can critique and challenge management on both traditional quantitative financial performance and ESG. In these respects, the efficacy of campaigns and these different approaches remains to be seen. In order for ESG-inspired activist campaigns to be successful, hedge funds must convince institutional shareholders that these risks and considerations are sufficient to force change. In this, activist approaches may be blunt or tactical; ESG could be packaged as either a single, material risk or as an aggregate tipping point directed against management, all of which together requires an intervention. Often, this agitation is as much art as science, as it is not certain that a particular focus on ESG will rally institutions behind the activists. Activism could be an aggressive solution to what could possibly be solved through non-confrontational means.[13] To this end, institutions may

11. *Infra* Part II.

12. *See infra* note 331 (providing examples of asset managers who emphasize ESG issues).

13. *See infra* text accompanying notes 156–67 (discussing defensive shareholder activism, which is a less confrontational method).

well consider activists too blunt an instrument. Perhaps non-quantitative risk does not require as acute an intervention as financial underperformance. Would institutions want to rely on activists and their aggressive tactics? If they decide they can, there are financial synergies that can flow to institutional investors in strategically playing activists against corporations. In this manner, it can be two sides against a managerial middle, albeit with an uneasy relationship stabilizing any coalition of shareholder groups.[14]

In practice, it may be that activists cannot unlock sufficient value from target companies based purely on ESG changes, especially if they act in concert with other funds.[15] If this was not the case, and ESG was merely used as a sales tack, then that company would have already been targeted. This compels us to the view that ESG alone may not inform activist target selection. For activists, adding ESG and non-financial factors to the analysis of potential targets does not diminish upfront costs nor the required internal rate of return hurdle to launch a campaign. This tension is heightened with regard to their relationship with institutional investors and their voting power. Since both activists and institutions are repeat players in the market for corporate control, reputation and previous experience greatly influence the success of a campaign.[16] Hedge funds already suffer from an information asymmetry when compared to the relations between management and institutions.[17] It remains to be seen whether ESG issues can become a driver of target selection. If ESG-troubled companies are unsuitable as targets, then institutional shareholders cannot rely on activists to check managerial agency

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14. *See infra* text accompanying notes 359–63 (explaining why institutional investors may encourage activists, despite their seemingly contradictory interests).

15. Hedge fund activists have taken to acting in concert in what is known as "wolf pack" behavior. John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 562–63 (2016). This group pressure proves to be stronger at coercing management acquiescence. However, it necessarily means that any positive returns are based upon each fund's individual ownership stake, which is lower than if it acted alone. Returns would therefore need to be greater since each individual fund is getting a smaller windfall percentage. See *infra* notes 187–97 and accompanying text for more information on wolf packs, their functionality, and their legal status.

16. *See* Melissa Sawyer & Marc Treviño, *Review and Analysis of 2017 U.S. Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 10, 2018), https://corpgov.law.harvard.edu/2018/04/10/review-and-analysis-of-2017-u-s-shareholder-activism/ (describing how activists and institutions maintain dialogue for strategic reasons).

17. *See* Robert Jacobson & David Aaker, *Myopic Management Behavior with Efficient, but Imperfect, Financial Markets: A Comparison of Information Asymmetries in the U.S. and Japan*, 16 J. ACCT. & ECON. 383, 386 (1993) (examining information asymmetry between managers and the market for managerial myopia); *see also* Bratton & Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 688–715 (2010) (discussing the information asymmetry between management and shareholders).

costs.[18] Conversely, if an activist uses ESG as a means to win support, but then brings about greater, unrelated changes, that will have a detrimental effect on future activists and campaigns. Institutions, who are already skeptical of activists,[19] would then have even more reason to withhold their support.

Finally, for firm management, one can reasonably anticipate a need for greater engagement with institutional investors. Since ESG can be intrinsically subjective and fact-sensitive, management can be expected to work productive lines of communication with their institutional shareholders.[20] Through this, they can best understand and anticipate broad, conflicting, and even shifting points of view. This proactive engagement could catalyze trust relationships with institutions, thereby mitigating the risk that outside activists may successfully align with institutional investors in forming a common, aggressive front.[21] This is an important consideration. A coalition or collection of activists and institutions would prove to be an indefensible foe.

Yet, engagement is not always possible, opening management to greater risk. Although scholarship routinely criticizes senior corporate executives for their agency problems,[22] managers still prove to be efficient because of their functional expertise in the firm.[23] They intimately know the operations and

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18. *See* Lucian A. Bebchuk et al., *The Agency Problem of Institutional Investors*, 31 J. ECON. PERSP. 89, 104 (2017) [hereinafter Bebchuk et al., *Agency Problem*] (arguing that activists can better effect change because they can largely avoid the agency problems that plague institutional investors).

19. Institutional investors, especially index funds, criticize hedge fund activists for their alleged short-term orientation and destructive policies towards long-term value. See *infra* notes 425–28 and accompanying text for a discussion on the dynamic between long-term value, institutional investors, and shareholder activists.

20. *See* Nelson, *supra* note 4 (explaining that CEOs communicate with shareholders to better understand ESG expectations).

21. *See* Gail Weinstein & Philip Richter, *The Road Ahead for Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 13, 2019), https://corpgov.law.harvard.edu/2019/02/13/the-road-ahead-for-shareholder-activism/ (noting that boards have responded to alignment between institutional investors and activists through increasing engagement with investments).

22. *See* John Armour et al., *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 29–48 (3d ed. 2017) (giving an overview of the different types of agency problems in corporate law and legal strategies employed to reduce these costs); *see also generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (providing the first work on the theory of agency costs); Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017) (giving a modernized discussion on the topic and the development of principal-cost theory).

23. *See* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 330 (1983) ("In the complicated production and distribution activities of large open corporations, coordinating the activities of agents, recontracting among them, and initiating and implementing resource allocation decisions are specialized tasks which are important to the survival of the organization and largely fall on its managers.").

strategy of their companies.[24] Understanding this, there are certain ESG issues prioritized by institutional investors that can be easily solved or mitigated. However, confrontation may be unavoidable when a cited ESG risk goes against the core of a firm's operation. Management cannot easily engage ESG issues that are antithetical to their corporate agenda.[25] This same rigidity, and attendant failure to appease institutions, opens pathways for opportunistic activists. A breakdown in engagement could end institutional appetites for friendly dialogue and lead these investors to take confrontational action. Without the safety embedded in institutional support, activists would have a much higher possibility of success.

This article is organized into four parts. Part I provides a background on institutional investors and how they have fundamentally realigned corporate governance leverage.[26] First, I describe the growing influence of these institutions and the regulatory and economic conditions that incubated their rise. I then dichotomize between hedge funds and other institutional investors to emphasize the unique environment in which hedge funds operate. The Part provides an in-depth look at hedge fund structure and behavior in order to understand the conditions that give rise to activism. Lastly, Part I gives an overview of the differences between institutional activism and hedge fund activism. Part II focuses on non-hedge fund institutional investors in the context of ESG.[27] It outlines the growth and primacy of ESG considerations in both *ex ante* investment decision-making and *ex post* engagement and stewardship. It also explains these asset managers' specific conceptions of ESG. Part III delves into the ongoing long-term versus short-term debate.[28] It describes institutional investors' pursuit of long-term value, as well as the criticisms levied at hedge fund activists for alleged short-term behavior. Rather than taking a stance on activist fund time horizons, I attempt to juxtapose the considerations and pressures facing both groups. This yields a discussion on the uneasy alliance between institutional investors and hedge fund activists that is condition precedent for any successful activist campaign. Part IV connects Parts II and III.[29] It discusses how activists have already begun changing their tactics to win over powerful institutions. It then describes and attempts to predict activist reactions to ESG risks and issues.

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24. *Id.*

25. *See infra* notes 456–59 and accompanying text (explaining how ESG campaigns directly conflict with ExxonMobil's business model).

26. *Infra* Part I.

27. *Infra* Part II.

28. *Infra* Part III.

29. *Infra* Part IV.

To conclude, I deliberate on what management might do to rebuff activists, but I also caution about the breadth and different levels of ESG risk.

I. INSTITUTIONAL INVESTORS AND CHANGING SHAREHOLDER ROLES

A. Increasing Institutional Equity Holdings

In 1950, institutional shareholders held 6.1% of total outstanding U.S. equities.[30] This number ballooned to 70% in 2016,[31] and is expected to continue apace.[32] The largest of these asset managers—BlackRock, Vanguard, and State Street—now each have greater than $1 trillion in assets under management (AUM)[33] and own almost 20% of the S&P 500 themselves.[34] In contrast, once dominant retail investors now hold less than 30% of the S&P 500, with this rate continuing to decline annually.[35] In part, this sharp change and ascendancy is traceable to societal changes in equity investing, investor demographics, and decisions to privatize retirement savings.[36] At the same time, capital markets and tax innovations incubated conditions that favored investment intermediaries offering low-cost, diversified investment vehicles.[37]

In matters of retirement savings, the promulgation of the Employee Retirement Income Security Act (ERISA) in 1974 catalyzed a shift from defined benefit plans to defined contribution plans,[38] specifically in the form of mutual funds. Defined benefit plans are prototypical pension plans.[39] These plans—which are becoming more rare—pay retirees based on a formula that takes a percentage of their final, average salary multiplied by

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30. Loop et al., *supra* note 8.

31. *Id.*

32. *See generally* Kenneth R. French, *Presidential Address: The Cost of Active Investing*, 63 J. FIN. 1537 (2008) (explaining how index funds have lower costs, tax advantages, and outperform most actively managed equity mutual funds). Between 1984 and 2006, passive funds increased from 1% of total fund assets to 12.6% and have continued to climb. *Id.* at 1544. From 2013 to 2016, more than $1.3 trillion were invested in passive funds. Anne Tergesen & Jason Zweig, *The Dying Business of Picking Stocks*, WALL ST. J. (Oct. 17, 2016), https://www.wsj.com/articles/the-dying-business-of-picking-stocks-1476714749.

33. Bebchuk et al., *Agency Problem*, *supra* note 18, at 94 (discussing how BlackRock, Vanguard, and State Street Global Advisors are referred to as the Big Three and respectively have $3.1 trillion, $2.5 trillion, and $1.9 trillion AUM).

34. Sawyer & Treviño, *supra* note 16.

35. *Id.*

36. 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, 867–68 (2013).

37. *Id.* at 868.

38. Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 471–72 (2004).

39. *Id.* at 455.

their number of years of employment with the sponsoring company.[40] Conversely, defined contribution arrangements, usually in the form of a 401(k), specify an input payment for each participant.[41] A retired employee is not guaranteed a set benefit or stream of payments, but rather a pool of money that might be created through regular investing in a group pool.[42] This overall pool is funded from individual deductions at source and usually with percentage employer matches.[43]

ERISA's provisions created the individual retirement account and introduced regulatory burdens that were much more exacting for defined benefit plans.[44] Because they are specific, funded obligations, the retirement law imposes minimum funding requirements for defined benefit plans.[45] These mandates forced these plans to save and fund annual payments necessary to cover extant and future financial obligations, as well as any previously unfunded costs.[46] The result was a sharp spike in these types of funds investing in the capital markets to meet their future obligations and minimum capital requirements.[47] Eventually, the funding requirements, which brought about an increase in administrative costs, deterred companies from providing defined benefit plans.[48] This was especially true when compared to the simplicity of regulations surrounding 401(k) plans.[49]

Altogether, ERISA helped stoke a shift in capital toward mutual funds as well as the concentration of capital to a select number of funds.[50] The advent of modern portfolio theory and beneficial tax treatment also jolted the institutional mutual fund industry forward.[51] Tax-favored treatments of 401(k) plans allowed for a cheap shift of stock ownership to financial institutions.[52] Adding to this tax element, Harry Markowitz's portfolio theory led to the conclusion that investing through intermediaries provided the best

40. *Id.*

41. *Id.* at 455, 457.

42. *Id.* at 455.

43. *See id.* at 457 (explaining that defined contribution accounts, while not pooled at the individual account level, accrue interest from market investment and are payable upon employment termination).

44. *Id.* at 471–72.

45. Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1082 (2018).

46. Gilson & Gordon, *supra* note 36, at 879.

47. TONELLO & RABIMOV, *supra* note 1, at 25 (showing that, from 1980 to 1990, pension fund AUM increased from $871 billion to $3.02 trillion).

48. Gilson & Gordon, *supra* note 36, at 884–85.

49. Zelinsky, *supra* note 38, at 477.

50. Gilson & Gordon, *supra* note 36, at 883–84.

51. *Id.* at 885.

52. Kristian Rydqvist et al., *The Evolution of Aggregate Stock Ownership—A Unified Explanation* 37 (Ctr. for Econ. Pol. Research, Working Paper No. DP7356), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1461985.

risk-adjusted returns.[53] This was because investors could take advantage of diversified portfolios of securities at lower costs.[54]

The importance of this reshaping of the financial landscape, seemingly in lockstep with their increased market share, is that institutional investors have also challenged managers for a greater say in matters of corporate governance.[55] This is no small feat, as it threatens to reshape, if not upend,[56] the traditional Berle and Means model of the public corporation that is premised on the separation of ownership and control.[57] In 1968, Adolph Berle himself expressed concern for the "emergence of a new concentrated power countervailing [managers] . . . in the hands of institutional investors."[58] Berle's view was prescient in that, aiming to both protect and maximize shareholder value, these groups do not shy away from critiquing and influencing corporate boards and their direction.[59] Indeed, although these funds are frequently not assertive in begetting change like hedge fund activists, they cannot be deemed mere passive investors.[60]

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53. Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77, 89 (1952).

54. Modern portfolio theory is an investment theory underpinned by the notion that risk-averse investors can construct portfolios to maximize expected return based on a given level of market risk. See *id.* at 77–91 for the seminal article on the topic. It argues that diversification improves risk-adjusted returns. *Id.* at 89. See also Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721 (1976) for a more in-depth summary of the theory's tenets and analysis on how investment law has adapted to its prominence.

55. Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671, 693 (1995).

56. Farrar & Girton, *supra* note 3, at 370 (explaining how Adolph Berle warned of institutional investors and concentrations of power as having the potential to upset the balance between management and stockholders).

57. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY 3, 355 (1932) (footnotes omitted) ("The . . . owner who invests in a modern corporation . . . surrenders his wealth to those in control of the corporation that he has exchanged the position of independent owner for one in which he may become merely recipient of . . . wages . . . . [These owners] have surrendered the right that the corporation should be operated in their sole interest . . . .").

58. Farrar & Girton, *supra* note 3, at 370 (second alteration in original) (citation omitted). Berle also thought that size limitations should be placed on institutional investors, as well as restrictions on the expansion of commercial banks and bank-holding companies to prevent the transfer of power to these institutions. *Id.*

59. *Id.* at 379.

60. *E.g.,* Angela Morgan et al., *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914, 927 (2011) (concluding that mutual funds act more like monitors than do other shareholders). *But see* Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843 (2009) (explaining how mutual fund advisors fall short of their duties to act and that they overwhelmingly cast votes in favor of management).

B. Hedge Funds and the Panoply of Institutional Investors

Institutional investors are defined as pooled investment entities that are professionally managed on behalf of their beneficiary members.[61] This Article operationalizes a distinction between hedge funds and other institutional investment funds, generally mutual funds and pension funds.[62] Substantial structural and regulatory differences demarcate the two groups. Perhaps most importantly, the Investment Company Act of 1940 (the 1940 Act) regulates mutual and pension funds, but generally not hedge funds.[63] In this, hedge funds are designed to operate with maximum flexibility under the law.[64] Hedge funds rely upon statutory exclusions in the definition of an investment company found in the 1940 Act to avoid falling under the law's oversight, something that institutions cannot do.[65] Importantly, hedge funds will have either less than 100 investors or only have investors who are deemed *qualified purchasers*.[66] Qualified purchasers are individuals with

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61. *Form 13F—Reports Filed by Institutional Investment Managers*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answers-form13fhtm.html (last visited Apr. 16, 2020).

> In general, an institutional investment manager is: (1) an entity that invests in, or buys and sells, securities for its own account; or (2) a natural person or an entity that exercises investment discretion over the account of any other natural person or entity. Institutional investment managers can include investment advisers, banks, insurance companies, broker-dealers, pension funds, and corporations.

Id.; Christopher Geczy et al., *Institutional Investing When Shareholders Are Not Supreme*, 5 HARV. BUS. L. REV. 73, 78 (2015) (describing how institutional investors also invest through a variety of financial instruments).

62. The Harvard Business School Spectrum database classifies institutional investors under five categories: (1) banks, (2) insurance companies, (3) investment companies, (4) independent investment advisors, and (5) other, which category includes pension funds and endowments. Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings Over Long-Run Value?*, 18 CONTEMP. ACCT. RES. 207, 222–23 (2001). For the purposes of this Article, the distinction between hedge funds and other institutional investors is most appropriate.

63. Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1735 (2008) [hereinafter Brav et al., *Hedge Fund Activism*] ("[H]edge funds avoid the Investment Company Act of 1940 by having a relatively small number of sophisticated investors."); Frank S. Partnoy & Randall S. Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, *in* NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES 115 (Yasuyuki Fuchita & Robert E. Litan eds., 2007); 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, 1887–88 (2017) [hereinafter Strine, *Flesh-and-Blood Perspective*] (discussing how there is a paucity of information about hedge fund investments and performance because they are not subject to extensive required disclosures).

64. *The Perils of Hedge Fund Regulation*, KNOWLEDGE@WHARTON (Feb. 26, 2003), http://knowledge.wharton.upenn.edu/article/the-perils-of-hedge-fund-regulation/ ("Regulation is in some sense incompatible with the fundamental role and character of hedge funds . . . .").

65. 15 U.S.C. § 80a-3 (2018).

66. *Id.* § 80a-3(c).

over $5 million in investments or entities with over $25 million in investments.[67] Additionally, hedge funds do not trade on exchanges like their mutual fund counterparts.[68] Even beyond federal regulatory oversight, hedge funds are not subject to extensive state or local influence, political or otherwise.[69] Overall, their deliberate structuring allows them to operate outside of most statutory umbrellas and within regulatory gray areas.

There is no clear definition for what constitutes a hedge fund. That said, they evince four general traits: "(1) they are pooled, privately organized investment vehicles; (2) they are administered by professional investment managers . . .; (3) they are not widely available to the public; and (4) they operate outside of securities regulation and registration requirements."[70] To this end, they are speculative investment vehicles designed to actively make use and trade off of superior information. The looseness of their description is characteristic of the freedom that inheres to hedge funds, especially when contrasted with other types of financial entities and institutions.[71]

Hedge funds also take advantage of exemptions from securities law requirements. In general, both the Securities Act and the Exchange Act focus on investor protection through mandatory disclosure duties and fraud deterrence.[72] By accomplishing this, the market can be efficient, with accurate pricing and sufficient liquidity. However, these laws provide built-in exemptions and opportunities for sophisticated[73] and accredited[74] investors. Indeed, it is through exemptions in Rule 506 of Regulation D that

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67. *Id.* § 80a-2(a)(51)(A).

68. THOMAS P. LEMKE, GERALD T. LINS & MARIE E. PICARD, MORTGAGE-BACKED SECURITIES § 6:6 (2019).

69. *See generally* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993) (arguing that pension funds suffer from investment conflicts, namely political pressures, that temper the benefits of their activism).

70. Brav et al., *Hedge Fund Activism*, *supra* note 63, at 1735 (citation omitted).

71. *Id.*

72. *See generally* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711 (2006) (explaining how securities regulations promote efficient and liquid markets).

73. Rule 506 of Regulation D defines a sophisticated investor as one who "alone or with [a] purchaser representative[] has [a sufficient] knowledge and experience in financial and business matters." 17 C.F.R. § 230.506(b)(2)(ii) (2019). With this, the investor "is capable of evaluating the merits and risks of . . . prospective investment[s]." *Id.* Case law has also established that investor sophistication and access to information can provide exemptions from public offerings. See *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893 (5th Cir. 1977) and *Sec. & Exch. Comm'n v. Ralston Purina Co.*, 346 U.S. 119 (1953) for case law on the sophisticated investor requirement and exemptions outside of Regulation D. See also C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 37 DUKE L.J. 1081, 1085 (1988) for a discussion of inconsistent judicial treatment of sophisticated investors.

74. 15 U.S.C. § 77b(15) (2018) and 17 C.F.R. § 230.501(a) provide comprehensive definitions of all the categories that an individual or entity can fit to become accredited.

hedge funds raise capital for their investment activities.[75] Rule 506 limits hedge fund investors to high net worth individuals, who constitute a minority of their investors, and other institutional funds, who form the majority.[76] This legal freedom presupposes that there is a lesser need to protect investors in these circumstances, and that hedge funds can perform necessary due diligence themselves while still having the ability to properly appraise risky positions.

Beyond securities law, hedge funds avoid ERISA by limiting pension fund ownership to less than 25% of its investor base.[77] Consumer protection not being as strenuous a priority further allows hedge funds to operate outside of regulatory frameworks.[78] In contrast, mutual and pension funds have retail beneficiaries, who are average consumers.[79] For this group, public policy demands protection, and therefore these institutions are comparatively limited in the exemptions available from securities law and other regulatory apparatuses.[80]

In all, this operational latitude has drawn strong criticism. There remain compelling arguments for increasing the regulation of hedge funds in a manner similar to other institutional investors. Outside of moral arguments, hedge funds have raised concerns around the integrity of markets and systemic risk.[81] The most acute example is the failure of Long-Term Capital Management (LTCM).[82] In 1998, the fund, founded by two Nobel laureates, collapsed after losing almost $3 billion in 4 months due to the preceding Asian and Russian financial crises.[83] Banks had allowed LTCM to borrow 100% of its collateral value and its leverage exceeded 130 to 1.[84] It also had

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75. 17 C.F.R. § 230.506.

76. *Id.* § 230.506(c)(2).

77. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L.R. 1021, 1067 (2007).

78. *See* Bebchuk et al., *Agency Problem*, *supra* note 18 (explaining that hedge funds operate outside of typical financial regulations because these funds limit their offerings to sophisticated investors).

79. *See* Joseph A. Franco, *A Consumer Protection Approach to Mutual Fund Disclosure and the Limits of Simplification*, 15 STAN. J.L. BUS. & FIN. 1, 10 (2009) (indicating that retail beneficiaries are the average investor).

80. *See id*. at 11–12 (explaining that securities laws treat sophisticated investors differently because their informational needs differ from ordinary investors).

81. *See* Chan et al., *Systemic Risk and Hedge Funds*, *in* RISKS OF FINANCIAL INSTITUTIONS 235–36 (M. Carey & R. Stultz eds., 2007) (examining the less understood, yet steadily increasing, systemic risk of hedge funds).

82. Paul L. Lee, *Long-Term Capital Management: A Retrospective—Part I*, 135 BANKING L.J. 429 (2018) [hereinafter Lee, *Part I*]; Paul L. Lee, *Long-Term Capital Management: A Retrospective—Part II*, 135 BANKING L.J. 483 (2018). The fall made national news as the first major hedge fund to fail and for its spectacular losses. *See, e.g.*, Michael Lewis, *How the Eggheads Cracked*, N.Y. TIMES (Jan. 24, 1999), https://www.nytimes.com/1999/01/24/magazine/how-the-eggheads-cracked.html.

83. Lee, *Part I*, *supra* note 82, at 436–37; Lewis, *supra* note 82.

84. Lee, *Part I*, *supra* note 82, at 434, 437.

over $1 trillion in off-balance sheet liabilities from the OTC derivatives market.[85] The size of the fund's debt meant that its creditors, which included Wall Street's largest financial institutions, would have been pushed towards insolvency. A consortium of these major banks, under the supervision of the Federal Reserve, organized a bailout to stabilize the fund and allow it to conduct an orderly liquidation.[86] Concerns over excessive leverage and opaqueness make it unclear if hedge funds pose a risk to the global financial system.[87] Most research following this incident determined that greater disclosure was warranted to increase transparency and market discipline, as well as curb excessive leverage.[88] Indeed, many of LTCM's failures were repeated a short time after in the Financial Crisis.[89]

Nearly a decade later, after financial contagion, the Dodd-Frank Act explicitly authorized the Securities and Exchange Commission (SEC) to regulate the registration of hedge fund advisors.[90] This ended a protracted and contentious courtroom and administrative battle about the proper oversight of these entities.[91] The Private Fund Investment Advisers Registration Act (PFIARA), Title IV of Dodd-Frank, gave the SEC authority to promulgate rules aimed at enhancing hedge fund disclosure and forcing the registration of managers.[92] Taking this congressional lead, the SEC introduced controversial and exacting reporting obligations to be filed in

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85. *Id.* at 433.

86. *Id.* at 438.

87. *See* Chan et al., *supra* note 81, at 236 (pointing to the LTCM crisis as an example of systemic risk).

88. John Kambhu et al., *Hedge Funds, Financial Intermediation, and Systemic Risk*, 13 ECON. POL'Y REV. 1, 3 (2007) (explaining how banks extend credit to unregulated hedge funds, which exposes them to counterparty credit risk); PRESIDENT'S WORKING GRP. ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 33 (1999) (arguing, *inter alia*, that hedge fund public disclosures should be made more frequent and consistent or more meaningful); Chan et al., *supra* note 81, at 236; *see* WULF. A. KAAL, HEDGE FUND REGULATION BY BANKING SUPERVISION: A COMPARATIVE INSTITUTIONAL ANALYSIS 133–71 (2006) (discussing responses by different countries after LTCM's failure).

89. *See* Lee, *Part I*, *supra* note 82, at 450–55 (highlighting issues common to both the LTCM crisis and the 2008 Financial Crisis).

90. Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act §§ 401–419, 15 U.S.C. §§ 80b-1 to 80b-20 (2018).

91. See Wulf A. Kaal, *Private Investment Fund Regulation—Theory and Evidence from 1998 to 2016,* 20 U. PA. J. BUS. L. 579 (2018) [hereinafter Kaal, *Private Investment Fund Regulation*] for a comprehensive legislative and judicial history. Since the 1980s, the SEC has repeatedly tried to regulate hedge funds by requiring hedge fund advisor registration. *Id.* at 585. Prior to Dodd-Frank, the SEC's last attempt in 2004 was deemed an instance of arbitrary rulemaking in *Goldstein v. Sec. & Exch. Comm'n*, 451 F.3d 873, 884 (D.C. Cir. 2006). This led to the immediate deregistration of all registered advisors, who had comprised the majority at that point. Kaal, *Private Investment Fund Regulation*, *supra*, at 586. However, Dodd-Frank explicitly authorized the SEC to force hedge fund advisors to register, in effect overruling *Goldstein*. *Id.* at 591.

92. Kaal*, Private Investment Fund Regulation*, *supra* note 91, at 591.

Form PF.[93] Form PF obligates the disclosure of specific information about investment managers, their funds, and their investors.[94] Hedge fund managers with more than $150 million AUM are further required to register as investment advisors.[95] These persons must maintain all records necessary to avoid systemic risk and provide confidential reports of information related to such risk.[96] Overall, the disclosure obligations are aimed at removing the murky informational haze surrounding the industry. The SEC is now privy to information such as strategies used, performance, risk metrics, and exposure, among other requirements.[97]

Aside from regulatory oversight, structurally, a hedge fund is organized as a partnership managed by a general partner with investors functioning as passive, limited partners.[98] The fund aligns manager incentives with those of its investors through its unique compensation scheme.[99] Typically, funds combine a fixed annual management fee set at 2% of AUM with a 20% performance fee based on annual return.[100] In comparison, mutual and pension fund managers are awarded a much smaller percentage of any returns, even after bonus-based compensation is taken into account.[101] Restrictions on institutional investor managers are imposed because the Investment Advisers Act places specific limitations on performance fees.[102]

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93. Dodd-Frank Act, §§ 401–16; 17 C.F.R. § 275.204(b)-1 (2019). See Wulf A. Kaal, *The Post Dodd-Frank Act Evolution of the Private Fund Industry: Comparative Evidence from 2012 and 2015*, 71 BUS. LAW. 1151 (2016) for a general overview of the regulatory changes. See also Final Rule: Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Release No. IA–3308, 70 Fed. Reg. 71,128 (Nov. 16, 2011) [hereinafter Final Rule] for more information on the SEC and CFTC's specific rulemaking.

94. *See generally* FORM PF: REPORTING FORM FOR INVESTMENT ADVISERS TO PRIVATE FUNDS AND CERTAIN COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS, SEC. & EXCH. COMM'N, http://www.sec.gov/about/forms/formpf.pdf.

95. 17 C.F.R. § 275.204(b)-1(a) (2011) (citation omitted) ("If you are an investment adviser registered or required to be registered . . . and, as of the end of your most recently completed fiscal year, you managed private fund assets of at least $150 million, you must complete and file a report on Form PF.").

96. Final Rule, *supra* note 93, at 71,129 (footnote omitted) ("These new requirements may include maintaining records and filing reports containing such information as the SEC deems necessary and appropriate in the public interest and for investor protection or for the assessment of systemic risk by FSOC.").

97. *Id.* at 71,143–44.

98. William Fung & David A. Hsieh, *A Primer on Hedge Funds*, 6 J. EMPIRICAL FIN. 309, 310 (1999).

99. *Id.* at 316.

100. *Id.* at 312.

101. *See id*. at 316 (comparing the incentive scheme for managers in pension and mutual funds to that of a hedge fund).

102. 15 U.S.C. § 80b-5(a)(1) (1940) (banning compensation based on a share of capital gains or appreciation of funds). But this rule has been relaxed in part since its inception. 17 C.F.R. § 275.205-3 (1986). The SEC adopted Rule 205-3 in 1985 to exempt an investment advisor from these restrictions

Even beyond compensation, strategy-wise, hedge funds can also take larger investment positions than other funds because they are not legally required to maintain diversified portfolios.[103] Relatedly, hedge funds can limit investor redemptions to a period of two years or longer, while other institutions must satisfy investor redemption requests by selling securities within one day.[104]

Hedge funds stand apart from the panoply of institutional investors.[105] Their unique regulatory position affords them greater freedom of movement.[106] An offshoot of these distinctions is that hedge funds have wider latitude in trading methodologies.[107] This permits them considerable flexibility compared to other institutional investors.[108] Notably, hedge funds are neither subject to heightened fiduciary standards, such as those created by ERISA,[109] nor "prudent person" investing standards.[110] This means their only regulatory check is antifraud liability.[111]

Moving beyond distinctions from other institutions, endogenously, the hedge fund moniker is a loose description that encompasses many categories

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when the client has a certain amount of capital invested (the *assets-under-management test*) or if the advisor reasonably believes the investor has a certain net worth (the *net worth test*). Seth Chertok, *A Comprehensive Guide to Title IV of the Dodd-Frank Act and the Rules Promulgated Thereunder*, 12 U.C. DAVIS BUS. L.J. 125, 214 (2012). After Dodd-Frank, these amounts are $1 million and $2 million respectively. *Id.*; 17 C.F.R. § 275.205-3 (2019).

103. Brav et al., *Hedge Fund Activism*, *supra* note 63, at 1735.

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.* (describing how hedge funds are permitted to trade on the margin and engage in derivatives trading, strategies which are not available to other institutional investors like mutual and pension funds).

108. *Id.*

109. Employee Retirement Income Security Act of 1974, § 3(21), (38), 29 U.S.C. § 1002(21)(A), (38) (2012). Section 21 is a more expansive category of fiduciary than § 38, which covers when a service provider is formally appointed by the plan sponsor. *See id.* § (38) (including the expansive "any" in its description of fiduciary). Both of these fiduciary standards are more strenuous and stringent than standards under general securities laws. *See Fiduciary Responsibilities*, U.S. DEP'T OF LAB., https://www.dol.gov/general/topic/retirement/fiduciaryresp (last visited Apr. 16, 2020) (describing the heightened fiduciary standards under ERISA).

110. 29 U.S.C. § 1104(a)(1) (1976) ("[A] fiduciary shall discharge his duties . . . solely in the interest of the . . . beneficiaries and . . . with the care, skill [and] prudence . . . that a prudent man acting in a like capacity . . . would use. . . [and] by diversifying the investments of the plan so as to minimize . . . risk."). In May 1990, the ALI adopted the Restatement (Third) of Trusts that changed the law to add provisions adopting modern portfolio theory and flexible risk-return objectives. *See* W. Brantley Phillips, Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 335, 353 (1997) (discussing section 227 of the Restatement (Third) of Trusts, also known as the prudent investor rule).

111. Brav et al., *Hedge Fund Activsm*, *supra* note 63, at 1735; *see also* Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (2012) (creating anti-fraud liability for investment advisors, including hedge funds).

of funds. We previously saw the ambiguous definition used to categorize them, so it is understandable for there to be large distinctions within the grouping.[112] Once so identified, hedge funds are classified and differentiated based upon the kinds of investment strategies they employ.[113] Fund strategies can be analyzed along two axes: style and location.[114] Style refers to the type of position taken, whereas location refers to the asset class invested in.[115] One caveat is that many umbrella hedge funds will have subset funds that utilize different strategies.[116]

The most common family of strategies is termed *equity hedges*.[117] Here, investment managers will simultaneously hold long and short positions in equities and equity derivatives.[118] Doing this helps with portfolio diversification and risk mitigation.[119] Both quantitative techniques and fundamental analysis can be used to arrive at investment decisions.[120] Funds can focus on specific sectors and have a range of holding periods, exposure levels, and valuation ranges.[121]

A second category employs *global macro* strategies.[122] These funds usually have the highest risk and return profiles for funds[123] and invest in a range of assets: stocks, bonds, currencies, commodities, etc.[124] For this group, fund managers will use economic variables and their subsequent effects on markets to develop investment decisions.[125] Usually, the strategy is based upon future movements in the underlying instruments and assets.[126] Perhaps

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112. *See supra* note 62 and accompanying text.

113. There is some deviation in the categorization of funds, though. See generally FILIPPO STEFANINI, INVESTMENT STRATEGIES OF HEDGE FUNDS (2006) for a comprehensive overview of each strategy, with examples. *See also HFR Hedge Fund Strategy Classification System*, HEDGE FUND RESEARCH, INC., https://www.hedgefundresearch.com/hfr-hedge-fund-strategy-classification-system (last visited Apr. 16, 2020) (providing a classification system for hedge funds based on several strategy types).

114. William Fung & David A. Hsieh, *Empirical Characteristics of Dynamic Trading Strategies: The Case of Hedge Funds*, 10 R. FIN. STUD. 275, 276–77 (1997) (explaining how asset classes are deemed to be the location axis and that hedge funds then have common stylistic trading strategies).

115. *Id.*

116. STEFANINI, *supra* note 113, at 13.

117. *Id.* at 15.

118. *Id.*

119. *See id.* at 47–70 (describing equity hedges in detail).

120. *Id.*

121. *Id.*

122. *See id.* at 239–58 (exploring the global macro strategy in depth).

123. *See, e.g.*, *supra* notes 82–84 and accompanying text (using the collapse of LTCM to exemplify this type of fund and its risks).

124. STEFANINI, *supra* note 113, at 239–58.

125. *Id.*

126. *Id.*

the most famous example is George Soros's shorting and subsequent profit on the English Pound.[127]

Next, there are *credit funds*.[128] This group invests in fixed income securities and typically focuses on corporate credit.[129] Many of these entities have also expanded their purview to include sovereign debt and distressed debt.[130]

There is then the *relative value arbitrage* category.[131] These funds purchase a security that they expect to appreciate and pair it with the simultaneous shorting of a related security expected to depreciate.[132] When the two positions converge, the fund makes its profit.[133] These purchases can be stocks or bonds, and result in an identifiable equilibrium value.[134] The key difference from long/short funds is that these relative value arbitragers exploit differences between the same or similar securities.[135]

The last category, and most germane for this discussion, is *event driven funds*.[136] It is to this group that *activist funds* belong.[137] These fund managers acquire or maintain positions in companies currently or prospectively involved in corporate transactions.[138] Examples of such transactions include mergers, restructurings, financial distress, or tender offers.[139] These funds are value investors that select targets based on pricing inefficiencies.[140] Investments are based solely upon fundamental analysis and projected future developments.[141]

C. A Primer on Shareholder Activism

Gone are the decades of corporate raiders,[142] who were countered with the creation of defensive mechanisms such as the poison pill and regulations

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127. *Id.*

128. *See* Mila Getmansky et al., *Hedge Funds: A Dynamic Industry in Transition*, 4 ANN. REV. FIN. ECON. 483, 566 (2015) (defining credit funds, also referred to as *fixed income arbitrage* funds).

129. *Id.*

130. *Id.*

131. STEFANINI, *supra* note 113, at 14.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.* at 207–17.

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

141. *Id.*

142. *See generally* Marina Martynova & Luc Renneboog, *A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?*, 32 J. BANKING & FIN. 2148, 2149 (2008) (analyzing

like the Williams Act. However, the proliferation of hedge funds in response to the dot com-led stock market rise in the late 1990s brought about a concomitant change in hostile shareholder engagements.[143] In this, the market for corporate control[144] saw the emergence of new managerial challengers: shareholder activists. This newer generation's tactics are subtler and more focused than their corporate raider predecessors'.[145] Broadly described, current "activism" is expansive and can include short- or full-slate proxy contests, shareholder proposals, and meetings with management to discuss concerns and compel responses.[146] In general, activists seek to use their status as shareholders to bring about changes to the corporation with an end goal of increasing shareholder value.[147] The descriptor, therefore, captures both institutional investors and hedge funds.[148] But the strategies undertaken by these groups sharply contrast.[149] Nonetheless, both of these

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the market for corporate control and trends during takeover waves from the 1960s to the 1990s); Margaret Isa, *Where, Oh Where, Have All the Corporate Raiders Gone?*, N.Y. TIMES (June 30, 1996), https://www.nytimes.com/1996/06/30/business/where-oh-where-have-all-the-corporate-raiders-gone.html (providing a look at how formerly prominent corporate raiders had been forced to give up their companies or filed for bankruptcy).

143. In 1990, there were around 600 hedge funds with an aggregate AUM of approximately $20 billion to $30 billion. GREGORY CONNOR & MASON WOO, LONDON SCH. ECON.: FIN. MKTS. GRP., AN INTRODUCTION TO HEDGE FUNDS (2004), https://eprints.lse.ac.uk/24675/1/dp477.pdf. By 2000, there were between 4000 and 6000 hedge funds, with an aggregate AUM of $400 billion to $600 billion. *Id.* The SEC's loosening of proxy statement rules also contributed to the surge. *See* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 686–94 (2007) (outlining regulatory changes that led to increased hedge fund activism).

144. The phrase *corporate control* describes the role of equity markets in facilitating takeovers, the threat of which disciplines management and ensures proper governance mechanisms. Henry Manne first discussed corporate control in 1965 when he argued that the stock price of a company in part reflects management performance. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965) ("The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently.").

145. STRATEGY&, PWC, SHAREHOLDER ACTIVISM: STRATEGIES FOR MITIGATING RISK AND RESPONDING EFFECTIVELY, https://www.pwc.com/us/en/deals/publications/assets/shareholder-activism.pdf (last visited Apr. 16, 2020) (differentiating between different types of activists and showing the hedge fund activist process from 13D filings and negotiations to proxy fights); *but cf.* Owen Walker, *The New Gordon Gekkos: Are Activist Investors Just Modern Corporate Raiders?*, INT'L BUS. TIMES (June 27, 2016), https://www.ibtimes.co.uk/new-gordon-gekkos-are-activist-investors-just-modern-corporate-raiders-1567676 (arguing that hedge fund activists' motivations are the same as corporate raiders' and that some prominent raiders are now prominent activists).

146. *See generally* Briggs, *supra* note 143 (surveying instances of hedge fund activism).

147. Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 56 (2011).

148. *Id.*

149. *See supra* notes 62–64, 105–11 and accompany text (discussing fundamental differences between the two groups).

modern corporate challengers have rebranded themselves as protectors of value and as defenders of shareholders and their legal and financial rights.[150]

To these ends, activist hedge funds pursue a strategy that has been termed *offensive shareholder activism*.[151] As the name implies, this strategy implies a more aggressive position towards management. Shares are acquired to engage in activism.[152] The relations between these funds and management do not necessarily need to be hostile, but oftentimes devolve to be expressed in that fashion.[153] The rationale behind this group's stock purchases is a determination that the company is underperforming, especially when compared against industry peers. The fund manager's belief is that situation-specific corporate changes can lead to greater financial returns, especially as measured through an increased stock price, share repurchase, or a sale.[154] Investment is therefore a strategic, *ex ante* decision.[155] This forethought also implies a willingness to push for any and all changes to the company and management deemed necessary.

Conversely, other institutional investors, such as mutual funds and pension funds,[156] will pursue a strategy of *defensive shareholder activism*.[157]

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150. J.P. MORGAN, THE ACTIVIST REVOLUTION: UNDERSTANDING AND NAVIGATING A NEW WORLD OF HEIGHTENED INVESTOR SCRUTINY 5 (2015) [hereinafter J.P. MORGAN, THE ACTIVIST REVOLUTION], https://www.jpmorgan.com/jpmpdf/1320693986586.pdf (addressing how activists have remade themselves in the post-financial crisis environment as defenders of shareholder value).

151. Cheffins & Armour, *supra* note 147, at 58–61 (explaining how the offensive distinction is predicated upon a purchase of shares with the notion that the company is not currently maximizing shareholder returns or value).

152. *Id.* at 58.

153. Joseph Cyriac et al., *Preparing for Bigger, Bolder Shareholder Activists*, MCKINSEY & CO. (Mar. 2014), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/preparing-for-bigger-bolder-shareholder-activists.

154. *Id.* at 59.

155. Kahan & Rock, *supra* note 77, at 1069 ("[H]edge fund managers first determine whether a company would benefit from activism, then take a position and become active. Hedge fund activism represents a blurring of the line between risk arbitrage and battles over corporate strategy and control."). Kahan and Rock then argue that the differences in activism between different institutional investors are endogenous, resulting from the pursuit of different profit-making strategies. *Id.*

156. Although pension fund activism is more assertive than its mutual fund counterpart, pension funds are subject to different pressures and incentives, too. *Id.* at 1061. This places their activism on a spectrum between mutual funds and hedge funds. *See generally* Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227 (1996) (examining the activist efforts of the leading pension fund activist). *See also* Romano, *supra* note 69 (arguing that political conflicts and constraints temper their activism and investments); Kahan & Rock, *supra* note 77, at 1061 (discussing how pension fund activism is broader than mutual fund activism—there are more shareholder proposals, published lists of target companies, and they are more open to being lead plaintiffs in securities class actions—as well as discussing how pension funds have avoided demanding specific strategy and management changes, have not engaged in proxy contests, and have not allied with hedge funds to trigger takeover transactions).

157. In general, this means a "defensive" engagement to protect value of an existing investment. *See* Cheffins & Armour, *supra* note 147, at 56 (explaining how this type of activism "occurs when an

These entities have traditionally shied away from more confrontational modes of activism.[158] Rather, mutual and pension funds engage in incidental and *ex post* activism.[159] That is, fund managers will notice underperformance and will engage with management to effect change.[160] Importantly, this method of activism will be softer and less confrontational than that of their hedge fund counterparts.[161] Formerly, shareholder proposals under Rule 14a-8 were most common.[162] These proposals sought changes in governance rules rather than to specific aspects of a company's business or management.[163] In the 2000s, shareholders regularly pushed for better corporate governance and the erosion of management entrenchment devices, such as staggered boards[164] and supermajority provisions.[165] Recently, private discussions with

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investor with a pre-existing stake in a company becomes dissatisfied with corporate performance . . . and reacts by lobbying for changes"); Kahan & Rock, *supra* note 77, at 1056 (arguing that institutional investors rely on less conflict-prone activist strategies to generate excess returns).

158. Kahan & Rock, *supra* note 77, at 1056 (discussing how mutual funds do not make shareholder proposals and their most common, albeit still rarely used, method is to engage in behind-the-scenes talks with management). But despite this, mutual funds have supported governance proposals brought by other shareholders, withheld votes from board nominees, and opposed management governance proposals. *See generally* Ying Duan & Yawen Jiao, *The Role of Mutual Funds in Corporate Governance: Evidence from Mutual Funds' Proxy Voting and Trading Behavior*, 51 J. FIN. & QUANT. ANALYSIS 489 (2016) (finding that proxy voting and threatening to exit are important ways mutual funds and proxy advisors affect governance changes).

159. Kahan & Rock, *supra* note 77, at 1069 (explaining that fund managers will first notice underperforming portfolio companies, or that governance procedures are lacking, and then will become active).

160. *Id.*

161. *See id.* at 1056–57 (discussing the passive tendencies of mutual fund management).

162. *Id.* at 1042; see 17 C.F.R. § 240.14a-8 (2019) for when a company must include a shareholder proposal on its proxy statement. Management has broad grounds to exclude these proposals. Most of these proposals were introduced by public pension funds. See generally Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275 (2000) for an analysis of these proposals.

163. Kahan & Rock, *supra* note 77, at 1042.

164. Re-Jin Guo, *Undoing the Powerful Anti-Takeover Force of Staggered Boards*, 14 J. CORP. FIN. 274, 275 (2008) (discussing how shareholder proposals have been an important driver in removing staggered boards); Lucian Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 900 (2002) (footnote omitted) ("The average shareholder vote in favor of proposals to de-stagger the board increased from 16.4% in 1987 to 52.7% in 2000.")

165. GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 6, fig.8 (2004) (showing how every resolution opposing supermajority provisions during the 2004 proxy season passed with an average of 74% of the vote). The *Entrenchment Index* is used as a popular tool to measure the defensive measures of management. Lucian Bebchuck et al., *What Matters in Corporate Governance*, 22 REV. FIN. STUD. 783, 786 (2009). The Index scores firms from zero to six based on the presence of six variables: (1) a staggered board, (2) a poison pill, (3) limits to shareholder bylaw amendments, (4) a supermajority voting requirement for mergers, (5) a supermajority voting requirement for charter amendments, and (6) golden parachutes. *Id.* at 784–85. Increases in the index level correlate with reductions in firm valuations and negative returns. *Id.* at 785. Shareholders have been very active in pursuing all six variables and trying to remove them from firms. *Id.* at 784.

management and directors are more common,[166] although shareholder proposals are still employed. Both these methods rely on the influence created by large voting blocs for legitimacy and support.[167]

The different approaches to activism used by hedge funds and other institutional investors are intrinsic to their investment purposes and strategies.[168] Activist hedge funds' lobbying for change functions as the catalyst for their profitability and returns.[169] Conversely, other institutional investors do not pursue activism solely for the purpose of profit maximization.[170] For them, activism is responsive and undertaken in a manner to protect returns.[171] It is the regulatory, structural, and political circumstances surrounding these investment vehicles that inform the divergent strategies.[172] In this context, pension funds and mutual funds are about low-cost risk mitigation and diversification.[173] This approach contradicts an offensive activist strategy that necessitates large, up-front costs and higher investments in fewer companies.[174] That said, hedge funds are not limited by the same constraints, and offensive activism proves a much better match for these entities to potentially achieve higher alpha returns on each distinct investment.[175]

Practically, activist hedge funds begin their campaigns by taking equity positions in target companies after they have identified ways to improve corporate management that increase stock prices and company value.[176] J.P. Morgan found that activists will commonly look to pressure management in five areas: (1) corporate underperformance; (2) poor capital allocation; (3) a lack of corporate clarity; (4) corporate control; and (5) poor governance.[177]

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166. Gillan & Starks, *supra* note 162, at 279 ("[I]nstitutional investors [have] more direct negotiation[s] with company management and less reliance on proxy proposals."); William T. Carleton et al., *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335, 1336 (1998) (arguing for the importance of private negotiations between institutional investors and management).

167. Kahan & Rock, *supra* note 77, at 1042.

168. *Id.* at 1069.

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.* at 1070.

173. *See supra* note 54; Kahan & Rock, *supra* note 77, at 1070 ("[T]he difference in strategies may also be due to the fact that mutual funds view and market themselves as vehicles for diversification . . . ."); William F. Sharpe, *Mutual Fund Performance*, 39 J. BUS. 119, 134 (1966) (summarizing how deltas in mutual fund returns can be explained by expense ratio differences, which supports the notion of efficient markets and managerial focus on evaluating risk and diversifying).

174. Kahan & Rock, *supra* note 77, at 1070.

175. *Id.*

176. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1892.

177. J.P. MORGAN, THE ACTIVIST REVOLUTION, *supra* note 150, at 5.

Realistically, acquired positions must be large enough to allow for sizable financial gains if the activism only succeeds in part. Activism is costly, particularly if the fund ultimately has to force its will through a proxy fight.[178] The activist hedge funds, therefore, must purchase sufficient shares, not only to have credible influence as a challenger, but also to create enough upside to justify risky upfront expenditures.[179] It is important to note that these funds do not seek a control block of shares.[180] Rather, they seek an equilibrium that mitigates risk, maximizes reward, and allows for the ability to agitate for change.[181] A 2009 study by Robin Greenwood and Michael Schor found that funds, on average, owned only 9.8% of their targets' outstanding equity.[182]

Under Section 13(d) of the Williams Act, investors must disclose their interest in a company within ten days of reaching a 5% ownership threshold.[183] Importantly, in the activist context, this means that a fund can continue to purchase equity during those intervening ten days.[184] As a result, a fund can become the owner of a much higher percentage by the time of mandatory disclosure.[185] Section 13(d) applies to any and all persons or groups who have directly or indirectly acquired beneficial ownership.[186] Nonetheless, this limitation has not prevented "wolf pack" behavior.[187] A *wolf pack* is an association of unaffiliated funds that act in concert.[188] A group (per the SEC definition) is not formed because the funds are careful not to

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178. *E.g.*, Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 611 (2013) (showing how the average activist campaign that results in a proxy fight results in a cost of over $10 million, which figure includes demand negotiations, board representation, and the proxy contest itself). As an extreme example, in 2017, P&G and Nelson Peltz engaged in the most expensive proxy contest ever. David Benoit, *P&G v. Nelson Peltz: The Most-Expensive Shareholder War Ever*, WALL ST. J. (Oct. 6, 2017), https://www.wsj.com/articles/p-g-vs-nelson-peltz-the-most-expensive-shareholder-war-ever-1507327243 [hereinafter Benoit, *P&G v. Nelson Peltz*]. Total costs surpassed $60 million. *Id.*

179. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1895.

180. *Id.* at 1895–96.

181. *Id.*

182. Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 365 (2009). The sample's dataset contained 784 events initiated by 139 unique hedge funds between 1994 and 2006. *Id.* at 364.

183. 15 U.S.C. § 78m(d) (2012); 17 C.F.R. § 240.13d-1 (2019) ("Any person who . . . is directly or indirectly the beneficial owner of more than five percent . . . shall, within 10 days after the acquisition, file with the Commission . . . .").

184. Coffee & Palia, *supra* note 15.

185. *Id.*

186. A beneficial owner of a security includes any person who, directly or indirectly, has or shares voting power or investment power of a security. 17 C.F.R. § 240.13d-3. Ownership can be attributed indirectly through a contract, arrangement, or understanding. *Id.*

187. Coffee & Palia, *supra* note 15, at 562.

188. *Id.*

have any explicit agreements.[189] The alpha wolf, or lead activist, will invest a significant amount in the target without reaching the 5% threshold.[190] Other members of the pack will then follow suit, buying up shares and supporting the alpha's campaign.[191] This means that Greenwood and Schor's median holding may not paint a complete picture of activist-owned equity threats.[192] This behavior walks a fine legal line.[193] If the holdings are aggregated, meaning each individual fund is deemed the beneficial owner of the total amount, and the pack passes the 5% threshold, then each member will be subject to enhanced disclosure requirements.[194] If the pack passes a 10% threshold, each member will then be subject to the onerous and restrictive provisions of § 16 of the Exchange Act.[195] Overall, the wolf pack technique has tilted the balance of power in shareholder activism.[196] Due to the ability of the group to acquire a markedly higher percentage of shares than a single

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189. Charles M. Nathan, *Recent Poison Pill Developments and Trends*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 12, 2009), https://corpgov.law.harvard.edu/2009/05/12/recent-poison-pill-developments-and-trends/.

190. Coffee & Palia, *supra* note 15, at 563.

191. *Id.* Tipping by the wolf pack leader to its allies is not legally considered insider trading. *Id.* at 566. This is because there is no breach of fiduciary duty, even though the information might be material and non-public. *Id.*

192. Greenwood & Schor, *supra* note 182.

193. In *Hallwood Realty Partners, LP v. Gotham Partners, LP*, 286 F.3d 613 (2d Cir. 2002), the wolf pack phenomenon first emerged. There, the Second Circuit construed § 13(d) and the definition of beneficial ownership very narrowly. *Id.* at 617. The court held that discussions between investment firms regarding their purchases did not constitute a group. *Id.* This had the downstream effect of fueling the growth of wolf pack activists. *See* David Benoit, *Congress Asked to Act on Activist Investor Disclosures*, WALL ST. J. (Apr. 15, 2015), https://www.wsj.com/articles/congress-asked-to-act-on-activist-investor-disclosures-1429107089 ("[T]he rules were intended to increase transparency in the stock market but are actually allowing activists to amass large positions in secret."). Watchdog groups have been lobbying congressional banking and finance committees to adapt to the changing times by shrinking the reporting window from ten days to one and modernizing the definition of beneficial ownership, among other things. *Id.*

194. See 17 C.F.R. § 240.13d-101 (2019) for a summary of the information to be included on a Schedule 13D. This includes the names of share owners, the number of shares by type of voting power and in aggregate amounts, and the type of reporting owner. *Id.*

195. Section 16 of the Exchange Act, 15 U.S.C. § 78p (2012), requires every person who is directly or indirectly a beneficial owner of more than 10% of a company to file a Form 3 with the SEC within 10 days. Section 16(b) is known as the short-swing profit rule. Brian V. Breheny et al., *Skadden Discusses Section 16 Settlements*, COLUM. L. SCH. BLUE SKY BLOG (Mar. 9, 2017), https://clsbluesky.law.columbia.edu/2017/03/09/skadden-discusses-section-16-settlements/. It requires insiders to return any profits made from both the purchase and sale of company stock if both transactions occur within a six-month period. *Id.*

196. *See* Marco Becht et al., *Returns to Hedge Fund Activism: An International Study*, 30 REV. FIN. STUD. 2933, 2934 (2017) ("We estimate that wolf packs are associated with almost one quarter of all engagements and we show that they achieve some of the highest returns for target shareholders.").

challenger, the probability that the consortium succeeds is much higher than for standalone activists.[197]

After achieving a satisfactory equity stake, activists will usually begin to seek operational changes, governance changes, or both.[198] Initially, a fund will typically first communicate with management to press for value-adding changes.[199] A fund may argue that a corporation with healthy profits[200] is not returning enough of its net income to investors, or that a struggling corporation is plagued by excessive costs and should cut its spending and increase debt to better investor outcomes. This might come in the form of a sale of the company or its major assets, the payment of dividends, share repurchases, or a change in long-term business plans.[201] Usually, a combination of spending reductions and increased dividends are sought.[202] If a private approach is not successful, then activists will usually turn public to place pressure on management.[203] First, this can be via the threat of legal action or by criticism funneled through news media.[204] Activists will then conduct a short-slate proxy fight if they cannot collaboratively change the company with an equity stake alone.[205] Activists have said that they prefer to avoid proxy battles due to high attendant transaction costs.[206] Despite this, Brav et al. found that a proxy contest was involved in 13% of activist engagements.[207] Cheffins and Armour suggest that this high number is intended to produce a signaling effect.[208] Future targets are put on notice that

197. *See id.* at 2956 (finding that the probability of achieving at least one successful outcome for a wolf pack is 78%, whereas it is 46% for a standalone activist).

198. Brav et al., *Hedge Fund Activism*, *supra* note 63, at 1741–44.

199. William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1379 (2007).

200. *See* April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 63 J. FIN. 187, 226 (2009) ("[T]here are distinct differences between hedge fund and other entrepreneurial activism. Hedge fund activists target more profitable and financially healthy firms than do other entrepreneurial activists.").

201. Bratton, *supra* note 199, at 1390–1401 (explaining the four things that activists look for in their targets and how those create the expected value from their investment).

202. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1901 (footnote omitted) ("[Hedge fund] arguments to reduce capital and other spending (including headcount) and to increase dividends or do a large stock buyback program are *de rigueur*.").

203. Cheffins & Armour, *supra* note 147, at 15.

204. *Id.*

205. *Id.* at 16.

206. *Winners and Losers in the Rising Tide of Proxy Wars*, KNOWLEDGE@WHARTON (Jul. 23, 2008), http://knowledge.wharton.upenn.edu/article/winners-and-losers-in-the-rising-tide-of-proxy-wars/.

207. Brav et al., *Hedge Fund Activism*, *supra* note 63, at 1743. This is compared to regular communication with management (48.3%), board representation without a proxy contest (11.6%), formal shareholder proposals or public criticism (32%), and threats to wage a proxy fight or sue the company (7.6%). *Id.*

208. *See* Cheffins & Armour, *supra* note 147, at 61 (footnote omitted) ("A likely explanation for many of the proxy battles that do occur is that hedge funds use contests for board seats to signal to potential

activists have the financial wherewithal and general persistence to fully invest in their campaigns.[209]

Not all hedge funds are activist, however.[210] As mentioned before, only event-driven funds, and a subset of this family at that, engage in these activities.[211] Currently, activist funds have approximately $112 billion in AUM,[212] a much smaller figure than the $2.5 trillion for the entire hedge fund industry.[213] However, activist funds have been more profitable, averaging a 13% return, which is more than double the return for hedge funds in totality.[214] These returns, and a strong economic recovery since the Financial Crisis, have emboldened funds. In total, more than 240 activist campaigns occur every year—a 1000% increase from a decade ago[215]—with three quarters starting collaboratively and half eventually turning hostile.[216] The number of large and mega-cap company targets, defined as those with a market capitalization over $25 billion, tripled between 2009 and 2014.[217] Even profitable companies are not immune, with their management being challenged for not returning excess profits to shareholders.[218] In itself, this is

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future targets that they are prepared to invest heavily in pursuing an activist campaign should this be required.").

209. *Id.*

210. Kahan & Rock, *supra* note 77, at 1046.

211. *See supra* notes 189–94 and accompanying text.

212. J.P. MORGAN, THE ACTIVIST REVOLUTION, *supra* note 150, at 1 (showing how AUM in 2009 were $36.2 billion and rose to $112.1 billion in 2014, for a compound annual growth rate of 26.8%).

213. Cyriac et al., *supra* note 153. Note, however, that the hedge fund industry has been shrinking overall in recent years. Ben Winck, *The Hedge Fund Landscape Shrinks for the 5th Straight Year as Investors Rebel Against Weak Returns*, MARKETS INSIDER (Dec. 30, 2019), https://markets.businessinsider.com/news/stocks/hedge-fund-industry-performance-more-closures-than-openings-5th-year-2019-12-1028788132.

214. *See* Michelle Celarier, *Activist Investors Set Bolder Course in 2014*, N.Y. POST (Jan. 4, 2015), http://nypost.com/2015/01/04/cash-flows-to-activists-after-delivering-best-returns/ (discussing how activist funds saw a return of 13%, the hedge fund industry as a whole saw a 5.8% return, and the S&P 500 had an 8% return over the same period).

215. Cyriac et. al, *supra* note 153; Coffee & Palia, *supra* note 15, at 554. One thousand one hundred fifteen activist campaigns occurred between 2010 and 2014, with a record 347 campaigns in 2014. *Id.* In comparison, there were only 52 campaigns between 2005 and 2006. *Id.* The authors argue that this stark increase means that hedge funds are pursuing fewer legitimate opportunities. *Id.*

216. Cyriac et al., *supra* note 153. At the beginning of an activist campaign, 73% are collaborative and 27% are hostile. *Id.* By the end of the campaign, 40% are collaborative and 60% are hostile, with almost two-thirds of the hostile campaigns resulting in a proxy fight, takeover bid, or lawsuit. *Id.*

217. J.P. MORGAN, THE ACTIVIST REVOLUTION, *supra* note 150, at 6 (explaining how even with larger targets, activists are still successful with comparatively smaller stakes of less than 1%); *see also* Richard Lee & Jason D. Schloetzer, *The Activism of Carl Icahn and Bill Ackman*, CONF. BOARD DIRECTOR NOTES 3 (May 2014) (explaining that "in 2013, for the first time, almost one-third of shareholder activism took place in companies with market capitalizations of more than $2 billion" and the number of targets greater than $10 billion jumped from 23 to 42 in one year).

218. *See* J.P. MORGAN, THE ACTIVIST REVOLUTION, *supra* note 150, at 11 ("Strong stock performance is not, however, a vaccine against activism. Even strong performers are targeted . . . .").

a development in the activism industry, since formerly only companies in the red or distressed firms were targeted.[219] Indeed, since 2006, around one-sixth of companies in the S&P 1500 have been the target of an activist campaign.[220]

II. EMERGENT ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INSTITUTIONAL ACTIVITIES

Especially recently, institutional investors' governance activities have exhibited greater awareness of, and willingness to leverage, social and political dimensions in order to shape their portfolio companies.[221] Having amassed large swaths of shares and concomitant voting rights, these entities operate as arbiters in resolving impasses between activist hedge funds and incumbent managers.[222] By extension, they are also effecting change on their own accord by becoming "more active in matters involving corporate control."[223] To this end, the largest asset managers are extremely transparent about their preferred governance practices.[224] Beyond simple economic matters, these entities are advancing social changes in the practices of both their portfolio companies and the market at large.[225] ESG has now become a major institutional concern and prime area for begetting change.[226] Investors see a pivotal role for non-financial information, ESG especially, to inform decision-making.[227]

BlackRock's 2019 proxy voting guidelines have integrated progressive matters as crucial elements of its corporate governance desires,[228] a unique footnote to typical governance debates aimed at minimizing managerial

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219. *See* Klein & Zur, *supra* note 200, at 189 (showing how hedge funds are now targeting more profitable firms).

220. Sharon Hannes, *Brave New World: A Proposal for Institutional Investors*, 16 THEORETICAL INQUIRIES L. 245, 258–59 (2015).

221. *See generally* Loop et al., *supra* note 8 (explaining the dimensions of shareholder engagement and proposals with management, broken down into governance rights, social and political issues, and executive compensation).

222. *See* Weinstein & Richter, *supra* note 21 (explaining that activist hedge funds and incumbent boards are both engaging institutional investors during activist campaigns).

223. Kahan & Rock, *supra* note 77, at 1045.

224. *See* ERNST & YOUNG, IS YOUR NONFINANCIAL PERFORMANCE REVEALING THE TRUE VALUE OF YOUR BUSINESS TO INVESTORS 1 (2017), https://www.ey.com/Publication/vwLUAssets/EY_-_Nonfinancial_performance_may_influence_investors/%24FILE/ey-nonfinancial-performance-may-influence-investors.pdf (highlighting the importance of disclosures).

225. *Id.* at 3 (explaining that BlackRock's 2016 letter urging companies to focus on long-term value creation influenced portfolio companies and the markets at large).

226. *Id.* at 2.

227. *See generally id.* (summarizing the increased global focus on non-financial information and ESG).

228. BLACKROCK, PROXY VOTING GUIDELINES FOR U.S. SECURITIES 4, 12–13 (2019).

agency costs.[229] These topics can be delineated along two axes: board diversity[230] and social risk governance.[231] On the former, BlackRock has an expansive view of diversity.[232] It emphasizes that it expects to see at least two women on every board, along with other objective metrics like ethnicity and career experience.[233] It also embraces a more subjective sweeping metric: diversity in way of thinking.[234] This diversity leads to greater awareness, a lower likelihood of groupthink, and a better chance of identifying opportunities for growth.[235] This broad, encompassing conceptualization of diversity in the pursuit of optimal conditions for value growth is inherently tied to social risk governance.[236] Both conceptions expand and blur the inputs on valuation growth.[237] It is much harder to quantify these characteristics than to appraise already quantitative cash flows and growth rates. This is a clear step in investment philosophy where BlackRock has understood that market performance and company values have become increasingly nuanced and sensitive to a wider variety of non-financial metrics. This mindset becomes clearer when approaching the issue from the consumer perspective. With millennials becoming a large part of the workforce and consumer base,

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229. For the seminal work on agency costs in corporations, see Jensen & Meckling, *supra* note 22, at 305; *see also* Goshen & Squire, *supra* note 22, at 770 (discussing control costs, which encompass both agency and principal costs).

230. BlackRock is not unique in this emphasis. See TIM ARMOUR ET AL., COMMONSENSE PRINCIPLES 2.0, http://www.governanceprinciples.org/wp-content/uploads/2018/10/Commonsense Principles2.0.pdf (last visited Apr. 16, 2020), for a series of framework principles signed by leading business executives and asset managers on a range of best practices, including board diversity, that lead to improved financial performance; *see also* David A. Katz & Laura A. McIntosh, *Corporate Governance Update: Prioritizing Board Diversity*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 30, 2017), https://corpgov.law.harvard.edu/2017/01/30/corporate-governance-update-prioritizing-board-diversity/ ("Momentum toward gender parity on boards is building, particularly in the top tier of public corporations.").

231. BLACKROCK, *supra* note 228, at 12–14.

232. *Id.* at 4.

233. *See id.* ("In addition to other elements of diversity, we encourage companies to have at least two women directors on their board.").

234. *Id.*

235. *See* Laurence D. Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter (last visited Apr. 16, 2020) [hereinafter Fink, *2018 Letter*] (explaining how boards with different axes of diversity have greater awareness and "are better able to identify opportunities that promote long-term growth").

236. Lutfey Siddiqi, *How Diversity and Risk Governance Can Help Companies Manage an Uncertain Future*, WORLD ECON. F. (Nov. 12, 2018), https://www.weforum.org/agenda/2018/11/diversity-can-help-companies-manage-an-uncertain-future-here-s-how/.

237. *See id.* (explaining that these concepts have led to difficulties in extrapolating future profits from past performance).

socially progressive and like-minded companies are better able to connect with customer values and drive top line growth.[238]

BlackRock's conception of social risk governance is unique, but not doctrine-breaking.[239] It does not upend the traditional shareholder primacy model well established in American corporate law.[240] The idea developed is still in pursuit of profit maximization, but it allows for a broader purview of how this is to be achieved.[241] In this way, it differs from the well-publicized notions of corporate social responsibility (CSR) and socially responsible investing (SRI). CSR refers to efforts to be aware of and take responsibility for negative impacts on the environment and society.[242] CSR spurs vigorous opposition over the legality of sacrificing profits in pursuit of non-financial interests.[243] In this way, it is closer to a stakeholder model of governance rather than a shareholder-centric conception. Similarly, SRI occurs when a fund or investor considers and seeks to effect positive social change in tandem with financial returns.[244]

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238. *See* Sarah Landrum, *Millennials Driving Brands To Practice Socially Responsible Marketing*, FORBES (Mar. 17, 2017), https://www.forbes.com/sites/sarahlandrum/2017/03/17/millennials-driving-brands-to-practice-socially-responsible-marketing/#5017a6064990 (explaining that millennials are more likely to do business with "pro-social messages, sustainable manufacturing methods and ethical business standards").

239. *See* BLACKROCK, *supra* note 228, at 3 (describing the traditional view of shareholder primacy within BlackRock's guidelines).

240. The shareholder primacy model is accepted and perpetuated in Delaware courts and corporate law. D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 278 (1998). A seminal case considered to be the first affirmation of the shareholder primacy model is *Dodge v. Ford Motor Co.*, 70 N.W. 668, 684 (Mich. 1919), where the Michigan Supreme Court held that the duty of loyalty runs to equity investors. However, there is still academic and managerial criticism to this maxim. *Cf.* R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (1984) (providing the first work on the stakeholder theory). Freeman identifies groups who comprise the stakeholders of the firm and recommends methods to support their interests. *Id.* Freeman believes that executives must create as much value for stakeholders as possible without resorting to tradeoffs. *Id.*

241. *See* BLACKROCK, *supra* note 228, at 1 (introducing the general themes of proxy voting for BlackRock).

242. *See generally* Forest L. Reinhardt et al., *Corporate Social Responsibility Through an Economic Lens*, 2 REV. ENVTL. ECON. & POL'Y 219 (2008) (providing an overview of CSR and showing its prevalence).

243. *Compare* Merrick E. Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1147–48 (1932) (challenging the idea that corporations exist for the sole purpose of making profits for their shareholders), *with* Adolph A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932) (arguing that managerial powers are held in trust for stockholders as sole beneficiaries of the corporation), *and* Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG. (Sept. 13, 1970) (arguing that the one social responsibility of corporate executives is to increase profits).

244. *See* Maria O'Brien Hylton, *"Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market*, 42 AM. U.L. REV. 1, nn.2–3 (1993) (citing attempts at defining socially responsible investing, as well as providing an overview of its history).

BlackRock disclaims CSR and SRI by asserting that its role is not to make social, ethical, or political judgments on behalf of its clients.[245] Rather, the asset manager takes a social risk approach to governance: it has an expectation that companies will operate with awareness of broader contexts and will plan for the effects, including any pushback, from the societal impacts of their businesses.[246] This is to say that BlackRock uses these ESG-related factors as part of its financial decisions. They are integrated into quantitative return seeking.[247] Stock selection and activism is informed by ESG issues, but is not driven towards that main end.[248] Additionally, companies should ideally serve a social purpose and make positive contributions to society in conjunction with delivering on financial performance metrics.[249] Management's ability to engage on social matters, therefore, shows proper leadership, effective governance, and a plan for adding economic value.[250] In this, the investor group has sharpened its focus on environmental and social issues (E&S), as well as climate change.[251] BlackRock expects companies to have actual knowledge of specific E&S risks and to explain responsive engagement to these threats.[252] It also wants management to explain how they govern in situations where E&S laws are ambiguous.[253] From the standpoint of social risk governance, therefore, BlackRock wants its companies to have knowledge of and a deliverable plan to address areas where policies could be implemented.[254] Rather than pursue a pro-CSR strategy, the company should explain how its decisions support

245. *See* BLACKROCK, *supra* note 228, at 12 ("Our fiduciary duty to clients is to protect and enhance their economic interest . . . . It is within this context that we undertake our . . . governance activities. We believe that well-managed companies will deal effectively with the material environmental and social . . . factors relevant to their businesses.").

246. *Id.*

247. *Id.*

248. *Id.* at 12–13.

249. *See* Fink, *2018 Letter*, *supra* note 235 ("Society is demanding that companies, both public and private, serve a social purpose. . . . [E]very company must not only deliver financial performance, but also show how it makes a positive contribution to society.").

250. *See id.* ("[A] company's ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process."). BlackRock is prepared to vote against the election of directors where they have concerns that a company is not appropriately dealing with these issues. BLACKROCK, *supra* note 228, at 13.

251. *See* BLACKROCK, *supra* note 228, at 12–13 (focusing on these topics within the voting guidelines).

252. *See id.* at 12 ("BlackRock expects companies to identify and report on the material, business-specific E&S risks and . . . to explain how these are managed. . . . [K]ey performance indicators in relation to E&S factors should also be disclosed and performance against them discussed . . . .").

253. *Id.* at 13.

254. *Id.*

long-term financial value.[255] BlackRock applies a similar analysis to climate change.[256] This governance model is still profit-centric at heart; it is merely informed by CSR and SRI values and awareness of broader constituencies.[257] This understanding is the motivation behind ESG.

BlackRock does not stand alone in adopting this approach. The second- and third-largest investment managers by AUM—Vanguard and State Street—have also published similar instructions with the same focus on board diversity, social risk governance, and ESG, among other things.[258] State Street, for example, has indicated it is willing to vote against an entire management slate if there is not sufficient female representation.[259] It has developed ESGX, an analytics tool that identifies and highlights ESG risks that may be overlooked by typical financial analyses.[260] Vanguard opines that risk and strategy are interrelated; every strategy involves risk, and every risk brings attendant opportunities.[261] From this touchstone, it believes that ESG risks significantly affect a public company's financial value.[262] These issues are material in a financial respect with regard to investment decisions and,

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255. *Id.*

256. *See* BLACKROCK, HOW BLACKROCK INVESTMENT STEWARDSHIP ENGAGES ON CLIMATE RISK 2 (2017), https://www.eenews.net/assets/2017/03/13/document_gw_05.pdf (explaining BlackRock's governance strategy as it relates to climate risks).

257. BLACKROCK, *supra* note 228, at 1.

258. *See* VANGUARD, 2018 INVESTMENT STEWARDSHIP ANNUAL REPORT 22 (2018), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf (discussing how social and climate risks are one of Vanguard's engagement priorities for the foreseeable future); *see generally* STATE STREET GLOBAL ADVISORS, STEWARDSHIP ACTIVITY REPORT (2017), https://www.ssga.com/investment-topics/environmental-social-governance/2017/Stewardship-Activity-Report-Q2-2017.pdf (publishing an entire stewardship report focused solely on environmental, social, and governance topics); STATE STREET GLOBAL ADVISORS, SSGA'S PERSPECTIVES ON EFFECTIVE CLIMATE CHANGE DISCLOSURE (2017), https://www.ssga.com/investment-topics/environmental-social-governance/2017/perspectives-on-effective-climate-change-disclosure.pdf (explaining the asset manager's policies regarding climate risk and governance for their investment strategy and portfolio companies).

259. Rusty O'Kelley et al., *Global and Regional Trends in Corporate Governance for 2018*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 29, 2017), https://corpgov.law.harvard.edu/2017/12/29/global-and-regional-trends-in-corporate-governance-for-2018/ ("[SSGA is] now willing to vote against either the chair or the entire nominating committee of companies with either no or only one female director if they have previously attempted to secure change . . . through engagement.").

260. STATE STREET GLOBAL ADVISORS, 2017 ANNUAL REPORT TO SHAREHOLDERS (2018), http://investors.statestreet.com/Cache/IRCache/e4ea0665-7806-6327-20be-14836c2af02a.PDF?O=PDF&T=&Y=&D=&FID=e4ea0665-7806-6327-20be-14836c2af02a&iid=100447 ("[T]o help clients better understand non-financial risks in their portfolio, Global Exchange launched ESGX[SM], an analytics tool designed to identify and highlight potential sources of . . . (ESG) risk that may be overlooked by traditional financial analysis."). ESGX compares ESG exposures and risks across portfolios and can measure return against volatility to create risk-adjusted returns.

261. VANGUARD, *supra* note 258, at 20.

262. *Id.* at 22–23 (discussing how ESG can significantly affect long-term financial value and that boards and management should oversee these risks as material issues).

later, stewardship.[263] ESG must be vigilantly overseen and refreshed, as well as coupled with disclosure. It is therefore up to management to promote these issues and a culture that inculcates these values.

This trend is not limited to these large, passive asset managers. A preponderance of non-indexed, actively managed funds also emphasizes these issues. The Investor Responsibility Research Center Institute (IRRCi) has corroborated institutional investors' increased levels of engagement with management, particularly regarding extra-financial concerns.[264] From their research, approximately 50% of the institutional investors surveyed reported engaging on both environmental and other social issues.[265] This is compared to 45% on financial-strategic issues, 52% on compensation, and 61% on director and takeover matters.[266] Beyond mere discussions with management, shareholder proposals also mirror this trend.[267] In 2017, the two most common types of proposals were social and environmental.[268] Indeed, over 40% of shareholder proposals in 2017 dealt with these two issues.[269] This differs from 2016 when proxy access topics were most germane.[270] In another related study, a report covering institutional investors with over $8 trillion AUM found that 88% of the surveyed funds integrated ESG factors into continuing investment and stewardship decisions,[271] emphasizing an increasing importance on ESG awareness and activism.

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263. *Id.* at 23.

264. Jon Lukomnik & Marc Goldstein, *The State of Engagement Between U.S. Corporations and Shareholders*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 15, 2011), https://corpgov.law.harvard.edu/2011/03/15/the-state-of-engagement-between-u-s-corporations-and-shareholders/.

265. MARC GOLDSTEIN, THE STATE OF ENGAGEMENT BETWEEN U.S. CORPORATIONS AND SHAREHOLDERS 16 (2011).

266. *Id.*

267. *See* Ronald O. Mueller & Elizabeth Ising, *Shareholder Proposal Developments During the 2017 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 12, 2017), https://corpgov.law.harvard.edu/2017/07/12/shareholder-proposal-developments-during-the-2017-proxy-season/ (summarizing trends in shareholder proposals).

268. There was a total of 201 social proposals and 144 environmental proposals. *Id.* Note, that is a rough measurement that has little bearing the success of the engagements because management regularly seeks no-action requests from the SEC to prohibit these proposals from appearing on proxy statements. *Id.* In 2017, the SEC granted 78% of no-action requests. *Id.* That said, the clear prominence signals a growing consensus among investors of the importance of these issues.

269. There were 345 ESG proposals out of 827 total proposals. *Id.*

270. *Id.* In 2016, there were 201 proxy access proposals compared to 160 social proposals and 139 environmental ones. *Id.*

271. Patel, *supra* note 5 ("The impact of ESG as an integral part of the investment decision making process continues to rise. . . . 88% of investors systematically integrate ESG factors into the investment decision-making process. . . . Maximising Risk Adjusted Returns is cited as the primary reason behind this development . . . .").

ESG is now an important consideration for investment.[272] Consequently, ESG clearly informs institutional investor engagement and activism for current portfolio companies. This approach is empirically backed. In perhaps the most comprehensive study on the subject, Gunnar Friede et al. compiled the results of over 2,000 studies from 1970 to 2014.[273] They found that 62% of the dataset yielded positive findings about the relationship between ESG factors and financial performance and 90% provided non-negative results.[274] This is not surprising. Although it is generally understood that markets are efficient and accurately incorporate information into pricing, research has shown that the market can fail to fully incorporate intangibles into stock valuations.[275] Nevertheless, ESG activism and awareness for the sake of being progressive does not necessarily imply financial growth. To this end, the materiality of ESG issues that are particularly germane to a company's industry or sector has import.[276] This means that institutional investors will need to isolate specific environmental and social issues that are high-impact for their specific investments.[277] Advocating in favor of unfocused ESG changes would not yield the financial growth and results that their activism intends.

Showing the strength of institutional power, this groundswell among institutional investors, who collectively hold controlling stakes in public companies, has spurred related legal constructions. Here, there appears to be

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272. The OECD has even taken note of this trend in its member countries. OECD, INVESTMENT GOVERNANCE AND THE INTEGRATION OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS 7–9 (2017), https://www.oecd.org/finance/Investment-Governance-Integration-ESG-Factors.pdf. It considers that ESG issues and their impact on investment and operating strategy are an integral part of good governance for institutional investors internationally. *Id.* at 9. It provides an overview of regulatory frameworks in member states and how ESG fits into traditional financial analyses. *Id* at 12–19.

273. *See generally* Gunnar Friede et al., *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. SUSTAINABLE FIN. & INV. 210, 210 (2015); *see also* TONELLO, SINGER & MITCHELL, *supra* note 1 (reviewing empirical analyses on the return on investment of ESG initiatives and discussing the academic debate on positive correlations).

274. Friede et al., *supra* note 273, at 217.

275. *See* Alex Edmans et al., *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 101 J. FIN. ECON. 621, 638 (2011) (analyzing how firms with high levels of employee satisfaction result in better long-term returns, "imply[ing] that the market fails to incorporate intangible assets fully into stock valuations . . . .").

276. *See generally* Mozaffar Khan et al., *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697 (2016) (finding that firms with high ratings on material sustainability issues outperform firms with poor ratings on the same issues, whereas firms with high ratings on immaterial sustainability issues do not outperform firms with poor ratings on the same issues). *See also SASB Materiality Map*, SUSTAINABILITY ACCOUNTING STANDARDS BD., https://materiality.sasb.org/ (last visited Apr. 17, 2020) (identifying industry-specific ESG issues that are likely to affect companies' financial health and operating performance). The SASB has 26 ESG-related business issues and projects whether it is likely to be material for greater than or less than 50% of industries in a sector. *Id.*

277. Khan et al., *supra* note 276.

a divergence between the U.S. and Europe.[278] Across the Atlantic, the European Commission has proposed investor ESG requirements.[279] The Commission seeks to explicitly require institutional investors to integrate ESG considerations into decision-making processes, as well as increase transparency towards how these factors affect engagement.[280] France and the Netherlands have also taken steps to add social and environmental governance to their bodies of corporate law.[281] Meanwhile, in the U.S., in October 2018, a group of institutional investors with over $5 trillion AUM joined corporate law professors and filed a petition for rulemaking to the SEC.[282] They lobbied for the agency to develop a comprehensive framework requiring all public equity issuers to disclose ESG issues as part of their current Exchange Act disclosure obligations.[283] To date, the SEC has taken no such action.

It is important to further differentiate the approach that major institutional investors take from pure ESG activists, impact investors, and responsible investing methods. BlackRock, Vanguard, State Street, and other asset managers have elevated ESG and use it as an important benchmark for their investment decisions and governance priorities.[284] Their sole

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278. See *infra* notes 344–49 and accompanying text for a longer discussion on American regulatory developments governing ESG and institutional investors.

279. EUROPEAN COMM'N, ACTION PLAN: FINANCING SUSTAINABLE GROWTH 1 (2018), https://ec.europa.eu/transparency/regdoc/rep/1/2018/EN/COM-2018-97-F1-EN-MAIN-PART-1.PDF.

280. *Id.* at 8–9 (discussing the Commission's legislative proposal to explicitly require institutional investors and asset managers to integrate sustainability considerations into investment processes). The Commission emphasized that managing ESG risks can foster transparency and long-term financial growth. *Id.*

281. Martin Lipton, *Corporate Purpose: ESG, CSR, PRI and Sustainable Long-Term Investment*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 4, 2018), https://corpgov.law.harvard.edu/2018/05/04/corporate-purpose-esg-csr-pri-and-sustainable-long-term-investment/

> [M]anagement . . . should develop a view on long-term value creation . . . and should formulate a strategy in line with this . . . it may be necessary to make short-term adjustments . . . [based on] aspects relevant to the company and its affiliated enterprise, such as the environment, social and employee-related matters . . . . [T]his [French] amendment integrates corporate and social responsibility considerations into corporate governance and goes on to state that each company has a purpose not reducible to profit and needs to be aware of its purpose . . . taking into account its social and environmental consequences.

Id.

282. Letter from Jill E. Fisch, Professor, Univ. of Pa. Law Sch. & Cynthia A. Williams, Osler Chair, York Univ., to Brent J. Fields, Sec'y, Sec. & Exch. Comm'n (Oct. 1, 2018), https://www.sec.gov/rules/petitions/2018/petn4-730.pdf. The letter also provides the SEC's statutory authority to compel ESG disclosure and discusses materiality of these issues. *Id.* It uses institutional investor focus on these issues to highlight the importance of ESG in the market. *Id.*

283. *Id.*

284. *Supra* notes 228–34, 258–63 and accompanying text.

consideration is still financial return and growth.[285] In contrast, impact investment funds and the like are dual purpose, meaning they aim for both return alongside a beneficial social or environmental impact.[286] These groups are fiduciarily able to sacrifice profit for this impact when the two seemingly opposed goals converge.[287] These entities pursue a strategy that BlackRock has explicitly repudiated and is legally required to repudiate.[288] While the end results of the decisions and engagements of these two groups may overlap, their intentions and legal duties remain distinct.

III. STAKEHOLDER INCENTIVES IN THE ACTIVIST ARENA

A. Long-Term versus Short-Term Value

The growth of environmental and social aspects in institutional activism should not be construed as a wholesale deviation from standard governance and engagement practices. Instead, it is a nuanced, progressive addition to the optimal strategy for long-term value creation. To fully understand this shift, our analysis is necessarily steered to one of the most robust debates regarding shareholder activism and its utility. As Hansmann and Kraakman aptly summarize, corporate law's principal purpose is to increase long-term shareholder value.[289] This principal goal is without challenge, having been widely accepted by the judiciary, government agencies, academics, and practitioners.[290]

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285. *See infra* Part III.B for a complete discussion on fiduciary duties and how they are integrated with financial return and ESG.

286. Impact investing is distinct from socially responsible investing. Impact investing actively seeks to invest in companies that have the potential to create positive economic, social, and environmental outcomes. KARIM HARJI & EDWARD T. JACKSON, ROCKEFELLER FOUND., ACCELERATING IMPACT: ACHIEVEMENTS, CHALLENGES AND WHAT'S NEXT IN BUILDING THE IMPACT INVESTING INDUSTRY at xi (2012). This is where an ESG analysis is crucial to *ex ante* decision-making. *Id.* at 41, 43. Conversely, SRI has advanced in nature, but at its roots was a screening mechanism to avoid or pursue investments based on ecological, social, environmental, or ethical criteria. *Id.* at 49–50. The term *impact investing* was created by the Rockefeller Foundation in 2012, with their famous report on the topic. *Id.* at 7. For more information on SRI, its evolution, and SRI funds, see RUSSELL SPARKES, SOCIALLY RESPONSIBLE INVESTMENT: A GLOBAL REVOLUTION (2002). See also Luc Renneboog et al., *Socially Responsible Investments: Institutional Aspects, Performance, and Investor Behavior*, 32 J. BANKING & FIN. 1723 (2008) for a review of SRI literature and a discussion of how SRI investors may not be willing to accept suboptimal financial performance to pursue social or ethical objectives.

287. HARJI & JACKSON, *supra* note 286.

288. *Supra* note 228 and accompanying text.

289. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) ("There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.").

290. There is a lack of challengers to this proposition as well. *See, e.g.*, William W. Bratton, *Framing a Purpose for Corporate Law*, 39 J. CORP. L. 713, 723 (2014) ("[C]orporate law should facilitate

Extensive research has been conducted on the problematic nature of a short-term investment perspective.[291] From an economic standpoint, taking steps to boost short-term stock prices at the expense of long-term growth reduces the size of the firm's overall pie.[292] This forces other parties with residual claims on the firm's value to bear the resulting economic cost.[293] As such, "short-term stock price[s] do[] not [accurately] reflect the value flowing to long-term shareholders and future shareholders."[294] Short-termism therefore results in an inefficient transfer of value.[295] Simply put, "[t]he more influence short-term traders have on market prices, the more volatile those prices will be[come]."[296] This is because they will be "less rooted in the fundamental value of the corporation."[297] Leo Strine argues in favor of this proposition, namely that long-term value best serves individual investors in their capacities as equity and debt investors, and as wage earners.[298] Short-termism negatively affects the viability and liquidity of the market at large, individual firms and their stakeholders, and investors as a whole.

Managerial short-termism hampers a corporation's overall business success.[299] Yet, even here, there exists a time-based agency problem.

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corporate attempts to maximize productive output . . . encouraging long-term investment at the lowest cost of capital, subject to exterior regulations that control externalities."); *see* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U.L. REV. 547, 573 (2003) ("[D]irectors [should be] obliged to make decisions based solely on the basis of long-term shareholder gain . . . ."). For the basis of the economics model, see Robert M. Solow, *Technical Change and the Aggregate Production Function*, 39 REV. ECON. & STAT. 312 (1957), which led to the development of endogenous growth theory, which argues that economic growth is the result of endogenous and not external forces.

291. Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1558 (2015) (discussing "the potential problems that can arise when a firm's investor base consists largely of short-term shareholders").

292. *Id.* at 1567.

293. *Id.* at 1567–68 (arguing that short-termism can arise in even a fully rational market and that the cost-bearing residual claimants are shareholders who buy shares at an inflated price in the short term).

294. *Id.* at 1564.

295. Though, Jesse Fried argues that serving long-term shareholders can also result in inefficiencies when long-term shareholder interests do not align with the maximization of economic value. *Id.* at 1592–98. This occurs during specific share buyback scenarios. *Id.*

296. Justin Fox & Jay W. Lorsch, *What Good Are Shareholders?*, HARV. BUS. REV. (July–Aug. 2012), https://hbr.org/2012/07/what-good-are-shareholders.

297. *Id.*

298. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1885 (footnote omitted) ("[A] short-term increase in . . . stock price at the expense of long-term reinvestment and wage growth will likely harm . . . the human investor.").

299. Certainly, there are studies and academics showing how long-termism can harm corporations, but the general consensus is that a focus short-termism is not beneficial for corporate growth. *See* Roger L. Martin, *Yes, Short-Termism Really Is a Problem*, HARV. BUS. REV. (Oct. 9, 2015), https://hbr.org/2015/10/yes-short-termism-really-is-a-problem (arguing that although research studies are mixed, the majority find it to be an issue, but most importantly, practitioners prove that it exists and is

Managers' and shareholders' time preferences are not aligned. This is exacerbated by a focus on stock price, especially created by regulatory pressures in the form of Exchange Act-required financial disclosures and quarterly earnings calls.[300] Clearly, mandatory disclosure obligations are positives for markets and investors.[301] The information provided allows investors to accurately assess companies, increasing transparency and limiting information asymmetry.[302] It also helps militate against fraud and helps with capital allocations.[303] But, with so many touchstones set against corporate and financial progress, managers are incentivized to orient towards these disclosure periods. This myopia arises for many reasons. For example, job stability and reputation depend on meeting or exceeding earnings,[304] and missed projections easily ratchet up pressure on the company and executive positions. Larry Fink, CEO of BlackRock, agrees, writing that the culture of quarterly earnings and its attendant hysteria counters the optimal approach needed for successful companies.[305]

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problematic); ASPEN INST., OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (2009), https://assets.aspeninstitute.org/content/uploads/files/content/docs/pubs/overcome_short_state0909_0.pdf (arguing that corporations' short-term objectives corrode the foundation of the American free enterprise system); WILLIAM A. GALSTON & ELAINE C. KAMARCK, BROOKINGS INST. , MORE BUILDERS AND FEWER TRADERS: A GROWTH STRATEGY FOR THE AMERICAN ECONOMY 6 (2015), https://www.brookings.edu/wp-content/uploads/2016/06/CEPMGlastonKarmarck4.pdf (showing how nonresidential capital investment is trending steadily downward); Richard Davies et al., *Measuring the Costs of Short-Termism*, 12 J. FIN. STABILITY 16 (2014) (arguing that corporate impatience is increasing); William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV. (Sept. 2014), https://hbr.org/2014/09/profits-without-prosperity (explaining how firms are increasingly devoting a disproportionate share of earnings to corporate buybacks, to the detriment of future growth). *But see generally* Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015) [hereinafter Bebchuk et al., *Long-Term Effects*] (arguing that hedge funds and short-term focus can catalyze improved corporate performance overall).

300. *See* Ariel Fromer Babcock & Sarah Keohane Williamson, *Comment Letter Regarding Earnings Releases and Quarterly Reports*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 19, 2019), https://corpgov.law.harvard.edu/2019/07/19/comment-letter-regarding-earnings-releases-and-quarterly-reports/ (summarizing evidence that quarterly earnings guidance can cause long-term harm and connecting frequent disclosures with detrimental short-term decision-making).

301. Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673, 695 (1984).

302. *Id.*

303. *Id.*

304. Bengt Holmström & Joan Ricart i Costa, *Managerial Incentives and Capital Management*, 101 Q. J. ECON. 835, 856 (1986) ("[R]eputational concerns may well be more central than effort aversion in explaining incongruities in risk preferences between managers and owners or superiors . . . ."); *see generally* Bengt Holmström, *Managerial Incentive Problems: A Dynamic Perspective*, 66 REV. ECON. STUD. 169 (1999) (discussing how a manager's concern for future career prospects may influence incentives to make decisions); M.P. Narayanan, *Managerial Incentives for Short-Term Results*, 40 J. FIN. 1469 (1985) (investigating how managerial decision-making for short-term gains at the expense of long-term shareholder interest due to reputation and incentive distortions).

305. Laurence D. Fink, *Larry Fink's 2016 Letter to CEOs*, BLACKROCK, https://www.blackrock.com/

Research shows that firms and managers tend to boost short-term earnings when they are close to missing earnings projections.[306] John Graham et al. report that 78% of executives would skip net present value positive projects if their adoption resulted in their firm missing quarterly earnings expectations.[307] Arthur Kraft et al. found that shorter reporting intervals gave rise to a statistically and economically significant decline in investments, operating efficiency, and sales growth.[308] To counter this, the U.K. and E.U. have relaxed their reporting obligations, moving from quarterly to bi-annual disclosure in 2014.[309] Overall, short-term incentives affect long-term firm value.[310] These temporal, managerial choices are individually beneficial, but detrimental to shareholder and firm value.[311] The short-term skews inevitably come at the expense of long-term value.[312] The issue when related to activism, therefore, is whether activism is beneficial in the long-term or

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corporate/literature/press-release/2016-larry-fink-ceo-letter.pdf (last visited Apr. 17, 2020) ("Today's culture of quarterly earnings hysteria is totally contrary to the long-term approach we need. To be clear, we do believe companies should still report quarterly results—'long-termism' should not be a substitute for transparency—but CEOs should be more focused in these reports on demonstrating progress against their strategic plans . . . .").

306. Edmans et al., *supra* note 275; *see also* Justice Jack B. Jacobs, *"Patient Capital": Can Delaware Corporate Law Help Revive It?*, 68 WASH. & LEE L. REV. 1645, 1649, 1657–63 (2011) (expressing concerns about the decline of patient capital and the rise of impatient capital, which is caused by investor pressure to generate short-term profits); *cf.* Renhui Fu et al., *Financial Reporting Frequency, Information Asymmetry, and the Cost of Equity*, 54 J. ACCT. & ECON. 132, 148 (2012) (showing how an increased rate of reporting frequency reduces information asymmetry and the cost of equity).

307. John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 47 (2005) (finding that 78% of executives would sacrifice a small, moderate, and even large amount of value in return for a smoother earnings path).

308. Arthur G. Kraft et al., *Frequent Financial Reporting and Managerial Myopia*, 93 ACCT. REV. 249, 272 (2018) (finding "a statistically and economically significant decline in investments after firms increase . . . reporting frequency[,]" with a particularly acute "decline in operating efficiency and sales growth"); *see also* Jürgen Ernstberger et al., *The Real Effects of Mandatory Quarterly Reporting*, 92 ACCT. REV. 33, 56 (2017) (finding an increase in manipulations for firms mandated to switch from semi-annual to quarterly interim management statements and that these manipulations increase with investor pressure). *But cf.* Suresh Nallareddy et al., *Consequences of Mandatory Quarterly Reporting: The U.K. Experience* 4 (Columbia Bus. Sch., Working Paper No. 17-33, 2017) (showing that, after the U.K. mandated quarterly reporting, there was no lowering of company investments and that the change was unlikely to cause substantial changes in managerial operational and investment decisions).

309. Marion Dakers, *Quarterly Reporting Quietly Comes to an End*, TELEGRAPH (Nov. 15, 2014), https://www.telegraph.co.uk/finance/good-news/11231685/Quarterly-reporting-quietly-comes-to-an-end.html; *see also Should Companies Abandon Quarterly Earnings Reports?*, KNOWLEDGE@WHARTON (Aug. 27, 2018), http://knowledge.wharton.upenn.edu/article/ending-quarterly-reporting/ (providing background on the U.K.'s switch and arguing that the U.S. should not follow suit because it would lead to a rise in the cost of capital and would negatively affect market transparency).

310. *See generally* Edmans et al., *supra* note 275 (documenting CEO-encouraged short-term profit gains at the expense of long-term firm value gains).

311. *Id.*

312. *See id.* at 7 (providing the example of mergers and acquisitions that commonly lose value for companies in the long run but provide short-term incentives and value).

simply increases short-term profits at the expense of future value. The answer may be different for activism in general rather than simply in the ESG context. It could also depend on if it is conducted by hedge funds or other institutional investors. To be favorable, activism must prove a check on these agency costs and reorient managerial incentives to a proper, longer-term horizon.

B. Institutional Investors and Long-Term Value

The connection between institutional investors and the pursuit of long-term value is grounded in fiduciary law. Mutual and pension funds owe fiduciary duties to their individual investors. These individuals are the beneficiaries of their investment activities. This obligation is statutorily codified in § 206 of the Investment Advisers Act.[313] Section 206 is an anti-fraud provision which prohibits these institutions from undertaking any fraudulent, manipulative, or deceptive practice.[314] On its face, the enactment does not lead to the natural presumption of a fiduciary relationship as it instead aims at preventing fraud. But, in 1963, the Supreme Court provided the link.[315] *SEC v. Capital Gains Research Bureau* interpreted § 206 as congressional recognition of the fiduciary nature of an investment-advisory relationship.[316] The agreed-upon legal conclusion is that every investment institution is obligated to further and safeguard the interests of its investors.[317] This duty takes primacy over any other competing commitments or responsibilities. Combining this with corporate law's prioritization of long-term shareholder value for managers, a firm's investment policies and activities must therefore be aimed at delivering value over the long-term for its beneficiaries and clients.[318]

313. Investment Advisers Act of 1940, § 206, 15 U.S.C. § 80b-6 (2012).

314. *Id.*

315. Sec. Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963).

316. *Id.* At first, the conclusion of the holding and its ramifications were unclear. *See id.* (remanding the case without explicitly stating the nature of the fiduciary standards). The confusion was later clarified in 1979. *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (citations omitted) ("As we have previously recognized, § 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers . . . . [T]he Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.").

317. *See Capital Gains*, 375 U.S. at 187, 189, 191 (emphasizing the advisor's role in helping, and protecting, an individual's investment).

318. *See* INT'L CORP. GOVERNANCE NETWORK, ICGN STATEMENT OF PRINCIPLES FOR INSTITUTIONAL INVESTOR RESPONSIBILITIES 8 (2013), https://www.icgn.org/sites/default/files/ICGN%20Institutional%20Investor%20Responsibilities_0.pdf ("[A]ll institutional investors should focus on delivering value to the benefit of beneficiaries or clients over an appropriate [long-term] time-horizon.").

This discussion of fiduciary duties is particularly apt in the context of ESG.[319] Institutional investors are interpreting the emphasis and appraisal of non-financial factors and risks to be for the long-term benefit of their beneficiaries.[320] Therefore, ESG may either fulfill, or even be required by, their fiduciary obligation.[321] However, a U.S. Department of Labor (DOL) interpretation adds some guidance and seems to run counter to the growing consensus among institutional investors.[322] In April 2018, the DOL issued a Field Assistance Bulletin for ERISA investors about ESG investment considerations.[323] Specifically, the release covers the role of ESG in shareholder campaigns and engagement activities, investment decision-making, and investment policies.[324] The Department iterated that

> [f]iduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue . . . . Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary's evaluation of . . . an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives.[325]

The DOL did leave a bit of leeway, disclaiming that investment policy statements are permitted to use ESG factors to evaluate investments, risk, and return.[326] Currently, there is a vigorous debate about whether this issuance forecloses ERISA investors from promoting ESG based upon the inference, correct or otherwise, that it militates against profitability and shareholder value.[327] Major pension funds such as CalPERS and CalSTRS, and their

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319. *See* OECD, *supra* note 272, at 7 (discussing the differing schools of thought on ESG and how it relates to investors' fiduciary duties).

320. *See id.* at 50 (noting how, in recent interpretations, fiduciary duties do not present barriers to implementing non-financial dynamics, such as ESG factors, into decision-making).

321. *See id.* (discussing how ESG factors relate to duty of care).

322. *See* U.S. DEP'T OF LABOR, FIELD ASSISTANCE BULLETIN NO. 2018-01, at 2–4 (2018) (explaining the Department's stance on ESG and providing an update to past publications on the topic).

323. *Id.* at 1.

324. *Id.* at 1–2 (reiterating the Department's position that investment managers may not sacrifice monetary returns for the promotion of policy goals).

325. *Id.* at 2.

326. *Id.* In Interpretive Bulletin 2016-01, the Department notes that ESG can be used to evaluate investment risk and return. *Id.* But the Department determines that this does not compel ESG integration and that fiduciary duties under ERISA may require managers to disregard ESG. *Id.* at 2–3.

327. Lipton, *supra* note 281 (noting that some readers view the Department's bulletin "as foreclosing ERISA investors from promoting ESG"); *see* DAVID M. SILK ET AL., WACHTELL, LIPTON,

approximately $400 billion AUM,[328] may be limited by this agency interpretation. Other asset managers are not similarly constrained and have more flexibility in establishing and pushing their ESG engagement priorities.[329]

The use of ESG in investing and activism is sufficiently widespread,[330] if not ubiquitous, among the largest asset managers[331] that it can arguably be considered to fulfill institutional investors' fiduciary duties. With such extensive support, this approach ought to be construed as within the actions of a prudent investor, none of which could have taken place without the concurrence of legal approval from counsel. Activism on ESG issues can at least now be considered essential in these entities' duty to monitor current investments, if not agreed upon for investment stock selection. The U.N. Global Compact has addressed the issue with a report, definitively asserting that it seeks to end disagreements around whether fiduciary duty is a barrier

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ROSEN & KATZ, AN ESG SETBACK? DOL SOUNDS CAUTIONARY TONE ON ESG-RELATED PROXY VOTING, SHAREHOLDER ENGAGEMENT AND ECONOMICALLY TARGETED INVESTMENTS (2018), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.25934.18.pdf ("[T]he cautionary language and tone of the bulletin may cause plan fiduciaries, asset managers and other interested stakeholders to pause before pursuing more aggressive tactics for escalating ESG issues at companies . . . .").

328. CalPERs, California's Public Employee Retirement system fund, has approximately $376 billion AUM. CAL. PUB. EMP. RET. SYS. (CALPERS), 2018–19 ANNUAL INVESTMENT REPORT 100 (2019), https://www.calpers.ca.gov/docs/forms-publications/annual-investment-report-2019.pdf. CalSTRS, California's Teacher Retirement funds, has approximately $230 billion AUM. *Investment Overview*, CalSTRS, https://www.calstrs.com/investments-overview (last visited Apr. 17, 2020). They are respectively the second and third largest pension funds in the U.S. and the sixth and eleventh largest pension funds in the world. *Top 20 Pension Funds' AUM Declines for First Time in Seven Years*, WILLIS TOWERS WATSON (Sept. 3, 2019), https://www.willistowerswatson.com/en-US/News/2019/09/top-20-pension-funds-aum-declines-for-first-time-in-seven-years.

329. *See supra* notes 228–57 and accompanying text (discussing how firms like BlackRock have incorporated ESG factors into their investing and firm culture).

330. *See* Ioannis Ioannou & George Serafeim, *The Impact of Corporate Social Responsibility on Investment Recommendations: Analysts' Perceptions and Shifting Institutional Logics*, 36 STRAT. MGMT. J. 1053, 1056, 1071 (2015) (arguing that analysts are engaging more with CSR and that analysts at higher-status brokerage firms are most likely to be first movers in embracing a positive connection between CSR and firm value); *see also* Robert G. Eccles et al., *The Impact of Corporate Sustainability on Organizational Processes and Performance*, 60 MGMT. SCI. 2835 (2014) (showing how half their sample of corporations voluntarily adopted sustainability initiatives and that these companies outperform their counterpart low-sustainability companies).

331. Other than the largest asset managers, mentioned earlier, which have focused on ESG—BlackRock, State Street, and Vanguard—most other large, preeminent asset managers have also begun to emphasize these issues. *See infra* notes 429–36 and accompanying text. Examples include Goldman Sachs Asset Management, J.P. Morgan Asset Management, BNY Mellon Investment Management, Fidelity, and PIMCO. Many of these groups published a yearly report on their progress. *See, e.g.*, J.P. MORGAN CHASE, ENVIRONMENTAL SOCIAL AND GOVERNANCE REPORT 3 (2017), https://www.jpmorganchase.com/corporate/Corporate-Responsibility/document/jpmc-cr-esg-report-2017.pdf (reporting on J.P. Morgan's ESG progress). They follow the Global Reporting Initiative (GRI) G3 Framework. *Id.* GRI is an international NGO that standardizes sustainability reporting. *Id.*

to ESG inclusion.[332] They even go so far to opine that not considering ESG constitutes a failure in the determination of long-term value and violates fiduciary duties.[333] This is perhaps a tad extreme, given the opaqueness and breadth of ESG matters and concerns about how they can be properly subsumed within fiduciary duties.[334] Active stock ownership is not even required by these duties. So, to have such a blanket declaration for all institutions goes too far.

A better conception would be the contrapositive. A lack of ESG awareness and activism does not, a priori, violate fiduciary law.[335] Rather, integration of ESG furthers fiduciary duties.[336] If ESG integration becomes a competitive advantage, then naturally, all institutions would become second movers in adopting it. Indeed, it is this interpretation that seems to be the standard applied by major institutional investor asset managers.[337] This approach is empirically backed.[338] Most research finds that ESG integration aids, or at least does not diminish, long-term value.[339] A Deutsche Bank meta-study found that companies with high ESG ratings outpaced their peers in terms of financial performance: 89% of studies showed market outperformance and 85% showed accounting outperformance.[340] Interestingly, governance was the strongest influencer, followed by environment and then social factors.[341] That said, for funds employing these strategies, the results were either neutral, positive, or mixed between the two.[342] No study reported fund underperformance because of ESG.[343] In all,

332. *See* SULLIVAN ET AL., *supra* note 6, at 9 (arguing that there should not be fiduciary barriers to incorporating ESG issues into investments processes and that it should be a breach of fiduciary duties to not do so).

333. *Id.*

334. *See id.* at 11 (defining the wide scope of fiduciary duties and noting that investors find that these duties and their obligation to provide returns hinders their ability to be more responsible investors).

335. *See id.* at 16 (explaining that the test that courts employ when examining fiduciary duties involves a balancing of risks and does not expressly prohibit the consideration of ESG factors).

336. *See id.* (positing that, by integrating ESG issues into their investment strategies, investors promote their beneficiaries' interests and advance their fiduciary duty).

337. *See supra* notes 245–72 and accompanying text (providing examples of large asset managers that use ESG to their investing advantage).

338. *See generally* MARK FULTON ET AL., DEUTSCHE BANK, SUSTAINABLE INVESTING: ESTABLISHING LONG-TERM VALUE AND PERFORMANCE (2012) (reporting that firms with high ESG ratings generally outperformed the market).

339. *See id.* at 8 (emphasizing the large amount of studies and dates reviewed and their positive findings).

340. *Id.* The study examined over 100 academic studies, 56 research papers, 2 literature reviews, and 4 meta-studies. *Id.* It excluded papers if they did not meet a minimum level of academic rigor. *Id.*

341. *Id.*

342. *Id.* at 8–9 (discussing how 88% of these funds showed neutral or mixed results and that fund managers struggled to attain alpha unless they were small, specialized funds).

343. *Id.*

studies have generally shown that ESG either results in positive or neutral financial performance.[344] The upshot was a lower cost of capital for both debt and equity.[345]

ESG factors do relate to a company's performance.[346] They either contribute to or have a negligible effect on long-term value.[347] It is understandable why institutional investors have begun to focus on these issues for their investment decisions and for their activism, regardless of the status of the debate on fiduciary obligations. In crowded, competitive sectors, ESG risk measurement can provide the potential for financial return differentiation and success.[348] Activism on these issues therefore seems well informed. Interest among academic, investor, and managerial spheres will likely only continue to proliferate.

Overall, institutional investors' long-term focus has yielded concomitant and dramatic effects on public companies' governance structures and choices. This is even before controlling for their support of environmental and social changes. Ownership by passively managed funds strongly correlates with a higher proportion of independent directors, the removal of takeover defenses, and equal voting rights.[349] The result is seen outside of actively managed funds, who, by definition, are more likely to seek governance changes.[350] All of these traits are value-added changes with clear connections to financial returns.[351] Studies show that many management-entrenching traits—such as staggered boards, limits to shareholder bylaw

344. *See* Christophe Revelli & Jean-Laurent Viviani, *Financial Performance of Socially Responsible Investing (SRI): What Have We Learned? A Meta-Analysis*, 24 BUS. ETHICS: A EUR. REV. 158, 159 (2015) (finding that incorporating corporate social responsibility in investment portfolios had a neutral result and was neither a weakness nor a strength compared with conventional investments); *see also* Friede et al., *supra* note 273, at 217 (finding that 90% of studies find a nonnegative ESG relation with financial performance); Luc Renneboog et al., *Socially Responsible Investments: Methodology, Risk Exposure and Performance* 1–2 (Eur. Corp. Governance Inst., Fin. Working Paper No. 175/2007, 2007) (showing underperformance in Europe, but not in the U.S. or the U.K.); Lloyd Kurtz & Dan diBartolomeo, *The Long-Term Performance of a Social Investment Universe*, 20 J. INV. 95 (2011) (discovering a statistically insignificant differentiation between the U.S. Social Investment Index and the S&P 500, indicating that risk exposures created by social screens can be managed through portfolio construction).

345. FULTON ET AL., *supra* note 338, at 8.

346. *See* Friede et al., *supra* note 273, at 226 (summarizing a meta study of over 2,200 studies that finds a positive effect between ESG factors and overall company performance).

347. *See id.* (commenting that over 2100 of the studies showed "positive ESG relation," while close to 150 other studies showed neutral or mixed performance).

348. *See e.g.*, FULTON ET AL., *supra* note 338, at 8 (noting that firms that have high ESG ratings and high CSR ratings outperform their lower-ranked counterparts).

349. Appel, *supra* note 3, at 134.

350. *See id.* at 112 (explaining that active owners "actively buy or sell shares to influence managerial decisions").

351. *See id.* at 129 (finding that passive fund ownership, characterized by a higher proportion of independent directors and equal voting rights, is related to an overall improvement in a firm's ROA).

amendments, poison pills, golden parachutes, and supermajority voting requirements—correlate with lower-value firms.[352]

This said, the agency problem for institutional fund managers remains pervasive, similar to managerial agency problems with their shareholders.[353] Here, however, the problem is not rooted in a time-based phenomenon. Rather, there is still a divergence between the interests of institutions and their individual beneficiaries.[354] This is because the business model of many investment intermediaries, especially mutual funds, is increasing AUM by performing better than the market.[355] Such a broad view can undermine the incentive to actively monitor the performance of individual companies held within a portfolio,[356] especially when that company is already outperforming the market. Or, put more cynically, both index and actively managed mutual funds have incentives to underspend on stewardship and bend toward management since working with incumbents lowers transaction costs.[357] Furthermore, many institutional investors lack the time or discipline to

352. Bebchuk et al., *What Matters*, *supra* note 164, at 783, 784–85, 823 (finding that there are six entrenching provisions that are associated with reductions in firm value and abnormally large negative returns during the study period: staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments); Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410 (2005) (showing that staggered boards are associated with a reduced firm value and that the association is not only statistically significant, but also economically meaningful). *But see* Robert Daines et al., *Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment* 19 (Harv. Bus. Sch., Working Paper No. 16-105, 2018) (showing that staggered boards improve managerial incentives to make long-term investments).

353. See *supra* notes 299–312 and accompanying text for a discussion of managerial agency problems with shareholders.

354. Gilson & Gordon, *supra* note 36, at 876 (arguing that shareholders face two agency relationships: those between managers and institutions and those between institutions and themselves); *see also* STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 248 (2012) (arguing that a lack of institutional monitoring "merely relocates [the] locus" of the principal-agent problem); Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U.L. REV. 877, 878–79 (2010) (explaining that mutual funds and pension funds have a separation of ownership from control and function like the Berle and Means corporation).

355. Gilson & Gordon, *supra* note 36, at 890–91.

356. *Id.* at 865.

357. Bebchuk et al., *Agency Problem, supra* note 18, at 100 ("[T]hose managing both passive index funds and active mutual funds, have incentives to be 'more passive' with respect to governance issues than is optimal for their beneficial investors."). It seems like this claim might even be conservative, since major funds have been spending negligible resources on stewardship beyond what is required to comply with regulations. *See* Sarah Krouse et al., *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016), https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101 (describing how, in 2016, Vanguard had 15 employees for voting and stewardship at its 13,000 portfolio companies, BlackRock had 24 employees for voting and stewardship at 14,000 portfolio companies, and State Street had fewer than 10 employees for voting and stewardship at 9,000 portfolio companies). These figures have likely increased since then.

engage in active monitoring, especially since distinct funds operate with different timeframes and priorities.[358]

With the increased incidence of activism and greater institutional focus on engagement and stewardship, a paradox has emerged. Institutional shareholders are intensifying their efforts to encourage boards to undertake long-term value-creation strategies.[359] Meanwhile, however, much of institutional activism is not value-increasing and does not achieve significant benefits for shareholders.[360] Institutional investors suffer from regulatory and structural barriers, which hinder efficacy and bring about complications such as collective action problems, conflicts of interest, and weak personal incentives for fund managers.[361] So, in part, institutions encourage hedge fund activism since they can mitigate agency problems and effect change.[362] Since hedge funds are fundamentally different investment vehicles, both in terms of their operation under the law and their priorities, they are unencumbered by many of those same concerns.[363] The encouragement exists despite institutions being on the lookout for long-term value. This is a fine line due to the divisive nature of hedge fund activism and whether or not it aims at long-term value creation.

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358. Fox & Lorsch, *supra* note 296 (arguing that these time-based problems make the cost of disciplining managers extremely high, and therefore rare).

359. Rusty O'Kelley & Anthony Goodman, *Global and Regional Trends in Corporate Governance for 2017,* HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 6, 2017), https://corpgov.law.harvard.edu/2017/01/06/global-and-regional-trends-in-corporate-governance-for-2017/ (mentioning how prominent business leaders and investors are imploring companies to focus on sustained value creation rather than maximizing short-term earnings); *see* Fink, *2018 Letter*, *supra* note 305 ("This responsibility goes beyond casting proxy votes . . . it means investing the time and resources necessary to foster long-term value. . . . [and] engagement needs to be a year-round conversation about improving long-term value.").

360. Brav et al., *Hedge Fund Activism*, *supra* note 63, at 1730 ("[H]edge funds are better positioned to act as informed monitors than other institutional investors.").

361. *See* Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459 (1998) (showing how institutional investors spend a nominal amount of money on overt activism efforts and that this lack of effort leads to negligible effects on firm performance); Kahan & Rock, *supra* note 77, at 1048–57 (concluding that mutual funds suffer from regulatory constraints, a lack of monitoring incentives, and conflicts of interest, all of which limit the outcomes of their activism); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 469, 478 (1991) (arguing that asset managers lack the incentives to engage in many circumstances); Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 250 (2001) (discussing how institutional investor shareholder proposals "have not had a significant impact on firm performance").

362. Bebchuk et al., *Agency Problem, supra* note 18, at 104 ("[A]ctivist hedge fund managers suffer less from . . . agency problems . . . and have incentives to make stewardship decisions that are significantly closer . . . [to] be[ing] optimal for . . . investors [than other investment managers.]").

363. *Id.* at 104–05.

C. Hedge Funds: Short-Term Value Predators?

Dovetailed with the Efficient Capital Markets Hypothesis is the notion that markets may be myopic.[364] At the heart of this idea of market myopia is an informational asymmetry between managers and investors.[365] Markets can fail to fully incorporate the value of long-term initiatives within a short-term time horizon.[366] This is to say, investors may prefer short-term returns over long-term investments even after future value is discounted to the present.[367] If market myopia is accepted as true, it could "either [be] because investors have different investment horizons, or . . . it is too costly to correct inefficient pricing."[368] Suffice to say, this proposition is controversial,[369] like claims about the termism of hedge funds, with a position on one regularly dictating an opinion on the other.

Certainly, the argument is easily made that hedge funds operate primarily for short-term profit. At their core, they exhibit little interest in agitating for systemic changes, instead focusing on firm-specific activism.[370] In so doing, their incentives are dependent upon the financial stake they have in a portfolio company.[371] Their "2 and 20" compensation structure underlies any short-termism argument.[372] Fund managers are subject to time constraints, because if they do not earn above-market returns, they will earn lower compensation and their investors can simply switch to other, more successful managers, all of which jeopardizes the manager's future prospects.[373] Compounding this, fund managers are assessed on the

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364. Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 580–81 (2016).

365. *Id.*

366. Kenneth A. Froot et al., *Herd on the Street: Informational Inefficiencies in a Market with Short-Term Speculation*, 47 J. FIN. 1461, 1480–81 (1992).

367. *Id.*

368. Goshen & Hamdani, *supra* note 364, at 581.

369. There is a robust debate on the topic, but many empirical studies support the existence of market myopia. *See, e.g.*, Adam Brandenburger & Ben Polak, *When Managers Cover Their Posteriors: Making the Decisions the Market Wants to See*, 27 RAND J. ECON. 523, 526–27 (1996) (showing how myopia is due to information asymmetries between managers and shareholders); Brian J. Bushee, *The Influence of Institutional Investors on Myopic Investment Behavior*, 73 ACCT. REV. 305 (1998) (arguing that a high level of institutional ownership with a high portfolio turnover and momentum trading significantly increases managerial incentives to pursue short-term projects).

370. Kahan & Rock, *supra* note 77, at 1069 (footnote omitted) ("[I]ncentives for a fund to engage in activism depend on its stake in a portfolio company."); *id.* at 1091 ("[H]edge funds engage in firm-specific agitation . . . .").

371. *Id.* at 1069.

372. Coffee & Palia, *supra* note 15, at 573 (arguing that, since finding undervalued companies and beating the efficient market is impossible, hedge funds instead focused on underperforming companies to justify their fees and short-term investor base).

373. *Id.*

performance of their stock portfolios in absolute and not relative terms, and over a short time-frame—either quarterly or annually.[374] In large measure, this structural landscape explains why hedge fund share turnover sits at approximately 300% annually.[375]

Paradoxically, therefore, management must base strategy off long-term prospects, but their constituent shareholders buy and sell based off of short-term stock price movements.[376] This, combined with skewed hedge fund incentives, means that activists can make proposals motivated by interests contrary to maximizing the long-term, sustainable profitability of the company.[377] Relatedly, unlike other institutional investors who hold diverse portfolios, activists hold concentrated blocks of shares in a limited number of companies.[378] This concentrated ownership makes activism rational from a cost-benefit perspective. In turn, larger holdings drive greater returns, which can justify the elevated sunk costs of launching and maintaining an activist campaign.[379]

Once an activist hedge fund announces its target and begins accumulating shares, that company's share price generally increases.[380] Management is immediately placed under great pressure to defend their current and past strategic decisions.[381] Target firms, however, will not

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374. MICHAEL E. PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS 528 (1990) ("With a strong incentive to find companies whose shares will appreciate in the near term and incomplete information about long-term prospects, portfolio managers turn to quarterly earnings performance as perhaps the single biggest influence on buy/sell decisions."). It is argued that this is a uniquely American problem. *See id.* at 376 (describing how the concern for quarterly earnings that is prominent in the U.S. is absent in German corporations). It is perhaps compounded by the SEC disclosure requirements. *See, e.g.*, 17 C.F.R. § 240.13a, 240.13a-11, 240.13a-13 (2019) (requiring annual, quarterly, and other disclosures).

375. Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates also Act and Think Long Term*, 66 BUS. L. 1, 10 (2010) [hereinafter Strine, *Governance Question*]. For Strine, the "gerbil-like" trading activity of mutual funds are more disturbing, with an average yearly turnover of around 100%. *Id.*

376. *Id.* at 17 ("It is contradictory to demand managerial responsiveness to stockholder sentiment, and then criticize managers for failing to resist stockholder demands for riskier business strategies and more highly levered balance sheets."); *see* Bratton & Wachter, *supra* note 17, at 715 (discussing that information asymmetries between management and stock holders and speculative pricing from heterogeneous expectations create an inevitable "gulf between managing to maximize long-term fundamental value and managing to maximize the market price of the stock").

377. Strine, *Governance Question*, *supra* note 375, at 7 ("Stockholders who propose long-lasting corporate governance changes should have a substantial, long-term interest [in the corporation's prosperity].").

378. Coffee & Palia, *supra* note 15, at 553.

379. *Id.*

380. *Id.* at 583–85.

381. *See, e.g.*, Kahan & Rock, *supra* note 77, at 1029–30 (providing examples of activist hedge funds challenging current management practices).

normally meekly succumb to activists.[382] Managers will often take entrenchment steps to secure their positions.[383] They can modify their charters and bylaws to restrict shareholder voting power or file lawsuits against their challengers.[384] Responses mirror the situations where managers are faced with threats of a hostile takeover.[385] This holds true even though "hedge funds express an interest in bidding for target[s] . . . in only 6% of . . . campaigns, and the[ir] median [equity stake] is only 8%."[386] Rather, it is the threat of change and sharp pressure on current strategic decisions that elicit this sharp response.[387] Operationally, this external pressure can often cause managers to divert from "promising but difficult-to-value projects toward less promising but more easily valued projects" with visible cashflow returns.[388] In real terms, to manage earnings, this means sacrificing research and development expenses, capital expenses, market development, and new ventures.[389] Beyond these sacrifices, target companies show trends of suffering from increased leverage and increased shareholder payouts (either in the form of dividends or stock buybacks).[390] This exacerbates already

382. *See generally* Stephen M. Gill et al., *Structural Defenses to Shareholder Activism*, 47 REV. SEC. & COMMODITIES REG. 151 (2014) (describing structural defenses that firms use to resist activists).

383. *See id.* at 152 (describing examples of structural changes that managers may implement to defend against activists).

384. *Id.* at 155; Coffee & Palia, *supra* note 15, at 562.

385. *See* Anna L. Christie, *The New Hedge Fund Activism: Activist Directors and the Market for Corporate Quasi-Control*, 19 J. CORP. L. STUDIES 1, 3, 7, 35 (2018) (explaining how hedge fund activists create a market for quasi-corporate control, similar in kind to previous corporate takeover raiders).

386. Nicole Boyson & Pegaret Pichler, *Hostile Resistance to Hedge Fund Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 28, 2016), https://corpgov.law.harvard.edu/2016/09/28/hostile-resistance-to-hedge-fund-activism/; *see also* C.N.V. Krishnan et al., *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296, 297 (2016) (discussing how, in addition to an 8% median equity stake, the hedge funds with the largest number of activism attempts have a relatively small market share).

387. Bratton, *supra* note 199, at 1379.

388. *Id.* See Gantchev, *supra* note 178, for a discussion of proxy costs.

389. Lipton, *supra* note 281 (arguing that when managers seek to boost short-term earnings, they generally forgo long-term "sustainable improvements in corporate performance"); Yvan Allaire & Francois Dauphin, *The Game of "Activist" Hedge Funds: Cui Bono?*, 13 INT'L J. DISCLOSURE & GOVERNANCE 279, 279 (2016) (finding that evidence of improvements from activists mainly results from target companies undergoing basic financial maneuvers like selling assets, cutting capital expenditures, buying back shares, and reducing workforce); *see* Coffee & Palia, *supra* note 15, at 576 (footnote omitted) ("[I]t seems safe to conclude . . . that research and development expenditures decline significantly in the wake of hedge fund pressure . . . ."). *But cf.* Alon Brav et al., *How Does Hedge Fund Activism Reshape Corporate Innovation?*, 130 J. FIN. ECON. 237 (2018) (finding that target firms decrease research and development spending, but do not see a concomitant decrease in the quality and quantity of company patents); Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIVATIVES RES. 169, 193 (2011) (finding that hedge fund activism can be effective in reducing the agency costs of free cash flow).

390. Coffee & Palia, *supra* note 15, at 550 ("[H]edge fund activism is associated with . . . increased leverage [and] increased shareholder payouts . . . ."); Bebchuk et al., *Long-Term*

existing agency costs and myopia. Hedge fund activists certainly will regularly counter any hostile managerial responses to their actions.[391] In all of this, it is frequently not in the long-term interest of the corporation to bend if short-term goals inform the activist solution, especially since activists owe no fiduciary duties to or obligations for the financial interests of other shareholders.[392]

From academic inquiry, almost all research points to the fact that hedge fund activist campaigns do result in short-term shareholder gains.[393] The evidence is a lot murkier and controversial with respect to long-term prospects.[394] Also complicating the matter is the finding that the median holding period for successful hedge fund activist campaigns usually sits around one year.[395] Comparatively, active institutional investors' holding periods are similar, but shorter, averaging seven to nine months.[396] It is more difficult to argue that activists are short-term predators if they hold their

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Effects, *supra* note 299, at 1135–36, call this trend "[i]nvestment-[l]imiting [i]nterventions" and argue that these force targets toward optimal investment levels.

391. *See, e.g.,* Kahan & Rock, *supra* note 77, at 1032 (describing examples of activist hedge funds suing target firms in an attempt to invalidate the firm's defensive measures).

392. *Id.* at 1074.

393. Coffee & Palia, *supra* note 15, at 551 (explaining how activist campaigns result, on average, in short-term gains for shareholders); Brav et al., *Hedge Fund Activism*, *supra* note 63, at 1730 (discovering an average short-term return of 7–8% over the period before and after a Schedule 13D filing); Bebchuk et al., *Long-Term Effects*, *supra* note 299, at 1122 (finding an average of a 6% abnormal return during the 20-day window before and after a Schedule 13D filing).

394. *See generally* Klein & Zur, *supra* note 200, at 201 (finding no evidence that target firms had better operating profits than a control sample as measured one year before and after a Schedule 13D filing); *see also* Chris Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 330–31 (2008) (finding that firms targeted by activists experience an increase on their return on assets, but this is because of asset divestitures rather than improved cash flows); Boyson & Mooradian, *supra* note 389, at 191 (finding that target firms did not have significant changes in their return on assets when compared to control firms); Ed deHaan et al., *Long-Term Economic Consequences of Hedge Fund Activist Interventions*, 24 REV. ACCT. STUD. 536 (2019) ("[O]ur results do not strongly support the hypothesis that hedge fund interventions drive long-term improvements in shareholder wealth or firms' operating performance."). *But cf.* Brav et al., *Hedge Fund Activism*, *supra* note 63, at 1742–44 (finding that targeted firms increased payouts, operating performance, and CEO turnover, and that activists positively impacted outcomes and stock prices).

395. Brav et al., *Hedge Fund Activism*, *supra* note 63, at 1731 ("The median holding period for completed deals is about [one] year, calculated from the date a hedge fund files a Schedule 13D to the date when the fund no longer holds a significant stake . . . .").

396. This figure only includes active mutual funds, which skews the results downward. An index fund would have a negligible turnover rate and would greatly raise the mean. BEN W. HEINEMAN, JR. & STEPHEN DAVIS, YALE SCH. OF MGMT., ARE INSTITUTIONAL INVESTORS PART OF THE PROBLEM OR PART OF THE SOLUTION? 9 (2011), http://web.law.columbia.edu/sites/default/files/microsites/millstein-center/80235_CED_WEB.pdf (explaining how the average holding period for the New York Stock Exchange was seven years in the 1970s and seven to nine months in 2011). The authors estimated that, for mutual funds in general, the average holding period was 10.6 months in 2009. *Id.*

shares longer than their active institutional counterparts.[397] That is unless you also recognize that active institutional investors are also oriented toward the short-term. Index funds and exchange-traded funds could not, by definition, be subject to the same criticism. Holding periods do not paint the whole picture though, as the rationale and structural-based incentives for these investment vehicles sharply differ. Regardless of where one stands in this debate, as Bebchuk claims, we are currently in the "golden age of activist investing."[398] Without a doubt, hedge fund activism is now a crucial part of corporate governance and the financial marketplace. Management and institutional investors are acculturated to these threats to corporate stasis and are increasingly taking steps to manage, placate, and work with activists in this new framework.[399]

IV. STRATEGIC ADAPTATION: APPLYING ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES TO SHAREHOLDER ACTIVISM

Large institutional investors have been outspoken in their view that activist hedge fund strategies are excessively oriented to the short-term.[400] Yet, the irony is that against the backdrop of ever-increasing institutional ownership concentrations, these activists require institutional support in order to be successful.[401] Trends reveal that activist successes are founded upon the support of allied institutions.[402] Moreover, with a certain amount of

397. Or, comparatively, an argument could be made that active mutual funds and pension funds do not seek long-term value. But this would be a difficult proposition to support. *See supra* notes 61–150, 162–83, 309–64 and accompanying text.

398. Bebchuk et al., *Long-Term Effects*, *supra* note 299, at 1087.

399. *See* Lucian A. Bebchuk et al., *Dancing with Activists* 3 (Harvard Law & Econ. Discussion Paper, No. 906, 2017) [hereinafter Bebchuk et al., *Dancing with Activists*] (documenting a significant rise in activist settlements from 2002 to 2011).

400. Andrew Ross Sorkin, *BlackRock's Chief Lawrence Fink, Urges Other C.E.O.s to Stop Being So Nice to Investors*, N.Y. TIMES (Apr. 12, 2015), https://www.nytimes.com/2015/04/14/business/dealbook/blackrocks-chief-laurence-fink-urges-other-ceos-to-stop-being-so-nice-to-investors.html (mentioning how so-called shareholder-friendly actions like paying dividends and buying back stock are often done under pressure from activists and harm long-term share value, companies, and investors).

401. Coffee & Palia, *supra* note 15, at 572.

402. *Id.* ("[Hedge funds] will need to sell their proposals to traditional diversified institutional investors, and this will likely serve as a moderating influence on some activists."); Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1898–99 (footnote omitted) ("Without the support of [institutional investors], the activist hedge fund leader would not have the clout to extract favorable concessions in a settlement, much less to prevail in a contested proxy fight."). For example, in the prominent 2015 takeover battle, activist Nelson Peltz sought seats on DuPont's board of directors, along with sales of business assets. Tom Hals, *DuPont Wins Board Proxy Fight Against Activist Investor Nelson Peltz*, REUTERS (May 13, 2015), https://www.reuters.com/article/us-dupont-trian/dupont-wins-board-proxy-fight-against-activist-investor-peltz-idUSKBN0NY1JI20150513. DuPont management narrowly prevailed in a proxy fight; sources commented that if any of the Big Three asset managers had voted for Peltz, he would have won, since he had the support of most non-indexed institutions. *Id.*

consolidation among asset managers' AUM, activists are able to acquire the requisite support with only a select few, large institutional investors in tow.[403] This is especially true since retail investors are less likely to vote their shares due to collective action and informational problems.[404] Ever opportunistic, and notwithstanding institutional skepticism around their motives, activists often develop relationships with significant institutional investors.[405] Prominent activists have communicated with these institutions during previous campaigns and maintain regular dialogue to ease future campaigns.[406]

Even though hedge funds are criticized for their high stock turnover,[407] the reality is that the mutual fund industry sees a turnover of around 100% annually.[408] In the drive to seek alpha, and with higher rates of activist success,[409] the natural conclusion is that institutional investors must view a rising number of activist campaigns as better for long-term value and thus worthy of their support. While both groups seem divergent, and have stark public perception differences,[410] they have a symbiotic relationship. Ronald Gilson and Jeffrey Gordon argue that, in this way, activists play a specialized role in capital markets.[411] They claim that hedge funds amplify institutional voices, thus increasing the value of their votes and lowering aforementioned agency costs.[412]

Through time, it appears that activist hedge funds have adapted their behavior to make their campaigns more palatable to institutional

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403. Coffee & Palia, *supra* note 15, at 568.

404. *Id.* at 561–62.

405. Sawyer & Treviño, *supra* note 16.

406. *Id.*

407. Strine, *Governance Question*, *supra* note 375, at 10.

408. *Id.* This turnover rate is for actively managed mutual funds. *Id.*

409. *Supra* notes 268–77 and accompanying text.

410. Hedge funds are routinely criticized for their exorbitantly high salaries and fees. *See Obama Targets Hedge Funds in Personal Remarks on Poverty, Race*, REUTERS (May 13, 2015), https://www.reuters.com/article/us-usa-poverty-obama/obama-targets-hedge-funds-in-personal-remarks-on-poverty-race-idUSKBN0NX2JR20150512 (calling hedge fund managers "society's lottery winners" and advocating for a higher tax rate on their fees); Igor Bobic, *Hillary Clinton Blasts Pay for CEOs, Hedge Fund Managers in Campaign Kickoff*, HUFFINGTON POST (Apr. 15, 2015), https://www.huffingtonpost.com/2015/04/15/hillary-clinton-ceos-hedge-fund-iowa_n_7069938.html ("[T]here's something wrong when hedge fund managers pay lower tax rates than nurses or . . . truckers . . . ."); Lawrence Delevinge, *Protesters Disrupt Activist Summit*, CNBC (Apr. 13, 2015), https://www.cnbc.com/2015/04/13/protesters-disrupt-activist-summit.html ("[P]rotesters interrupted [an activist investor conference] . . . chanting slogans like 'hedge fund billionaires, pay your fair share!'").

411. Gilson & Gordon, *supra* note 36, at 867.

412. *Id.*

shareholders. First, their overall holding periods are lengthening.[413] This is a clear rebuke to the short-termism claim and a sign that the activists are more willing to invest with a relatively longer-term view. But even if this is not an accurate conclusion, the result is the same—holding periods are longer than those of median active institutional investors. Second, with short-slate proxy contests and campaign settlements,[414] hedge funds are putting representatives on target boards. In all, 70% of fund-nominated director slates include at least one hedge fund employee.[415] This means that these persons now owe a fiduciary duty to the entity as a whole and must commit to pursue the corporation's long-term value strategy.

These settlements, previously rare occurrences, have begun to take place with increasing frequency. Activists are now more likely to extract a settlement agreement if there is a likelihood of winning seats in the event of a proxy fight.[416] Since settlements are more common and institutional investors continue to grow their ownership of the stock market, institutions must be determining that it is beneficial to align with activists and, therefore, are doing so more often. This development would naturally also embolden and strengthen resolve amongst activists in regard to future campaigns. These settlements usually bring about board changes, even without a contested proxy fight.[417] Activists will seek to add directors friendlier to their cause.[418] And although settlements usually are not conditioned on a required removal of the target's CEO, they are followed by a marked increase in CEO turnover.[419] Major institutional funds have pushed back on this practice,[420]

413. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1892–93. Hedge fund share turnover has fallen to a record low of 13%. However, this figure is not solely limited to activist hedge funds. Crystal Kim, *Hedge Fund Returns: A Game of Concentration*, BARRON'S (Nov. 22, 2017), https://www.barrons.com/articles/hedge-fund-returns-a-game-of-concentration-1511371200. This reduction in turnover has been a general trend since 2008. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1893 n.72.

414. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1905 (footnote omitted) ("[I]t is increasingly common for settlements to involve the hedge fund placing one or more of its key employees directly on the board . . . .").

415. John C. Coffee et al., *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board?*, 104 CORNELL L. REV. 381, 382 (2019) [hereinafter Coffee et al., *Activist Directors*].

416. *See* Lucian A. Bebchuk et al., *Dancing with Activists*, *supra* note 399, at 3 (finding an increasing trend in activist settlement outcomes, from 3% between 2000 and 2002 to 18% between 2009 and 2011).

417. *Id.* at 4.

418. *Id.*

419. *Id.* ("[W]hile settlements generally do not specify an ouster of the CEO, settlements are followed by a considerable increase in CEO turnover and in the performance-sensitivity of CEO turnover in the years following the settlement.").

420. *E.g.*, Michael Flaherty, *Big Funds Push Back Against Activist Investor Settlements*, REUTERS (July 18, 2016), https://www.reuters.com/article/us-activist-investors/big-funds-push-back-against-activist-

mainly out of the fear that settlements allow activists to shift value from other shareholders, namely themselves, who are not privy to the negotiations. Institutions now want managers to discuss any proposed settlement with them before an agreement is made.[421] The contradiction is evident. Institutional support stokes activist success and then, to quell the threat, these same institutions want to participate in the resolution process. With this evolution in activist strategy, outcomes for hedge funds with a longer-term outlook have been more positive.[422] Indeed, empirical evidence shows that hedge funds with a longer-term focus are less likely to pursue cuts to longer-horizon areas such as research and development.[423] These changes can readily be attributed to institutional investor apprehensions and power.[424]

At present, with institutions adding to and altering their views on what constitutes an optimal governance structure for long-term value,[425] especially through ESG engagement, hedge fund activists are forced to continue their strategic evolution. The activist arena has been fundamentally altered. No longer will it suffice for activists to claim underperformance and then require payouts or business changes. Institutional investors now have a sharper, more nuanced focus on what constitutes a long-term value strategy and are increasing their stewardship with management by expanding dedicated staff and resources to monitor portfolio companies.[426] Because social governance changes are now a crucial piece of long-term strategy and investment decisions,[427] hedge fund activists will need to broaden their criticisms to encompass these viewpoints. Activists will need to show institutional investors a long-term plan that references these matters in order to gain their

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investor-settlements-idUSKCN0ZY2DP (discussing examples of funds pushing back against investor settlements).

421. *See id.* (discussing conversations between Chico's CEO and major shareholders to push back against an activist hedge fund).

422. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1905; Krishnan et al., *supra* note 386, at 312 (showing that activists with materially larger investments who bring managerial skill over a longer period of time generate better returns for shareholders); *see* Bratton, *supra* note 199, at 1420 (finding that the best portfolios in the sample involved companies where activist hedge funds had longer-term ownership). *But cf.* Coffee et al., *Activist Directors*, *supra* note 415, at 382 (finding that, once a fund-nominated director gets on a board of directors, there is a significant increase in material, non-public information leakage). This results in the target corporation's stock price shifting to anticipate future public disclosures. *Id.* The leakage can only be attributed to hedge funds, and no other type of activist. *Id.* at 408.

423. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1908; Krishnan et al., *supra* note 386, at 298, 309 (discovering that targets of high-performing hedge funds experienced growth in research and development spending compared to targets of other funds).

424. Strine, *Flesh-and-Blood Perspective*, *supra* note 63, at 1908.

425. *See supra* Part II.

426. *See* Rusty O'Kelley et al., *supra* note 259 (discussing how there is an enhanced interest in investor stewardship due to a rise in accountability after the financial crisis for how investors can influence the strategic direction of companies).

427. Loop et al., *supra* note 8.

support in any proxy contest. This also creates greater possibilities for challenging management. A more complex conception of long-term value brings a greater number of ways to show that current strategies deviate from the optimal path. Board diversity is a concrete, objective standard, but social and environmental risk awareness and mitigation are not. And now, the greater focus on long-termism means that activists will be able to scrutinize the value-creation history of each and every director, both in their professional and board careers.[428]

Always strategic, activists have begun to embrace environmental and social issues in their criticism of existing firm management. Trian Partners, famous for waging the most expensive proxy fight in history with P&G,[429] has added a specific ESG policy.[430] It essentially mimics the policies publicly adopted by BlackRock, Vanguard, and State Street.[431] The activist fund highlights major environmental, social, and governance issues that it believes improve long-term performance.[432] It further offers examples of the ESG changes it has brought about in its portfolio companies.[433] Trian is not alone in emphasizing this new investment and governance focus.[434] A multitude of other funds have recently begun to publicly embrace ESG.[435] In examining these funds' motivations, two key explanations stand out. First, as institutional investors increasingly subscribe to ESG factors in evaluating investments, it is logical that Trian and other funds would use this screen as

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428. *Id.*

429. Benoit, *P&G v. Nelson Peltz*, *supra* note 178. Trian, and its founder and CEO Nelson Peltz, are also famous for Trian's unsuccessful, bitter short-slate proxy contest with Dupont that helped beget the DowDuPont merger. *See* Jacob Bunge & David Benoit, *DuPont Defeats Peltz, Trian in Board Fight*, WALL ST. J. (May 13, 2015), https://www.wsj.com/articles/dupont-appears-poised-to-win-over-peltz-1431521564 (reporting that DuPont defeated an attempt by Trian Partners to grab seats on the company's board); *see also* Ronald Orol, *Nelson Peltz is in a League of His Own When it Comes to Activist Investing*, THESTREET (May 15, 2018), https://www.thestreet.com/markets/nelson-peltz-is-in-a-league-of-his-own-when-it-comes-to-activist-investing-14589053 ("[E]ven with a loss, Peltz's campaigns can have an impact on a company's future especially if its share price and total shareholder returns are lackluster in the months and years to come.").

430. *ESG*, TRIAN PARTNERS, https://trianpartners.com/esg/ (last visited Apr. 17, 2020) (emphasis omitted) ("Promoting good business practices and strong corporate governance principles has been part of Trian's operating strategy since our inception and we have had success in bringing about positive . . . [ESG] changes at many of our portfolio companies.").

431. *See supra* text accompanying notes 284–88.

432. TRIAN PARTNERS, *supra* note 430.

433. *Id.*

434. *See* Attracta Mooney, *Activists Don Sustainability Cloak to Whip Up Support*, FIN. TIMES (May 13, 2018), https://www.ft.com/content/b74d2adc-2b8e-11e8-97ec-4bd3494d5f14 ("[M]any activists know that using ESG will help round up wider support from pension funds and traditional asset managers, but also believe there is investor demand.").

435. *Id.* In addition to Trian, other funds like Blue Harbour, Red Mountain Capital, ValueAct, Cartica, Elliott Management, and Jana Partners have been outspoken on these issues and are regularly incorporating them in activist strategies. *Id.*

well.[436] Activists, after all, are value investors trying to exploit pricing inefficiencies. The second explanation is that this public support for ESG is posturing. They know that major institutional holders are voracious supporters of ESG and this signaling provides a basis for institutions to align with activists and support their cause.

Activists have moved beyond merely accepting ESG issues. Jana Partners, for example, teamed with CalSTRS to publish a joint letter directed at Apple.[437] The letter asks Apple to recognize the dangers for children around excessive use of their devices and to create a research program on the negative effects of extreme social media use.[438] Going even further, Jana has also created an impact fund that will pursue a strategy of socially responsible investing.[439] Additionally, Jana liquidated all of its non-activist funds to focus solely on activism.[440] This approach integrates ESG more aggressively into activist activities. Instead of simply mirroring institutional investors, ESG is now central to campaigns against management. The success of this approach remains to be seen. Will the ESG focus give Jana greater clout with other shareholders to advance its activist campaign? Will the ESG issues be seen as a large enough problem to require reliance on an activist investor instead of engagement with management? Additionally, will Jana choose its targets based predominantly on ESG issues and will this provide enough of a financial return when compared to traditional focus areas for activism? To balance the structural need for shorter-term profits against preaching long-term value, activists will need to find targets that are underperforming, or could change, in both the short- and long-term. ESG alone may not provide enough of a nexus.

Structurally, there is a market impediment to any activism. Hedge funds suffer from an information asymmetry,[441] as well as an asymmetry of access to firm management, when compared to institutional shareholders. Hedge

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436. *Id.*

437. *Open Letter from Jana Partners and CalSTRS to Apple Inc.*, JANA PARTNERS LLC & CALSTRS (Jan. 6, 2018), http://schoolpress.cshgreenwich.org/cshmsparents/2018/01/15/open-letter-from-jana-partners-and-calstrs-to-apple-inc/.

438. *Id.*

439. Svea Herbst-Bayliss & Ross Kerber, *Fields of Gold? Jana Seeks New Money, Allies with Impact Hedge Fund*, REUTERS (Jan. 12, 2018), https://www.reuters.com/article/us-janapartners-sting/fields-of-gold-jana-seeks-new-money-allies-with-impact-hedge-fund-idUSKBN1F12L4.

440. Adam Jeffery, *Jana Liquidates Two Hedge Funds to Focus Only on Activism*, CNBC (Jan. 15, 2019), https://www.cnbc.com/2019/01/15/jana-liquidates-two-hedge-funds-to-focus-only-on-activism.html (summarizing how the hedge fund has dissolved two stock-picking funds and will focus on a general activist fund and a social activist fund).

441. *See generally* Jacobson & Aaker, *Myopic Management*, *supra* note 17 (studying international trends in information asymmetry between management and shareholders); *see also* Bratton & Wachter, *supra* note 17 (discussing the information asymmetry between management and shareholders).

fund activists operate outside of management and institutional investor dialogue. When social factors are added to the mix for long-term strategy, a company's risks, cash flows, and projections become harder to value. While long-term value is still defined monetarily, the inputs now consist of a greater number of both soft and hard assumptions. And since institutions are increasingly engaging with management, they can more clearly value a company's strategy.

There are, however, countervailing factors to this asymmetry. Index funds are seen as the future of investing.[442] They are on track to surpass active fund assets by 2024.[443] These funds merely track a basket of underlying stocks in the market.[444] So, by definition, they will not be undertaking activist strategies. For them, in corporate governance, voting principles will need to be scalable and objectively comparable. These funds use relative share price performance and other objective measures for their voting activities. Although index funds place a large emphasis on ESG, their structural composition strongly determines their voting behavior and support for ESG. This shift is a main catalyst for activists to adopt ESG positions. Index funds will not spend as much time or resources on management engagement, so activists that mirror their policies should see a higher rate of support.

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442. The shift to passive investing is occurring around the world. Adam Zaremba, *The Cross Section of Country Equity Returns: A Review of Empirical Literature*, 12 J. RISK & FIN. MGMT. 165, 165 (2019). Passive funds made up 45% of AUM in equity funds at the end of 2017, while they were at less than 5% in 1995. *Id.* Passively managed funds also hold a rising share of total financial assets. *See* Patrick McCabe, *The Shift From Active to Passive Investing: Potential Risks to Financial Stability?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 29, 2018), https://corpgov.law.harvard.edu/2018/11/29/the-shift-from-active-to-passive-investing-potential-risks-to-financial-stability/ (tracing the global shift towards passive investing). The efficient markets hypothesis led to the questioning of active investing to seek alpha, instead suggesting that investors should hold the market itself. *See generally* Utpal Bhattacharya & Neal Galpin, *The Global Rise of the Value-Weighted Portfolio*, 46 J. FIN. & QUANTITATIVE ANALYSIS 737 (2011) (discussing this evolution); *see also* French, *supra* note 32, at 1558 (explaining that a typical investor would increase average annual return by 67 basis points using a passive market portfolio). This realization has precipitated a sharp growth in index funds. There have also been regulatory and legal innovations. See *supra* notes 30–60 and accompanying text for a more in-depth discussion on this. *See generally* Jill Fisch et al., *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17 (2019) (asserting that passive investors attempt to neutralize active funds' ability to change their investment portfolio and shed underperforming companies by suing their engagement to prevent investor outflow). *But cf.* Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2035 (2019) (discussing the dangers in this shift). The authors argue that index funds have an incentive to under-invest in stewardship and defer excessively to management and suggest several policy proposals, including limiting business relationships with management and having more transparent private engagements. *Id.* at 2037. In their view, index fund managers should tend towards supporting hedge fund activists. *Id.* at 2097.

443. MOODY'S INV'RS SERV., PASSIVE MARKET SHARE TO OVERTAKE ACTIVE IN THE US NO LATER THAN 2024, at 1 (2017) (estimating that this change will occur between 2021 and 2024 and that there still remains plenty of room for global growth in passive funds).

444. Bebchuk & Hirst, *supra* note 442, at 2043–44.

Overall, hedge funds are operating on an increasingly convoluted playing field. In all, these evolutions to the activist landscape should result in a greater number of opportunities to argue for an underperforming company, due to wider latitude around and additions to notions of what constitutes long-term value.[445] But this may occasion a lower success rate because institutional incentives to side with management have been strengthened by increased levels of engagement. [446] The activist environment is evolving, pushed forward by institutional investors. Hedge funds are playing a responsive role, where they need to adapt to keep apace. This change is slowly occurring, and its proliferation will be tested by opportunities to challenge management in the future based on ESG issues.

CONCLUSION

Environmental and social risks are just one piece of an institutional investor-influenced governance structure. Clearly, traditional governance issues—such as board composition and, with the potential retraction of Dodd-Frank protections, executive compensation—remain important engagement matters.[447] However, these are binary issues; it is fairly easy for management to know when they have placated institutional shareholders on these traditional issues. For example, either the board has a majority of outside directors or it does not. Comparatively, for environmental and social issues, approval is much more subjective and ambiguous. For managers, this means they should prioritize contact with their institutional shareholders to ensure compliance.

Institutional investors and managers comprise two pillars in a corporate governance system, and shareholder activists comprise the third. It is in a corporation's best interest to internalize this structure. Their symbiosis and alignment with institutions and asset managers will help in the successful

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445. Of course, this argument is premised on institutional investors actually internalizing these factors into their conception of long-term value. I suspect that financial risks will outweigh these non-financial risks at some point, though the current conception of fiduciary duty does support both. Empiricism, through an increase of ESG shareholder proposals, is telling for the staying power of this expanded conception of long-term value.

446. Many in scholarship are already determining that institutional investors have incentives to side with management. *Supra* note 357 and accompanying text; *see also* Bebchuk & Hirst, *supra* note 442 (arguing that added engagement, comfort, and trust would only exacerbate pro-managerial inclinations).

447. *See generally,* Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213 (2012) (showing the importance of proxy advisors on executive pay proposals and the growing role for shareholders in influencing executive pay practices).

pursuit of long-term value strategies and growth.[448] Institutional investors, as part of their stewardship, should work to understand corporate strategies and operations. These shareholders should increase their engagement to align incentives and understandings.[449] But, management should continue to push engagement, even though it provides *ex ante* influence on directorial and operational action and is time consuming. Consider it a sunk cost of an executorial position. Continual engagement will bring about change through incremental, non-confrontational means,[450] rather than the sharp push delivered by institutionally supported activists. Equally, managerial fiduciary duties run to their shareholders, so engagement should not be construed as a nuisance. Engagement will improve security and strategy continuity over the long-term. It builds trust and facilitates dialogue in search of mutually productive outcomes.[451] The importance of engagement is only going to increase with the current trend towards passive investment vehicles and the focus on ESG.

Certainly, not every manager will be able to reach optimal, or even sufficient, levels of engagement. Some management teams will have limited relationships with institutional shareholders. Prioritizing the largest institutions would be most impactful. But once a sufficient program and practice is developed, it should not be difficult to incorporate all institutional investors into the fold. This could be more troublesome for small market capitalization companies, since they may not have the ability to meet with governance teams at funds who focus on larger portfolio companies. Small-cap companies, unless they are high-growth companies, would also be at a lower risk from activists due to their generation of lower returns. It would still be advisable for these companies to incorporate engagement programs and to increase the linkages with their shareholders beyond regular disclosures and earnings calls.

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448. *See* MARTIN LIPTON, WACHTELL LIPTON ROSEN & KATZ & WORLD ECON. FORUM, THE NEW PARADIGM 3–4 (2017), https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.25960.16.pdf (discussing how investors and corporate management need to work in tandem to "combat short-termism" and grow economic value).

449. *See* Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuk-Strine Debate*, 12 NYU J.L. & BUS. 385, 392–94 (2016) (arguing that a collaborative, engagement-driven approach is best for an economic allocation of resources and allows a company to best sever the tension between seeking long-term value and short-termism).

450. *See id.* at 392 (explaining that this can be more effective than voting for influencing management and bringing about change). Mary Jo White, former Chair of the SEC, agreed, saying in 2013 that direct engagement with a company is more impactful than voting on shareholder proposals. *See* Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Remarks at the 10th Annual Transatlantic Corporate Governance Dialogue (Dec. 3, 2013), https://www.sec.gov/news/speech/2013-spch110313mjw.

451. *See* Andrew C. Wicks et al., *The Structure of Optimal Trust: Moral and Strategic Implications*, 24 ACAD. MGMT. REV. 99, 99 (1999) (explaining that trust between management and stakeholders is a critical part of corporate operations and strategy).

Another, more hazardous, problem that attaches to engagement and ESG is what happens if institutional investors seek changes that management is unwilling or unable to implement. This would seem like a prime opportunity for activists. In the earlier Jana Partners, CalSTRS, and Apple example, the solution was fairly straightforward.[452] Apple has begun to create controls that allow parents to limit their children's phone usage.[453] Starting a research project is also simple for a company with Apple's resources. A more complex case is that of ExxonMobil and climate change. In May 2017, shareholders defeated management in a proxy vote, requiring the energy behemoth to publicly report on measures designed to limit climate change.[454] BlackRock, Vanguard, and State Street all supported the proposal, which garnered 62.3% shareholder approval.[455] The resolution says that the company must now "analyze the impacts on . . . oil and gas reserves and resources under a scenario in which reduction in demand results from carbon restrictions and related rules or commitments adopted by governments consistent with the globally agreed upon 2 degree [Celsius] target."[456] This is a much different case than Jana. Climate change directly affects the core of ExxonMobil's business operations and has a large impact on the company's bottom line. This is not as simple a fix. Here, management and institutions are more directly opposed, and engagement proved fruitless.

As ESG increases in importance, companies whose business rests on values that are not aligned with this progressivism will find themselves under greater pressure. First it will come from institutions and next, if engagement is unsuccessful, from activists. ExxonMobil is a prime example of this. The successful climate change shareholder proposal occurred after a similar, unsuccessful proposal the year before and constant institutional engagement

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452. *See supra* notes 437–39 and accompanying text.

453. Laura Sydell & Charlotte Norsworthy, *Apple Aims to Help Parents Crack Down on Kids' iPhone Use*, NAT'L PUB. RADIO (June 4, 2018), https://www.npr.org/sections/thetwo-way/2018/06/04/616833880/apple-aims-to-help-parents-crack-down-on-kids-iphone-use.

454. Steven Mufson, *Financial Firms Lead Shareholder Rebellion Against ExxonMobil Climate Change Policies*, WASH. POST. (May 31, 2017), https://www.washingtonpost.com/news/energy-environment/wp/2017/05/31/exxonmobil-is-trying-to-fend-off-a-shareholder-rebellion-over-climate-change/?noredirect=on&utm_term=.10952e8c8eb0. This was groundbreaking even beyond the ESG advancement. ExxonMobil management has rarely lost on shareholder resolutions, having been defeated only one other time since 2006. *Id.* For the specific proxy voting results, see U.S. SEC. & EXCH. COMM'N, *Form 8-K: Exxon Mobil Corporation* (June 6, 2017), https://www.sec.gov/Archives/edgar/data/34088/000003408817000031/r8k053117.htm.

455. *Mufson*, *supra* note 454; U.S. SEC. & EXCH. COMM'N, *supra* note 454; *see also* BLACKROCK, SUPPORTING A SHAREHOLDER PROPOSAL FOLLOWING EXTENSIVE MANAGEMENT ENGAGEMENT (2017), https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-exxon-may-2017.pdf (explaining BlackRock's history of engaging with ExxonMobil's management and its reasons for opposing management on the climate change shareholder proposal).

456. Mufson, *supra* note 454 (second alteration in original).

in the intervening period.[457] While ExxonMobil did not attract an activist hedge fund, this is because it is unlikely that such a large market capitalization company would become a target. After all, ExxonMobil is second on the Fortune 500 list.[458] Slightly smaller companies, even if they are large-cap firms, would be much more likely to be targeted.

Overall, activism has become frequent and acute in the corporate landscape. In 2014, activists succeeded in 73% of proxy contests for board seats in the U.S., a dramatic increase over 2012's 52% success rate.[459] Both underperforming and successful companies are at risk.[460] These trends have placed even more power in the hands of institutional shareholders and also in the proxy advisory firms that serve them.[461] Even though certain activist campaigns may be anathema to these large institutions,[462] the existence of the activist threat has itself helped attain long-term value.

Without the threat of activist upheaval, managers would not be as incentivized to engage with institutional shareholders. So, regardless of whether activists themselves bring long-term value, they still play an influential role in the market for corporate control,[463] affecting all other players. Their threats provide the pivot for institutions to effect change and engage with incumbent officers and directors. As institutions adjust and amend their conceptions of preferred strategies for creating long-term value, as is presently the case with ESG issues, managers are required to notice and respond accordingly. Failing to anticipate and address these issues may well proactively invite an inevitable barrage of activist challengers.

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457. BLACKROCK, *supra* note 455.

458. *Fortune 500*, FORTUNE, https://fortune.com/fortune500 (last visited Apr. 17, 2020) (ranking ExxonMobil only behind Walmart for 2019).

459. David Benoit & Kirsten Grant, *Activists Investors' Secret Ally: Big Mutual Funds*, WALL ST. J. (Aug. 9, 2015), https://www.wsj.com/articles/activist-investors-secret-ally-big-mutual-funds-1439173910. Along with this, they found that activists captured one or more board seats at a record 107 companies in 2014. *Id.*

460. J.P. MORGAN, THE ACTIVIST REVOLUTION, *supra* note 150, at 11.

461. The topic of proxy advisors is beyond the scope of this paper. *See generally* David F. Larcker et al., *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173 (2015) (describing how the increased outsourcing to, and influence of, proxy advisory firms results in boards of directors choosing strategies that decrease shareholder value). *But cf.* Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869 (2010) (finding that when accounting for company- and firm-specific factors, the influence of ISS is greatly overstated). The authors estimate that an ISS recommendation shifts 6% to 10% of shareholder votes. *Id.* at 906.

462. Bebchuk et al., *Agency Problem, supra* note 18, at 105.

463. *See generally, e.g.*, Adrian A. Corum & Doron Levit, *Corporate Control Activism*, 133 J. FIN ECON. 1 (2019) (highlighting the complementarity between shareholder activism and takeovers). *See also* Christie, *supra* note 385, at 3 (arguing that activist board representation has created a power greater than influence, but that falls short of actual corporate control); Martynova & Renneboog, *supra* note 142, at 2151 (providing an overview of historical takeover waves and attendant endogenous and exogenous conditions).