Investor Activism: Reshaping the Playing Field?

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In recent years, there have been a number of efforts to extend the shareholder franchise. The major stock exchanges, for example, have implemented new listing standards expanding the number of corporate compensation plans that must be approved by shareholders. (E.g., NYSE § 3.12.) As of this writing, the Securities and Exchange Commission (SEC) is still at least nominally considering a proposal to permit shareholders, under limited circumstances, to nominate directors and have their nominees listed in the company's proxy statement and on its proxy card. In addition, on July 25, 2007, the SEC issued two new, conflicting rule proposals regarding "proxy access," potentially a valuable tool in the activists' arsenal. This paper considers the following questions:

- What are the arguments for and against "democratization" of the proxy?
- How will such power, if granted, be used by activists to affect both the structure of corporate governance and the strategic operations of the corporation?
- To what extent do activist investors have objectives for the firm that differ from those of passive investors (e.g., social responsibility versus profit maximization)

and how will this affect corporate performance, economic efficiency, and economic growth?

Under current law, shareholder voting rights are sharply limited. Under the Delaware code, for example, shareholder voting rights are essentially limited to the election of directors and approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution. (Dooley 1995, 174-77) As a formal matter, only the election of directors and amending the bylaws do not require board approval before shareholder action is possible. (Del. Code Ann., tit. 8, §§ 109, 211) In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board. (Manning 1958, 1485-89)

These direct restrictions on shareholder power are supplemented by a host of other rules that indirectly prevent shareholders from exercising significant influence over corporate decision making. Three sets of statutes are especially noteworthy: (1) disclosure requirements pertaining to large holders;[1] (2) shareholder voting and communication rules;[2] and (3) insider trading and

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[1] Securities Exchange Act § 13(d) and the SEC rules thereunder require extensive disclosures from any person or group acting together which acquires beneficial ownership of more than 5 percent of the outstanding shares of any class of equity stock in a given issuer. 15 U.S.C. § 78m. The disclosures required by § 13(d) impinge substantially on investor privacy and thus may discourage some investors from holding blocks greater than 4.9% of a company's stock. U.S. institutional investors frequently cite Section 13(d)'s application to groups and the consequent risk of liability for failing to provide adequate disclosures as an explanation for the general lack of shareholder activism on their part. (Black 1998, 461)

[2] To the extent shareholders exercise any control over the corporation, they do so only through control of the board of directors. As such, it is the shareholders' ability to affect the election of directors that determines the degree of influence they will hold over the corporation. The proxy regulatory regime discourages large shareholders from seeking to replace incumbent directors with their own nominees. (Bainbridge 1992, 1075-84 (describing incentives against proxy contests)) It also discourages shareholders from communicating with one another. (Choi 2000

short swing profits rules. These laws affect shareholders in two respects. First, they discourage the formation of large stock blocks.[3] Second, they discourage communication and coordination among shareholders.

In Defense of the Separation of Ownership and Control

The laws just described help de facto codify the phenomenon famously associated with Adolf Berle and Gardiner Means' 1932 book THE MODERN CORPORATION AND PRIVATE PROPERTY; namely, that public corporations are characterized by a separation of ownership and control. The corporation's nominal owners, the shareholders, exercised virtually no control over either day to day operations or long-term policy. Instead, control is vested in the board of directors and the professional managers to whom the board delegates authority, neither of which group typically owns more than a small portion of the firm's shares.

According to Berle and Means, dispersed shareholder ownership arose as a consequence of the development of large capital-intensive industrial corporations during the late-19th century. These firms required capital investments far greater than any single entrepreneur could provide; instead, the capital they required could be raised only by attracting funds from many investors. Because investors recognized the necessity of diversification, even very wealthy individuals limited the amount they put at risk in any given firm, which further fragmented share ownership.

(explaining that liberalization of the proxy rules has not significantly affected shareholder communication practices))

[3] Large block formation may also be discouraged by state corporate law rules governing minority shareholder protections. Under Delaware law, a controlling shareholder has fiduciary obligations to the minority. See, e.g., Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947). A controlling shareholder who uses its power to force the corporation to enter into contracts with the shareholder or its affiliates on unfair terms can be held liable for the resulting injury to the minority. See, e.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971). A controlling shareholder who uses its influence to effect a freeze-out merger in which the minority shareholders are bought out at an unfairly low price likewise faces liability. See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

Walter Werner dismissed important aspects of the Berle and Means account by pejoratively referring to their claims as the "erosion doctrine." As he explained, Berle and Means erroneously believed there had been a time when the corporation behaved as it was supposed to:

> The shareholders who owned the corporation controlled it. They elected a board of directors to whom they delegated management powers, but they retained residual control, uniting control and ownership. In the nation's early years the states created corporations sparingly and regulated them strictly. The first corporations, run by their proprietors and constrained by law, exercised state-granted privileges to further the public interest. The states then curtailed regulation ..., and this Eden ended. The corporation expanded into a huge concentrate of resources. Its operation vitally affected society, but it was run by managers who were accountable only to themselves and could blink at obligations to shareholders and society. (Werner 1981, 1612)

In contrast, Werner demonstrated that the separation of ownership and control in fact was a feature of American corporations from the earliest periods: "Banks, and the other public-issue corporations of the [pre-Civil War] period, contained the essential elements of big corporations today: a tripartite internal government structure, a share market that dispersed shareholdings and divided ownership and control, and tendencies to centralize management in full-time administrators and to diminish participation of outside directors in management." (Werner 1981, 1637)

If this version of history is correct, there never was a time in which unity of control and ownership was a central feature of American public corporations. To the contrary, it appears that ownership and control separated at a very early date. In turn, this analysis suggests that the separation of ownership and control may be an essential economic characteristic of such corporations.

What survival value does the separation of ownership and control confer? In brief, it creates a central decision-making body vested with the power of fiat. To be sure, Armen Alchian and Harold Demsetz famously claimed that the firm "has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people." (Alchian and Demsetz 1972, 777) Hence, Alchian and Demsetz argued, an employer's control over its employees differs not all from the power of a consumer over the grocer with whom the consumer does business.

If they were right, however, the firm would be nothing more than a quasi-market arena within which a set of contracts between various factors of production are constantly renegotiated. It is not. Power exists within firms, however, and it matters. The corporation has a nexus—and that nexus wields a power of fiat different from that of a consumer over a grocer. Indeed, fiat is the chief characteristic that distinguishes firms from markets. As Ronald Coase explained long ago, firms emerge when it is efficient to substitute entrepreneurial fiat for the price mechanisms of the market. (Coase 1937) By creating a central decision maker—a nexus—with the power of fiat, the firm thus substitutes ex post governance for ex ante contract.

Granted, coordination can be achieved without fiat, as demonstrated by the democratic decision-making processes of many partnerships and other small firms. As the contrast between such firms and the public corporation illustrates, governance arrangements fall out on a spectrum between "consensus" and "authority." (Arrow 1974, 68-69) Authority-based decision-making structures are characterized by the existence of a central office empowered to make decisions binding on the firm as a whole and tend to arise when the organization's constituencies have different interests and access to information.

Unlike partnerships and some other small firms, public corporations are rife with asymmetries of information and interests among their various constituencies. Shareholders care about the value of the residual claim on the corporation. Customers care about the quality and quantity of the goods produced by the corporation. Workers care about salary and conditions of employment. And so on. Under such conditions, efficient decision making demands an authority-based governance structure.

This is true even though corporation law confers rights to participate in corporate governance only to shareholders. Overcoming the collective action problems presented when one is dealing with many thousands of shareholders would be difficult and costly, of course, if not impossible. Even if one could do so, moreover, shareholders lack both the information and the incentives necessary to make sound decisions on either operational or policy questions. Under these conditions, it is "cheaper and more efficient to transmit all the pieces of information to a central place" and to have the central office "make the collective choice and transmit it rather than retransmit all the information on which the decision is based." (Arrow 1974, 68-69) Accordingly, shareholders will prefer to irrevocably delegate decision-making authority to some smaller group; namely, the board of directors. In every, state the law thus provides that the business and management of the firm shall be conducted by or under the supervision of the board of directors.

To be sure, the separation of ownership and control creates a principal-agent problem, as Berle and Means explained: "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge." (Berle and Means 1932, 6) Associated with the shareholders' purchase of the residual claim on the corporation’s assets and profits is an obligation on the part of the board of directors and managers to maximize shareholder wealth. Given human nature, it would be surprising indeed if the board of directors (or some members thereof) did not occasionally use its control of the corporation to increase their own wealth rather than that of the shareholders. Consequently, much of corporate law is best understood as a mechanism for constraining agency costs.

Having said that, however, most corporate governance specialists are far too preoccupied with agency costs. In the first instance, corporate managers operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by firm agents.

In the second, agency costs are the inescapable result of placing ultimate decision-making authority in the hands of someone other than the residual claimant. The law could substantially reduce agency costs by eliminating discretion. That the law does not do so implies that discretion has substantial virtues.

A complete theory of the firm thus requires one to balance the virtues of discretion against the need to require that discretion be used responsibly. Neither the power to wield discretionary authority nor the necessity to ensure that power is used responsibly can be ignored, because both promote values essential to the survival of business organizations. (Dooley 1992, 471) Unfortunately, however, they also are antithetical. Because the power to hold to account differs only in degree and not in kind from the power to decide, one cannot have more of one without also having less of the other. As Kenneth Arrow explained:

> [Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict

> and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem. (Arrow 1974, 78)

Hence, directors cannot be held accountable without undermining their discretionary authority.

The principal argument against shareholder activism follows ineluctably from this line of analysis. The chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, but rather that it provides a hierarchical decision-making structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm, someone must be in charge: "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success." (Arrow 1974, 69) While some argue that shareholder activism "differs, at least in form, from completely *shifting* authority from managers to" investors (Roe 1994, 184), it is in fact a difference in form only. Shareholder activism necessarily contemplates that institutions will review management decisions, step in when management performance falters, and exercise voting control to effect a change in policy or personnel. For the reasons identified above, giving investors this power of review differs little from giving them the power to make management decisions in the first place. Even though investors probably would not micromanage portfolio corporations, vesting them with the power to review board decisions inevitably shifts some portion of the board's authority to them. This remains true even if only major decisions of A are reviewed by B.

If the foregoing analysis has explanatory power, it might fairly be asked, why does the law impose any restrictions on the powers of corporate takeovers or any prospect for them to be ousted in a takeover or proxy contest? Put another way, why does the law provide any right for shareholders to vote?

In the purest form of an authority-based decision-making structure, all decisions in fact would be made by a single, central body—here, the board of directors. If authority were corporate law's sole value, shareholders thus in fact likely would have no voice in corporate decision making. As noted above, however, authority is not corporate law's only value, because there must be some mechanism for ensuring director accountability with respect to the shareholders' contractual right requiring the directors to use shareholder wealth maximization as their principal decision-making norm. Like many intra-corporate contracts, the shareholder wealth maximization norm does not lend itself to judicial enforcement except in especially provocative situations. Instead, it is enforced indirectly through a complex and varied set of extrajudicial accountability mechanisms, of which shareholder voting is just one.

Importantly, however, like all accountability mechanisms, shareholder voting must be constrained in order to preserve the value of authority. As Arrow observes:

> To maintain the value of authority, it would appear that [accountability] must be intermittent. This could be periodic; it could take the form of what is termed "management by exception," in which authority and its decisions are reviewed only when performance is sufficiently degraded from expectations.... (Arrow 1974, 78)

Accordingly, shareholder voting is properly understood not as an integral aspect of the corporate decision-making structure, but rather as an accountability device of last resort to be used sparingly, at best. Indeed, as Robert Clark observes, the proper way in which shareholder voting rights are used to hold corporate directors and officers accountable is not through the exercise of individual voting decisions but rather collectively in the context of a takeover. (Clark 1986, 95) Because shares are freely transferable, a bidder who believes the firm is being run poorly can profit by offering to buy a controlling block of stock at a premium over market and subsequently displacing the incumbent managers, which presumably will result in an increase in firm value exceeding the premium the bidder paid for control. Hence, just as one might predict based on Arrow's analysis, shareholder voting properly comes into play as an accountability mechanism only "when [management] performance is sufficiently degraded from expectations" to make a takeover fight worth waging.[4]

In sum, given the significant virtues of discretion, one ought not lightly interfere with management or the board's decision-making authority in the name of accountability. Indeed, the claim should be put even more strongly: Preservation of managerial discretion should always be default presumption. Because the separation of ownership and control mandated by U.S. corporate law has precisely that effect, by constraining shareholders both from reviewing most board decisions and from substituting their judgment for that of the board, that separation has a strong efficiency justification.

The Rise of Institutional Investors

Does the foregoing analysis change when we take into account the rise of institutional investors? Since the early 1990s, various commentators have argued that institutional investor corporate governance activism could become an important constraint on agency costs in the corporation. (E.g., Black 1990; Roe 1994)

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[4] Space does not permit an evaluation here of whether shareholders therefore ought to have unfettered rights to accept any takeover offer or, to put it another way, whether the board of directors properly has a gate-keeping function even with respect to corporate takeovers. For a discussion of that issue, see Bainbridge 2006b.

The Theory

Institutional investors, they argued, will approach corporate governance quite differently than individual investors. Because institutions typically own larger blocks than individuals, and have an incentive to develop specialized expertise in making and monitoring investments, the former should play a far more active role in corporate governance than dispersed shareholders. Their greater access to firm information, coupled with their concentrated voting power, should enable them to more actively monitor the firm's performance and to make changes in the board's composition when performance lagged. Corporations with large blocks of stock held by institutional investors thus might reunite ownership of the residual claim and ultimate control of the enterprise. As a result, concentrated ownership in the hands of institutional investors might lead to a reduction in shirking and, hence, a reduction in agency costs.

In Practice

In the early 1990s, it seemed plausible that the story might eventually play out. Institutional investors increasingly dominated U.S. equity securities markets. They also began to play a somewhat more active role in corporate governance than they had in earlier periods: taking their voting rights more seriously and using the proxy system to defend their interests. They began voting against takeover defenses proposed by management and in favor of shareholder proposals recommending removal of existing defenses. Many institutions also no longer routinely voted to reelect incumbent directors. Less visibly, institutions influenced business policy and board composition through negotiations with management. But while there seemed little doubt that institutional investor activism could have effects at the margins, the question remained whether the impact would be more than merely marginal.

By the end of the 1990s, the answer seemed to be no. A comprehensive survey found relatively little evidence that shareholder activism mattered.[5] (Black 1998) Even the most active institutional investors spent only trifling amounts on corporate governance activism. Institutions devoted little effort to monitoring management; to the contrary, they typically disclaimed the ability or desire to decide company-specific policy questions. They rarely conducted proxy solicitations or put forward shareholder proposals. They did not seek to elect representatives to boards of directors. They rarely coordinated their activities. Most importantly, empirical studies of U.S. institutional investor activism found "no strong evidence of a correlation between firm performance and percentage of shares owned by institutions." (Black 1998, 462)

A more recent literature review analyzed empirical studies measuring "short-term stock market reactions to announcement of shareholder initiatives, longer-term stock market and operating performance, outcomes of votes on shareholder proposals, and changes in corporate strategy and investment decisions in response to activism." Event studies of shareholder proposals and announcements of other forms of shareholder activism generally found no statistically significant abnormal returns to shareholders, although some studies of various subsamples found significant returns. Results of long-term performance studies have been "mixed," but virtually all find no statistically significant changes in operating performance. (Gillian and Starks)

Today, although conventional wisdom is to the contrary, institutional investor activism remains rare. It is principally the province of union and state and local public employee pension

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[5] Due to a resurgence of direct individual investment in the stock market, motivated at least in part by the day trading phenomenon and technology stock bubble, the trend towards institutional domination stagnated. Large blocks held by a single investor remained rare. Few U.S. corporations had any institutional shareholders who owned more than 5-10% of their stock.

funds. But while these investors' activities generate considerable press attention, they can hardly be said to have reunited ownership and control. Indeed, the extent to which public pension funds engage in shareholder activism varies widely. Much public pension fund activism, moreover, takes the form of securities fraud litigation rather than corporate governance activities. Most funds have demonstrated little interest in such core governance activities as nominating directors or making shareholder proposals.[6] (Choi and Fisch 2007)

Even Institutions are Rationally Apathetic

One should not be surprised that most institutions appear to be just as apathetic as individual shareholders. Because institutional investors generally are profit maximizers, they will not engage in an activity whose costs exceed its benefits. Even ardent proponents of institutional investor activism concede that institutions are unlikely to be involved in day-to-day corporate matters. Instead, they are likely to step in only where there are serious long-term problems. Even in such cases, however, many institutions will still find corporate governance activism to be unattractive because activism often is unlikely to be availing. In some cases, intervention will come too late. In others, the problem may prove intractable, as where technological changes undercut the firm's competitive position.

Turning to the cost side of the equation, because it is impossible to predict ex ante which corporations are likely to experience such problems, activist institutions will be obliged to

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[6] The chief exception to that rule, as of this writing, is an apparent increase in the willingness of private hedge funds to exercise the limited control rights granted shareholders. A recent study by Robin Greenwood confirms the growing impact of activism by such funds, but also finds that hedge fund managers generally are poorly suited to making operational business decisions and, with their short-term focus, are unlikely "to devote time and energy to a task delivering long-term value. After all, there are no guarantees that the effort will pay off, or that other shareholders would recognize the increase in value by paying a higher price per share." Instead, hedge funds profit mainly through corporate control—rather than corporate governance—activism. (Greenwood 2007)

monitor all of their portfolio firms.[7] Because corporate disclosures rarely give one a full picture of the corporation's prospects, moreover, additional and more costly monitoring mechanisms must be established.

In any case, monitoring costs are just the price of entry for activist institutions. Once they identify a problem firm, steps must be taken to address the problem. In some cases, it may suffice for the activist institution to propose some change in the rules of the game, but less tractable problems will necessitate more extreme remedial measures, such as removal of the incumbent board of directors.

In public corporations with dispersed ownership of the sort under debate here, such measures necessarily require the support of other shareholders, which makes a shareholder insurrection against inefficient but entrenched managers a costly and difficult undertaking. Putting together a winning coalition will require, among other things, ready mechanisms for communicating with other investors. Unfortunately, SEC rules on proxy solicitations, stock ownership disclosure, and controlling shareholder liabilities have long impeded communication and collective action. Even though the 1992 SEC rule amendments somewhat lowered the barriers to collective action, important impediments remain. (Choi 2000)

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[7] It is for this reason that Professor Black's economies of scale arguments fail. Black contends that activist investors will find that monitoring issues cut across a wide range of companies, which permits them to make use of economies of scale by developing standard responses to managerial derelictions, while non-activist investors can obtain economies of scale by developing standardized voting procedures. (Black 1990) If institutional activism is more likely to take the form of crisis intervention, however, such economies of scale are unlikely to obtain because different crises will necessitate differing responses. At most, institutions might adopt standard voting practices on issues such as takeover defenses, which is a low-cost technique consistent with observed institutional behavior. It is also consistent with the thesis that only marginal effects should be expected from institutional activism.

Yet even if there were further erosion in the barriers to shareholder communication, coordinating shareholder activism may remain a game not worth playing, because the benefits are low. Because many companies must be monitored, and because careful monitoring of an individual firm is expensive, institutional activism is likely to focus on crisis management. In many crises, however, institutional activism is unlikely to be availing. In some cases, intervention will come too late. In others, the problem may prove intractable, as where technological changes undercut the firm's competitive position.

Even where gains might arise from activism, only a portion of the gains would accrue to the activist institutions. Suppose that the troubled company has 110 outstanding shares, currently trading at $10 per share, of which the potential activist institution owns ten. The institution correctly believes that the firm's shares would rise in value to $20 if the firm's problems are solved. If the institution is able to effect a change in corporate policy, its ten shares will produce a $100 paper gain when the stock price rises to reflect the company's new value. All the other shareholders, however, will also automatically receive a pro rata share of the gains.[8] As a result, the activist institution confers a gratuitous $1,000 benefit on the other shareholders.

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[8] One could plausibly expect institutions to surmount this problem by seeking private benefits, which makes investor activism even less appealing. Instructively, one of the most high profile successes of shareholder activism was the effort to get investors to withhold authority for their shares to be voted to elect directors at Disney's 2004 annual shareholder meeting. In that case, however, the campaign had a central organizing figure—Roy Disney—with a private motivation for doing so. Even then, as the Economist reported on July 16, 2005, a plurality of the shares was voted to re-elect the incumbent board. It is also instructive that, according to subsequent press accounts, Disney management later persuaded Roy Disney to drop his various lawsuits against the board and sign a five year standstill agreement pursuant to which he would not run an insurgent slate of directors in return for being named a Director Emeritus and consultant to the company, which nicely illustrates how a company can buy off the requisite central coordinator when that party has a private agenda.

As a result, free riding is highly likely. In a very real sense, the gains resulting from institutional activism are a species of public goods. They are costly to produce, but because other shareholders cannot be excluded from taking a pro rata share, they are subject to a form of non-rivalrous consumption. As with any other public good, the temptation arises for shareholders to free ride on the efforts of those who produce the good.

Granted, if stock continues to concentrate in the hands of large institutional investors, there will be a marginal increase in the gains to be had from activism and a marginal decrease in its costs. A substantial increase in activism seems unlikely to result, however. Most institutional investors compete to attract either the savings of small investors or the patronage of large sponsors, such as corporate pension plans. In this competition, the winners generally are those with the best relative performance rates, which makes institutions highly cost-conscious. Given that activism will only rarely produce gains, and that when such gains occur they will be dispensed upon both the active and the passive, it makes little sense for cost-conscious money managers to incur the expense entailed in shareholder activism. Instead, they will remain passive in hopes of free riding on someone else's activism. As in other free riding situations, because everyone is subject to and likely to yield to this temptation, the probability is that the good in question—here shareholder activism—will be under-produced.

In addition, corporate managers are well-positioned to buy off most institutional investors that attempt to act as monitors. Bank trust departments are an important class of institutional investors, but are unlikely to emerge as activists because their parent banks often have or anticipate commercial lending relationships with the firms they will purportedly monitor.

In contrast, when CalPERS, the biggest institutional investor of them all, struck out on its own in 2004, withholding its shares from being voted to elect directors at no less than 2700 companies, including Coke director and legendary

Similarly, insurers "as purveyors of insurance products, pension plans, and other financial services to corporations, have reason to mute their corporate governance activities and be bought off." (Roe 1994, 62) Mutual fund families whose business includes managing private pension funds and 401(k) plans for corporations are subject to the same concern.

This leaves us with union and state and local pension funds, which in fact generally have been the most active institutions with respect to corporate governance issues. (Thomas and Martin 1998, 51-52) Unfortunately for the proponents of institutional investor activism, however, these are precisely the institutions most likely to use their position to self-deal—i.e., to take a non-pro rata share of the firms assets and earnings—or to otherwise reap private benefits not shared with other investors. With respect to union and public pension fund sponsorship of shareholder proposals under existing law, Roberta Romano observes that:

> It is quite probable that private benefits accrue to some investors from sponsoring at least some shareholder proposals. The disparity in identity of sponsors—the predominance of public and union funds, which, in contrast to private sector funds, are not in competition for investor dollars—is strongly suggestive of their presence. Examples of potential benefits which would be disproportionately of interest to proposal sponsors are progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers, as well as advancements in personal employment. … Because such career concerns—enhancement of political reputations or subsequent employment opportunities—do not provide a commensurate benefit to private fund managers, we do not find them engaging in investor activism. (Romano 2001, 231-32)

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investor Warren Buffet, press accounts made clear that the project went nowhere.

This is not just academic speculation. The pension fund of the union representing Safeway workers, for example, used its position as a Safeway shareholder in an attempt to oust directors who had stood up to the union in collective bargaining negotiations. Nor is this an isolated example. Union pension funds tried to remove directors or top managers, or otherwise affect corporate policy, at over 200 corporations in 2004 alone. Union pension funds reportedly have also tried shareholder proposals to obtain employee benefits they couldn't get through bargaining. (Bainbridge 2006a, 1755)

Public employee pension funds are even more vulnerable to being used as a vehicle for advancing political/social goals unrelated to shareholder interests generally. According to the Los Angeles Times, for example, activism in the 2004-2005 period by CalPERS was being "fueled partly by the political ambitions of Phil Angelides, California's state treasurer and a CalPERS board member, who [later ran] for governor of California in 2006."

More generally, using public pension fund investments to support socially responsible investments long has been a particularly popular program of politicians and others on the left. Some have gone so far as to suggest that "the road to socialism, or some substantial socialization of the investment process, might lie through an expanded, publicly regulated system of pension finance." (Simon 1993, 166) Somewhat to the right of that position was President Clinton's call for a "Rebuild America Fund," which would have leveraged federal funding by tapping "state, local, private sector, and pension fund contributions." (Clinton and Gore 1992, 144) Although that proposal never came to fruition, the Wall Street Journal reported in September 1994 that the Clinton Department of Labor planned to encourage pension funds to make "economically targeted investments" in such areas as infrastructure, housing and job creation.

To be sure, like any other agency cost, the risk that management will be willing to pay private benefits to an institutional investor is a necessary consequence of vesting discretionary authority in the board and the officers. It does not compel the conclusion that we ought to limit the board's power. It does suggest, however, that we ought not to give investors even greater leverage to extract such benefits by further empowering them.

Rearranging the Deck Chairs

The analysis to this point suggests that the costs of institutional investor activism likely outweigh any benefits such activism may confer with respect to redressing the principal-agent problem. Even if one assumes that the cost-benefit analysis comes out the other way around, however, it should be noted that institutional investor activism does not solve the principal-agent problem but rather merely relocates it locus.

The vast majority of large institutional investors manage the pooled savings of small individual investors. From a governance perspective, there is little to distinguish such institutions from corporations. The holders of investment company shares, for example, have no more control over the election of company trustees than they do over the election of corporate directors. Accordingly, fund shareholders exhibit the same rational apathy as corporate shareholders. As amusing illustration was provided by a 1994 Wall Street Journal article, which reported that Kathryn McGrath, a former SEC mutual fund regulator, had admitted that a "lot of shareholders take ye olde proxy and throw it in the trash." The proxy system thus "costs shareholders money for rights they don't seem interested in exercising." Indeed, McGrath herself conceded that she "often tosses a proxy for a personal investment onto a 'to-do pile' where 'I don't get around to reading it, or when I do, the deadline has passed.'" Nor do the holders of such shares have any greater access to information about their holdings, or ability to monitor those who manage their holdings, than do corporate shareholders. Worse yet, although an individual investor can always abide by the Wall Street Rule with respect to corporate stock, he cannot do so with respect to such investments as an involuntary, contributory pension plan.

For beneficiaries of union and state and local government employee pension funds, the problem is particularly pronounced. As we have seen, those who manage such funds may often put their personal or political agendas ahead of the interests of the fund's beneficiaries. Accordingly, it is not particularly surprising that pension funds subject to direct political control tend to have poor financial results. (Romano 1993, 825)

Conclusion

If the separation of ownership and control is a problem in search of a solution, encouraging institutional investors to take an active corporate governance role simply moves the problem back a step: it does not solve it. Yet, it is not at all clear that the separation of ownership and control is a pathology requiring treatment. As we have seen, the system of corporate governance is designed to function largely without shareholder input and, despite the bad press corporate capitalism has gotten in recent years, the system works pretty well. As the Wall Street Journal explained in a 2003 article:

> The economy and stock market have performed better in recent years than any other on earth. "How can we have done marvelously if the system is fundamentally flawed?" [economist Bengt] Holmstrom asks. If the bulk of American executives were stealing from shareholders and financial markets were rigged, they reason, then capital would flow to the wrong places and productivity wouldn't be surging.

Holmstrom and Kaplan likewise concluded that:

> Despite the alleged flaws in its governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries. U.S. productivity gains in the past decade have been exceptional, and the U.S. stock market has consistently outperformed other world indices over the last two decades, including the period since the scandals broke. In other words, the broad evidence is not consistent with a failed U.S. system. If anything, it suggests a system that is well above average. (Holmstrom and Kaplan 2003, 1)

Accordingly, if one may invoke an old adage: if it ain't broke, don't fix it.

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