



Investor Activism: Reshaping the Playing Field?

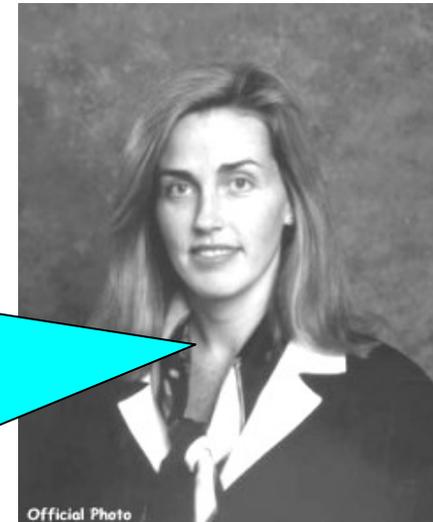
Stephen M. Bainbridge
Federal Reserve Bank of Atlanta
Financial Markets Conference
May 14, 2008 - Sea Island, Georgia

Complaints about the Field

"The battle centers on shareholders' access to proxy proposals that are voted on by investors at annual meetings. As usual, the combatants are investors who own American companies and the hired hands who run them.

"As *owners*, shareholders should be able to nominate directors to a company's board when current representatives are failing in their fiduciary duties."

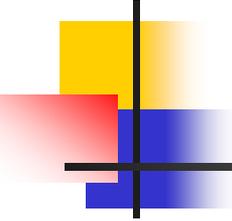
--Gretchen Morgenson, NY Times





Changing the Shape of the Field?

The Shift from Individuals to Institutions

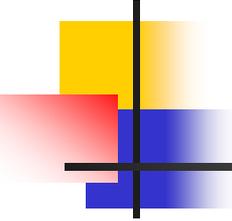


Reshaping the Field: The Agenda

- SEC Chairman Cox, Remarks to the 'SEC Speaks in 2008' Program
 - "One important rulemaking effort will be a continuation of ... making the federally-regulated proxy system fit better with the state-authorized rights of shareholders to determine the directors of the companies they own."
 - I.e., Rule 14a-8 and the access question
- Shareholder proposals:
 - Say on pay
 - Majority voting for directors

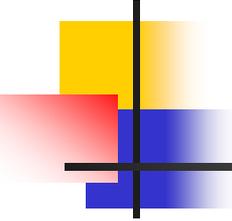
Why

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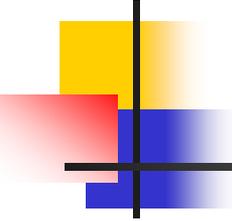
The Case for Activism

- Separation of ownership and control (Berle & Means)
 - Managers run firms
- Agency costs pervasive
 - Managers shirk – don't maximize shareholder wealth
 - Breaches "the deal"
 - Deal hard to enforce judicially
- Many market constraints on agency costs ineffective
 - E.g., demise of hostile takeovers
- Monitoring by investors could constrain agency costs



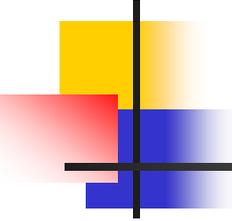
The Traditional Shape of the Field: Rational Apathy

- Individual shareholders lack sufficient equity stakes to justify spending resources to closely monitor managers
 - Why shoulder the entire expense of activism for only a small portion of the gains, while inactive shareholders get a “free-ride”?



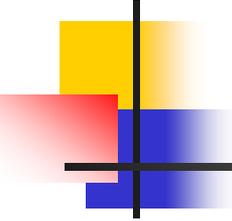
Will Institutions Reshape the Field?

- Various commentators argue that institutional investor corporate governance activism could become an important constraint on agency costs in the corporation.
 - Institutional investors, they argue, 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.
 - 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.



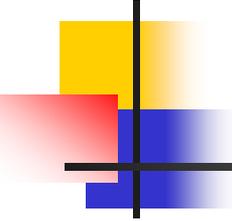
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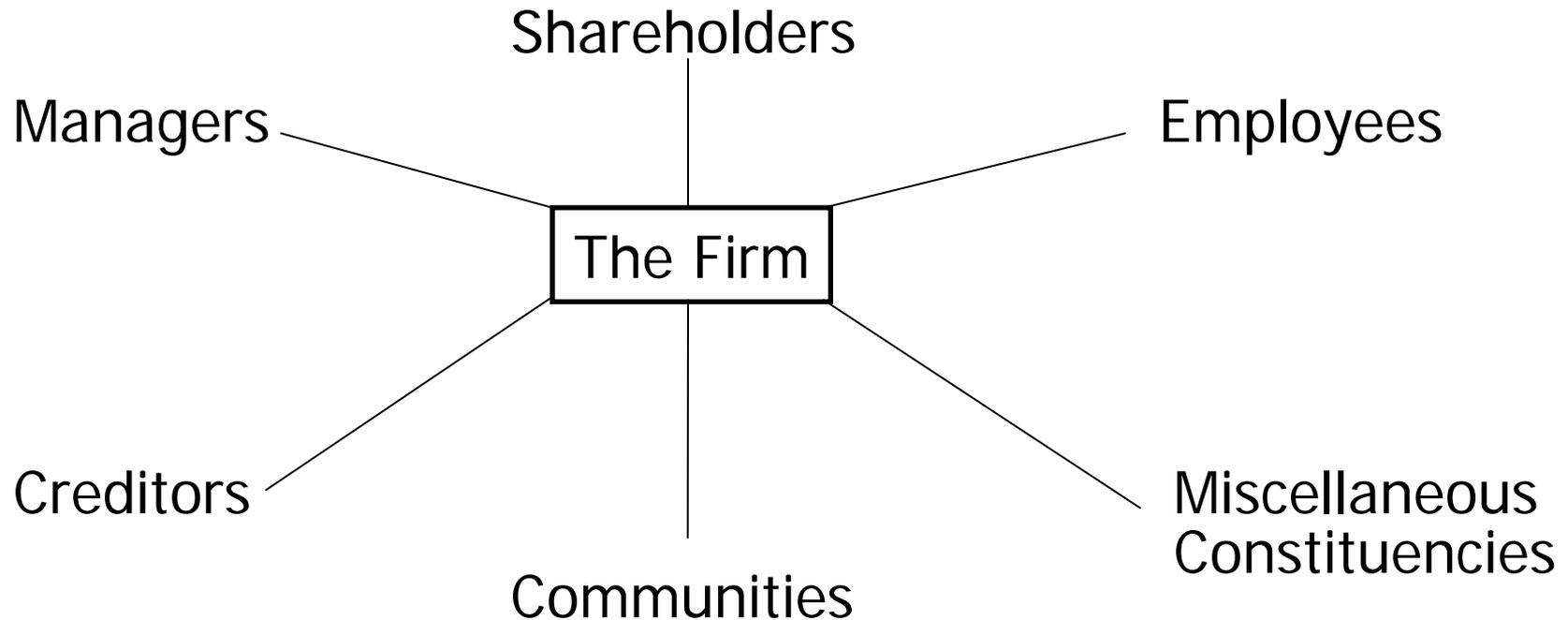
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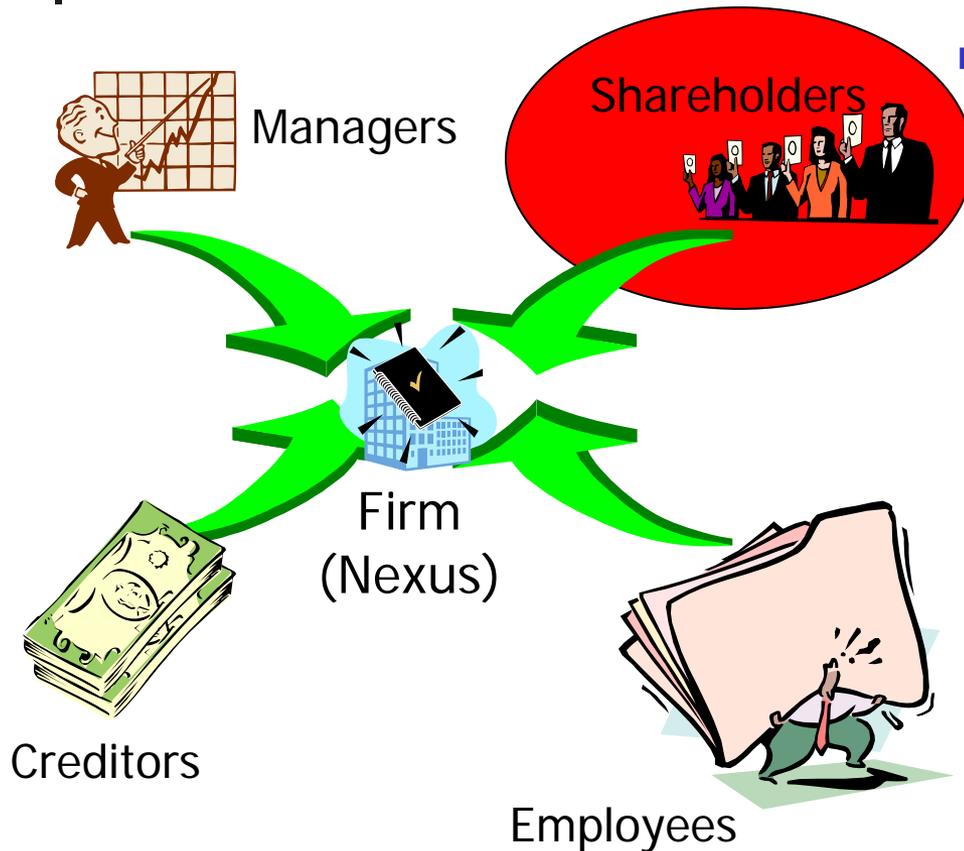
Activism in a Theoretical Framework

Director versus Shareholder Primacy

“A corporation is just a nexus of contracts, subject to rearrangement in many ways.” Central States, Southeast and Southwest Areas Pension Fund v. Sherwin-Williams Co., 71 F.3d 1338, 1341 (7th Cir. 1995)



The Contractarian View

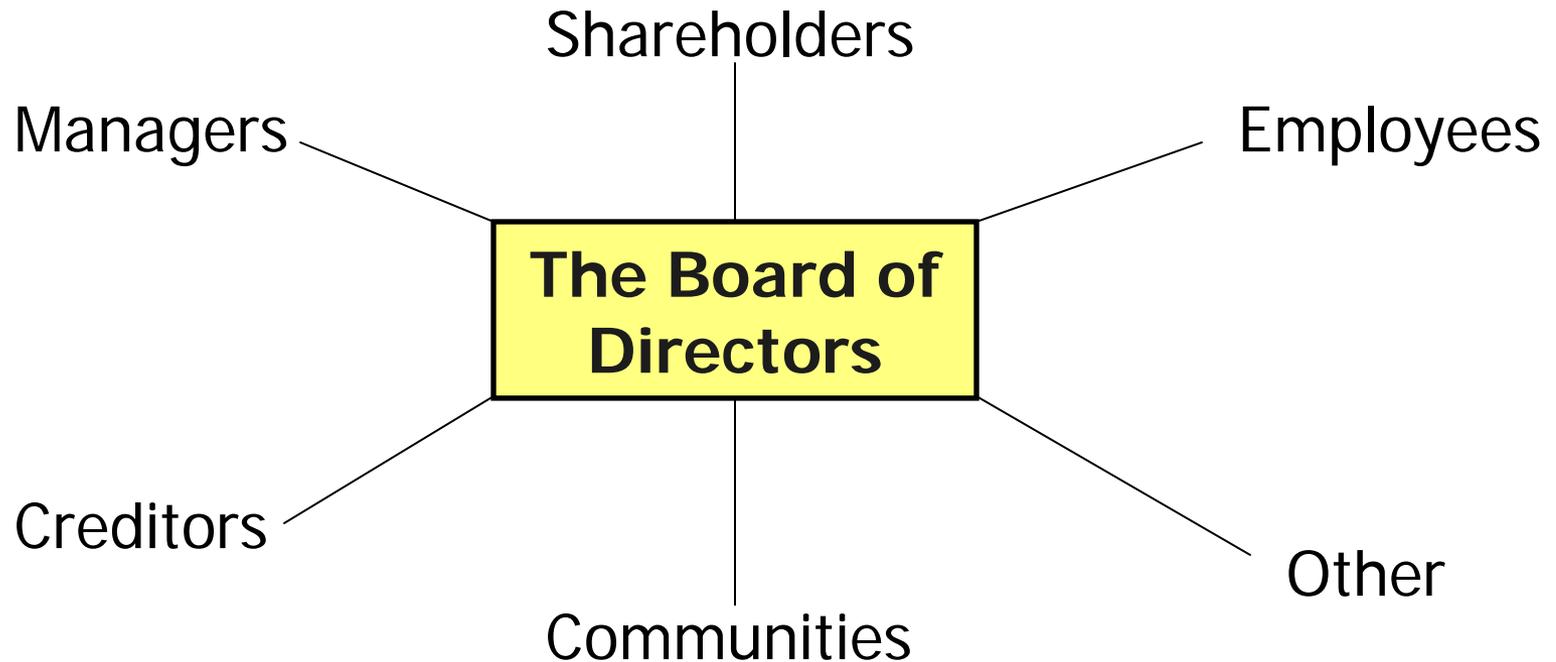


- Nexus of contracts model allows (requires) us to rethink intra-corporate relationships

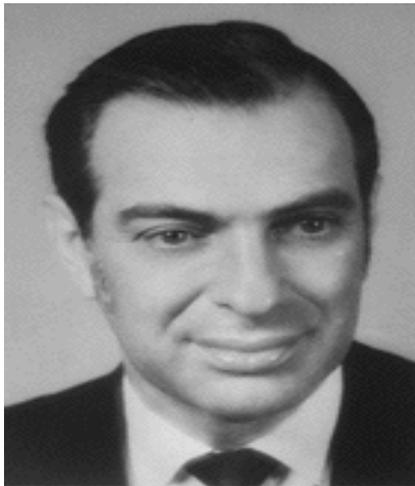
- Ownership not meaningful concept in contractarian theory
- Hence, control rights do not follow *per se* from ownership of equity claims

The Central Office: "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, **its board of directors**" DGCL §

141



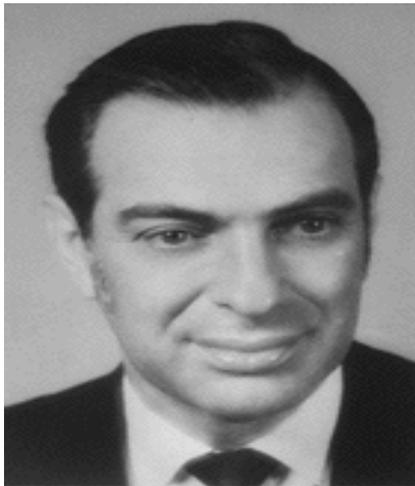
On the necessity for a central office



Kenneth J. Arrow

Where constituents have asymmetric information, divergent interests, and face collective action problems, it is “cheaper and more efficient to transmit all the pieces of information to a central place” that makes “the collective choice and transmit it rather than retransmit all the information on which the decision is based”

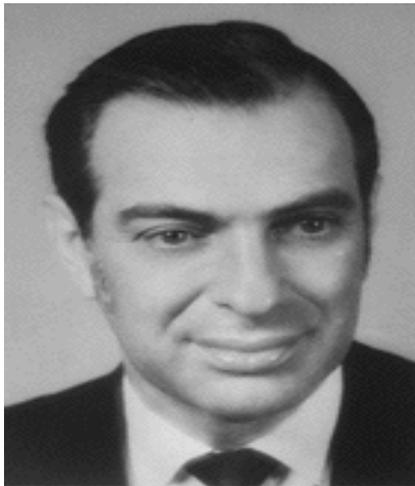
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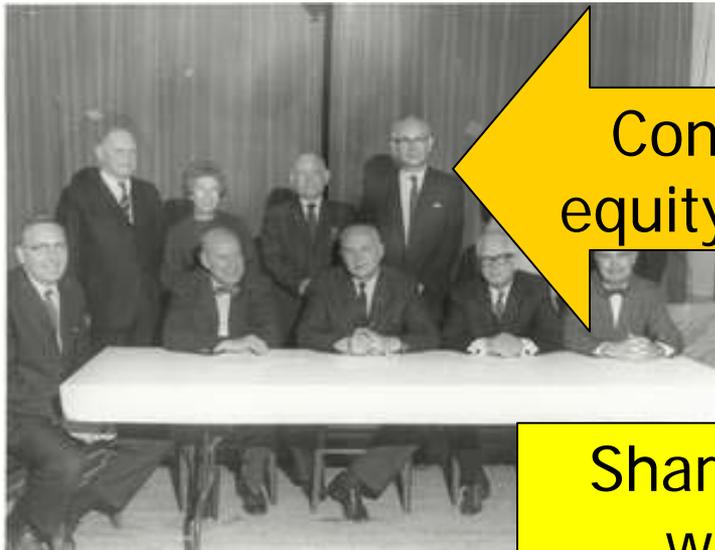
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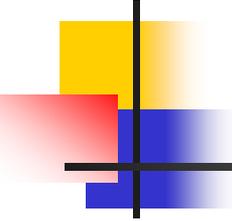
The "deal"



Contribute
equity capital

Shareholder
wealth
maximization

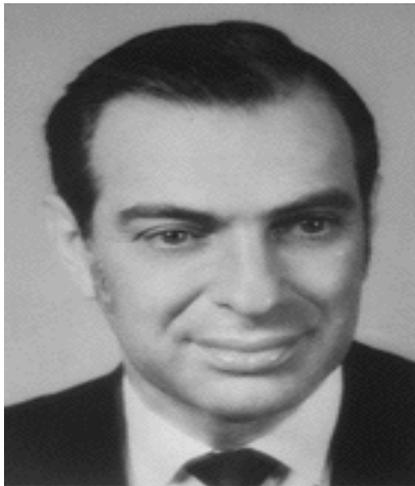




What the deal excludes

- Shareholder control
 - Voting rights limited to review of a few fundamental decisions
 - Proxy system and 13(d) restrictions on shareholder voting and communication
 - Also
 - Derivative litigation burdened by procedural barriers and BJR
 - Market for corporate control hampered by combination of poison pill and classified boards

Authority and Accountability Cannot be Reconciled

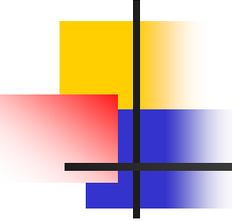


Kenneth J. Arrow

"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"



Applying Theory to Practice



Costs and Benefits to Institutions of Activism

- Little evidence that activism leads to increased returns. Why not?
 - Free-rider problems at the targeted firm (other shareholders benefit)

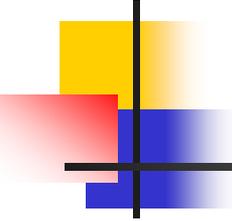
Suppose that the troubled company has 110 outstanding shares, currently trading at \$10 per share, of which the potential activist institution owns ten.

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.

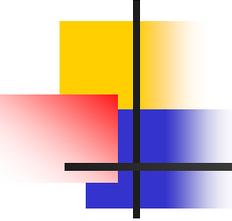
All the other shareholders, however, will also automatically receive a pro rata share of the gains.

As a result, the activist institution confers a gratuitous \$1,000 benefit on the other shareholders.



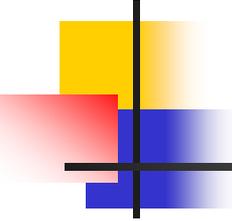
Costs and Benefits to Institutions of Activism

- Little evidence that activism leads to increased returns. Why not?
 - Free-rider problems at the targeted firm (other shareholders benefit)
 - Value effect is noisy and lagged
 - Activists themselves may be more interested in publicity and related benefits
 - Private Sector
 - Public Sector



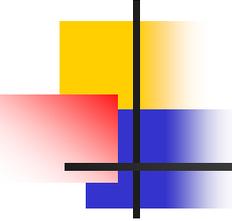
Private sector institutions

- Most 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.



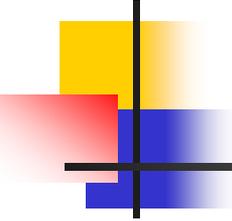
Private sector institutions

- Corporate managers are well-positioned to buy off most institutional investors that attempt to act as monitors
 - Bank trust departments are unlikely to emerge as activists because their parent banks often have or anticipate commercial lending relationships with the firms they will purportedly monitor
 - 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



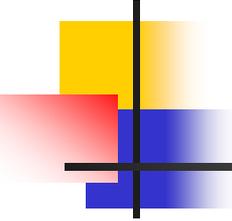
So Who are Activists?

- Social activists
- Personal/group grievants
- Labor unions
- Pension funds
 - AFSCME
 - CALPERs



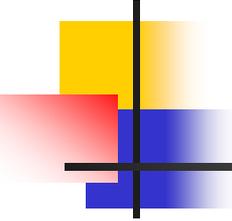
State/local and union fund activism

- Among the most active on governance issues
- They have private interests:
 - “progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers” – Roberta Romano
 - E.g., CalPERS – Safeway
 - Angelides



Hedge Funds and Private Equity

- Growing impact
- (Greenwood 2007) 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.



Hedge Funds and Private Equity

- Empty voting:
 - Henderson Land Development Co. proposes freezeout merger
 - Large institutions backed the deal
 - Hedge funds borrowed Henderson Investment shares before the record date, voted against the buyout, and then sold those shares short, thus profiting from private knowledge that the buyout would be defeated
- Not really an activism issue
 - Problem is state corporate law voting rules woefully outdated



**Institutional investor
activism does not solve
the principal-agent
problem**

**It merely relocates the
locus of the Problem**

Not solving the basic problem

Out west, near Hawtch-Hawtch,
there's a Hawtch-Hawtcher Bee-
Watcher.

His job is to watch...

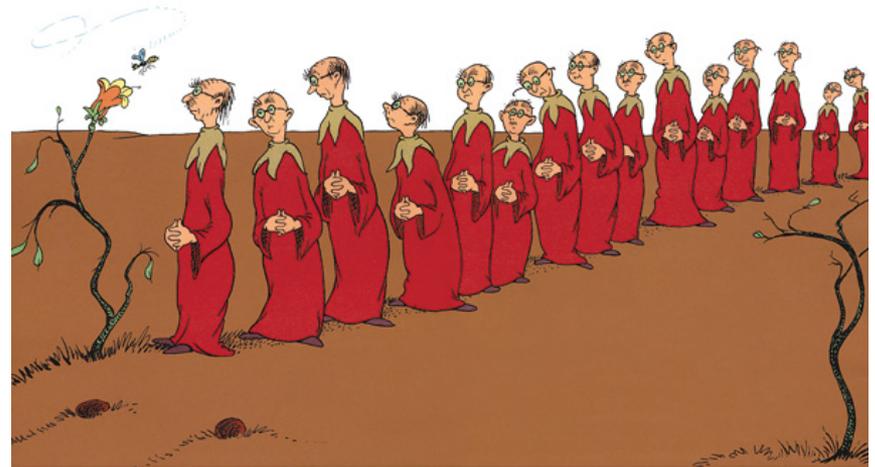
is to keep both his eyes on the
lazy town bee.

A bee that is watched will work
harder, you see.

Well...he watched and he
watched.

But, in spite of his watch,
that bee didn't work any harder.

Not mawtch.



Dr. Seuss

Not solving the basic problem

So then somebody said,
“Our old bee-watching man
just isn’t bee-watching as
hard as he can.

*He ought to be watched by
another Hawtch-Hawtcher.*

The thing that we need
is a Bee-Watcher-
Watcher.”

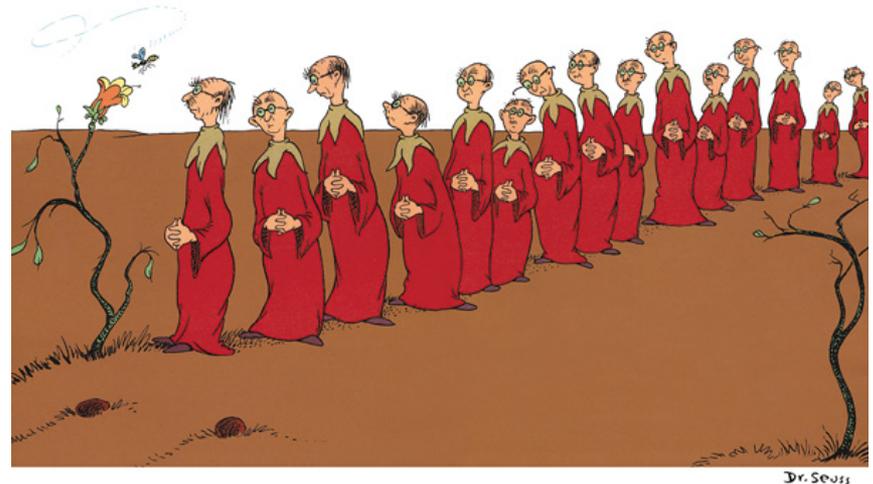
WELL...



Dr. Seuss

Not solving the basic problem

The Bee-Watcher Watcher
watched the Bee-Watcher.
He didn't watch well. So another
Hawtch-Hawtcher
had to come in as a Watch-
Watcher-Watcher.
And today all the Hawtchers who
live in Hawtch-Hawtch
are watching on Watch-Watcher-
Watchering-Watch,
Watch-Watching the Watcher
who's watching that bee.
You're not a Hawtch-Hawtcher.
You're lucky you see.





If it ain't broke, don't fix it

Holmstrom and Kaplan:

“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 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.”