Of Tax and Corporate Governance

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Abstract

In this article we demonstrate how tax credits can be used to enhance the involvement of sophisticated investors in corporate governance. It is widely believed that the involvement of sophisticated investors in the management of firms is a key to improved performance. It is also assumed that the current levels of engagement are suboptimal on account of the positive externalities institutional investors generate for all shareholders and for the public at large. Corporate law scholars have sought to enhance the rate of engagements via various regulatory interventions. We argue that tax credits provide a superior solution. The use of targeted tax credits has four principal advantages over competing proposals. First, taxes constitute a highly effective tool for altering behavior as they transform the underlying motivations of the subject. Second, tax credits are a flexible tool that could be designed to generate optimal incentives in complex situations. Third, our proposal has the potential to create a virtuous financial cycle: the expected increase in tax revenues from the improved performance of firms generated by the tax should far surpass the cost of providing the credits. Fourth, and finally, from a political economy standpoint, due to its non-coercive nature, our proposal will not attract opposition from the investment industry and thus stands a realistic chance of being adopted.

Keywords: Corporate Governance, Negative Tax, Pigouvian Subsidy, Rational Apathy, Shareholder Activism, Institutional Investors, Activist Hedge Funds, Passive Fund, Active Funds

JEL: E60, G23, G28, G30, G32, G34, G38, H23, H25, J33, K22, K34, M14

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INTRODUCTION

In the eyes of many, sophisticated investors represent a great promise for improving corporate governance and for a better corporate world. Such investors possess business acumen, knowledge and expertise that ordinary shareholders lack. Furthermore, they have resources and influence that far exceed those of mortal shareholders. Involving institutional investors and sophisticated investors in the governance of corporations is, thus, widely considered a laudable goal and the key to improving corporate performance.

The ability of sophisticated investors to improve corporate governance has not escaped the searching gaze of corporate scholars. On the contrary, it is a prominent theme in contemporary corporate law scholarship. Theorists and regulators have proposed various mechanisms to induce investors to take a more active role in the management of firms. Some scholars have sought to force companies to adopt cumulative voting or proxy access rules to give institutional investors more influence

over board nominations.[1] Others have focused on facilitating cooperation among institutional investors, either by adopting a regulatory framework that erases barriers to such cooperation,[2] or by allowing them to pool their resources and create a single task force to manage their efforts.[3] Regulators, for their part, have attempted to induce sophisticated investors to become more involved by requiring institutional investors to participate in certain votes.[4] Other theorists still have suggested requiring institutional investors to spend a certain minimal amount of their resources on analysts that will monitor the companies in their portfolio.[5] Finally, there have been proposals to increase the power of active funds at the expense of passive funds by shifting voting power from passive to active funds.[6] Missing from the discussion, to date, is the option of inducing institutional involvement through tax incentives. Our goal is to fill this gap.

[1] Regarding cumulative voting, *see* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1947-49 (1996); Jeffery N. Gordon, *A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994). Proxy access rules are an additional regulatory aspect that enhances the influence of institutional investors by enabling them to nominate directors to the board. See: Lucian Bebchuk, Letting Shareholders Set the Rules, 119 HARV. L. REV. 1784, 1795-97 (2006)

[2] *See* Norma M. Sharara & Anne E. Hoke-Witherspoon, *The Evolution of the 1992 Shareholder Communication Proxy Rules and Their Impact on Corporate Governance*, 49 BUS. L. 327 (1993). The U.K. has established an investor forum in order to facilitate such cooperation and coordination. *See About The Investor Forum*, THE INVESTOR FORUM, https://www.investorforum.org.uk/about. Regarding proxy access rules, see *infra*, Part II.B.i.

[3] *See* Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163, 164-65 (2015).).

[4] The first to do so was the department of labor which served as the regulator of defined-benefit pension plans, and has required institutional investors of defined-benefit plans to vote their proxies. For the origination of the voting mandate, *see* Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, Pension & Welfare Benefits Admin. of the U.S. Dep't of Labor, to Helmuth Fandl, Chair of the Retirement Bd., Avon Products, Inc., 1988 WL 897696, at *2 (Feb. 23, 1988).). For the codification of this mandate, *see* Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Guidelines, 29 C.F.R. § 2509.08-2 (Oct. 17, 2008), *superseding* 59 Fed. Reg. 32607 (June 23, 1994).).

[5] Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 56 (European Corp. Governance Inst., Working Paper No. 433, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794.

[6] Dorothy Shapiro Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. (forthcoming 2019) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3028173 (suggesting that companies adopt dual structure with non-voting stock that will mostly be owned by passive funds). *See* also Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. Corp. L. 101101 (2018) (suggesting to exclude the ability of passive funds to vote). It should be noted, though, that not all scholars agree that it is desirable to give more power to sophisticated investors. *See e.g.*, Einer Elhauge, *Horizontal Shareholding*, 129 Harvard Law ReviewReview129 Harv. L. Rev. 1267 (2016); Fiona Scott Morton and Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 Yale L.J. 2026 (2018); *cf.* David Gilo, *The Anticompetitive Effect of Passive Investment*, 99 Mich. L. Rev. 1, 29-33 (2000); Edward B. Rock and Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance* (N.Y.U. Law & Economics Research Paper Series, Working Paper No. 17-05, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2925855; John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*. (Sep. 20, 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337; ERIC A. POSNER & E. GLEN WEYL, RADICAL MARKETS: UPROOTING CAPITALISM AND DEMOCRACY FOR A JUST SOCIETY (2018) (dedicating an entire chapter to the problems posed by active investors). The proposal in this article does not necessarily stand in opposition to the view of scholars that are worried from the power of institutional investors. Their main concern, in the sheer size of the institutional investors. The argument in this Article is not to increase the size of the share of institutional shareholders in the stock market, but to increase their involvement in the companies they hold.

There is virtual unanimity among corporate theorists that the main challenge that besets activism on the part of sophisticated investors is simple: insufficient motivation. Many sophisticated investors, like the rest of us, prefer a passive investment strategy, predicated on diversification. Active involvement in the day to day affairs of a corporation consumes time and resources. These costs are fully born by activist investors. The benefits, by contrast, are spread over all shareholders, as well as society at large. The firm's shareholders derive the same pro-rata benefit from an engagement that improves the corporate governance of the firm. In addition to shareholders, society at large benefits from such engagements—they improve the general norms of corporate governance and increase tax revenues. Hence, the actions of sophisticated investors generate positive externalities in the economy. As economic theory teaches, in the absence of legal intervention, behavior that generates a positive externality will be under-supplied relative to the optimal social amount because the actor bears the full marginal cost of the relevant activity, but appropriates only a fraction of the marginal benefit.[7] For this reason, Arthur Cecil Pigou famously argued for the use of taxes and subsidies to correct the problem of externalities (both positive and negative) which would, thus, bring about the optimal level of the behavior.[8] Building on Pigou's seminal insight, in this Article we explore the option of using various tax mechanisms to incentivize sophisticated investors to assume an active role in corporate governance.

In particular, we examine how targeted tax benefits, in the form of tax credits, can modify the behavior of sophisticated investors. After all, the world of tax offers a unique toolkit that is readily available for this task. As an illustration, consider the basic mechanism of tax credits. Tax credits may be refundable, providing a positive payment for tax-payers and in essence functioning as a negative tax, or non-refundable, applying only when the tax paying entity has a tax liability. In addition, tax credits may be keyed to efforts or outcomes. An "effort-based" tax credit, as we define it, will be triggered whenever a sophisticated investor incurs specific expenses associated with corporate activism—for example, when it engages in a proxy contest or spends money on corporate governance analysis—irrespectively of the ultimate result. A "result based" tax credit, as we envision it, will be outcome-dependent. Hence, it will only be awarded to successful sophisticated activists whose efforts bear fruit. The magnitude of the rebate will be determined based on a menu of milestones. The milestones may reflect inner-firm changes—for example, an appointment of a director representing institutional activists or a restructuring of management compensation—or they can be predicated on the performance of a company's stock.[9] Either way, the milestones that are chosen must be observable and verifiable.

It is important to note that effort-based tax benefits and result-based tax benefits are not mutually exclusive. It is possible to provide small effort-based tax benefits to sophisticated investors in order to spur them to take initiatives and explore opportunities

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[7] *See, e.g.*, Carl J. Dahlman, *The Problem of Externality*, 42 J.L. & ECON. 141 (1979).
[8] ARTHUR CECIL PIGOU, THE ECONOMICS OF WELFARE 188 (2nd ed.,1924).
[9] For detailed discussion, see part III.B.2, *infra*.

to get involved in specific corporations and then to add result-based benefits if a desirable outcome is ultimately attained.

Our proposal has four principal advantages relative to competing mechanisms. First, tax incentives constitute a far more effective tool for encouraging corporate activism than the alternatives that can be found in relevant literature. Properly designed tax incentives have the potential to alter sophisticated investors' a priori reluctance to play a role in corporate governance. If investors have no interest in enhancing their levels of engagement, it is highly doubtful that legal mandates forcing engagement would achieve their desired goal of *meaningful* engagements. Worse yet, mandatory measures would necessitate significant expenditures on monitoring and enforcement. Tax benefits, by contrast, have the potential to transform the fundamental preferences of sophisticated investors and align the interests of such investors with those of society at large. Second, tax instruments are flexible and dynamic. Unlike binary regulatory mechanisms, a tax benefit can be keyed to multiple performance indicators and can be adjusted to fit the changing magnitude of the positive externalities generated by sophisticated investors. Third, and counter-intuitively, the implementation of our proposal is likely to increase overall tax revenues. At first blush, one might get the impression that our proposal will hurt tax-payers by forcing them to finance tax credits for sophisticated investors. This is incorrect, however. The involvement of sophisticated investors in corporate governance can dramatically increase the aggregate profits of firms, and, consequently, the tax collected from them. Hence, our proposal is likely to boost the tax base, not erode it. Fourth, and finally, our proposal stands a much better chance of being implemented, relative to all other proposals. From the vantage point of investors, all existing proposals rely on "sticks", i.e., coercive measures that seek to force a behavior change. Our proposal, by contrast, employs a "carrot" in the form of tax benefits to achieve the desired result.[10] As a vast literature in economics and political science demonstrates, industries are much more likely to support policy proposals that rely on carrots, rather than sticks. This is especially true in the case of the investment industry—institutional investors and hedge funds constitute one of the strongest lobbies in Washington. A scheme that seeks to force unwanted regulations on the investment industry stands no realistic chance of being adopted. A proposal like ours that can gain the support of the investment industry is much more likely to pass.

Structurally, this Article is comprised of five parts. Part I will discuss the positive externalities generated by active sophisticated investors and how they improve corporate governance structures. Part II will identify the key actors whose active involvement in the management of firms should be encouraged. Part III will explain the advantages of tax benefits as a means for enhancing corporate activism relative to competing proposals. Part IV will present a specific policy proposal detailing how tax incentives can be employed to promote investors' engagement in corporate governance. Part V enumerates the advantages of our proposal, relative to preexisting ones. A short conclusion will ensue.

[10] *See e.g.*, Brian Galle, *The Tragedy of the Carrots: Economics and Politics in the Choice of Price Instruments*, 64 STAN. L. REV. 797, 803-06 (2012) (defining carrots and sticks).

I. POSITIVE EXTERNALITIES OF ENGAGEMENTS

A. *The Core of the Problem: Rational Apathy of Shareholders*

In their seminal work on corporate law, Adolf Berle and Gardiner Means identified the central challenge posed by the separation of ownership and control in public corporations: the small stakes of shareholders gives them no inherent incentive to monitor management and be actively involved in firms.[11] Subsequent scholarship in the emerging field of public choice has reinforced their prediction.[12] Of particular note is Mancur Olson's "The Logic of Collective Action," which pointed to the phenomenon of dispersed stockholders as an example of the inability of large and dispersed groups to further their mutual interests.[13] This phenomenon, which has become known as the "rational apathy of shareholders," has received close attention in corporate governance literature.[14]

The lack of shareholder incentives to engage in active monitoring and in the firm's affairs is caused by two central factors: shareholders' low stake in the firm and the minimal value of their input. Individual shareholders typically lack the business skills to actively involve themselves in corporate management. They are also inadequately informed to undertake this task. Active involvement in a firm's management requires two types of information: general market information and firm specific information. General market information requires analysis of industry-wide and global economic conditions, trends and forecasts.[15] Firm specific information consists of data about the performance, structure and potential of individual firms.[16] A typical individual shareholder readily possesses neither type of information. In theory, individual shareholders could purchase general market information from professional analysts and could glean information about firms in which they invest. In practice, the

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[11] ADOLF A. BERLE, JR. AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 112-16 (1932).

[12] *See, e.g.*, Michael C. Schouten, *The Case for Mandatory Ownership Disclosure*, 15 STAN. J.L BUS. & FIN. 127, 135 (2009) (arguing that in firms with dispersed ownership, no individual shareholder has enough incentive to monitor management).

[13] MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 55 (1965). Olson's work is a systemized development of prior work in the field of public choice with similar arguments. *See* ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 265-76 (1957) (who coined the term "rational abstention")."). Regarding the general application of Olson's work to the field of corporate governance, *see* Robert Charles Clark, CORPORATE LAW § 9.5 at 289-400 (1986); Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1837-40 (1989); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445, 454-57 (1991).

[14] *See* Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427 (1964); Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 824 (1982); Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395 (1983); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 526-29 (1990); Lucian A. Bebchuk, Reiner Kraakman & George G. Triantis, Stock Pyramids, *Cross-Ownership and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights* in CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck ed. 2000).).

[15] Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 721 (2006).

[16] *Id.*

cost of doing so is prohibitive. General market analysis can only be obtained at a very high price and it needs to be updated constantly. Similarly, different types of firm specific information are often kept secret,[17] and even publicly available data can only be accessed periodically. Furthermore, individual shareholders, who commit to information gathering, would need to do so on a continuous basis. This, of course, would necessitate massive expenditures and come at a steep opportunity cost. Once we account for the fact that most investors hold diverse portfolios, it becomes abundantly clear that active monitoring is not a practical option for individual shareholders. It is also undesirable from a social perspective as it requires enormous duplicative investments in monitoring. It should be added that the problem is aggravated by the presence of a free riding effect: even shareholders who might personally benefit from engaging in monitoring would rather have other shareholders perform this task in order to reap the benefits without incurring the cost.

Activism by dispersed individual shareholders is plagued by yet another problem. Even if a shareholder was to incur the significant expense of gathering the necessary information about a firm, she would not be able to accomplish her desired goal. Dispersed ownership, as the name implies, suggests that each shareholder typically holds a tiny fraction of a firm's share. Consequently, she stands no realistic chance of changing the firm's path. In the famous terminology of Albert Hirschman,[18] she has no voice in the company–or, to put the matter slightly differently, her voice will not be heard. Realizing this much, no individual shareholder would invest the time and money necessary to educate herself about a corporation's affairs even she had the financial wherewithal to do so. The investment would simply go to waste. Hence, the only sensible investment strategy for individual shareholders is therefore to hold a diversified portfolio of firms, remain passive and rely on exit (i.e., sale of shares) if one is dissatisfied with corporate management's decisions.[19]

Indeed, most dispersed individual shareholders do not even show up to vote, despite the negligible cost of doing so. Empirical data show that retail investors, who comprise approximately 30% of all shareholders in U.S. public companies in 2016, voted only 27% of their proxies in 2016.[20] The cost of voting is negligible, and yet the large majority of retail shareholders are not willing to incur this minimal cost, let alone invest to make a fully informed decision.

[17] *See, e.g.*, Omri Ben-Shahar & Lisa Bernstein, *The Secrecy Interest in Contract Law*, 109 YALE L.J. 1885, 1886 (2000) (arguing that when contracting, firms prefer to keep private certain information such as labor costs, inventory size, availability of alternative suppliers and business plans).

[18] *See* ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES (1970).

[19] *See* Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* 17 (U.C.L.A. Law & Economics Research Paper Series, Research Paper No. 05-20, 2005), 17 ("[T]hey 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.").

[20] *2016 Proxy Season Review*, PROXYPULSE, p. 1, https://www.broadridge.com/_assets/pdf/broadridge-2016-proxy-season-review.pdf.

The low participation of dispersed individual shareholders caused by their rational apathy significantly weakens the central mechanism for confronting and reducing managerial agency costs—board accountability and stockholder involvement in the firm. As fewer stockholders vote in the basic arena for stockholder voting–board elections–the board becomes less accountable to stockholders and feels less obliged to take their interests into account. A board without strong accountability to stockholders has little reason to insist that management decisions are aligned with stockholders' interests.[21] In sum, the low participation of ordinary shareholders impairs the important role of voting in diminishing managerial agency costs.[22]

In contrast to individual shareholders, who do not represent a real hope for improving corporate governance, sophisticated institutional investors carry a real promise for a brighter corporate world. Sophisticated investors have the resources and knowledge necessary to improve corporate governance. Yet, their motivation to become actively involved in the management of corporations is beset for another reason. It is to this reason that we next turn.

B. *Sophisticated Investors' Engagement as a Positive Externality*

Unlike individual shareholders, sophisticated investors have both the expertise and the means to play an active role in corporate governance. Large shareholders enjoy economies of scale and scope that are not available to individual shareholders. For example, when large institutional shareholders purchase general market analysis, they can utilize it for many investment decisions, not just one. Institutional shareholders can apply general market analysis across industrial sectors and use it for multiple activities. To some degree, this is also true for firm specific information. Information about one firm can be used to identify lucrative investment opportunities in other firms. For example, a careful study of firm A can reveal potential synergies and complementarities between its activities and those of firms B and C. Moreover, unlike dispersed individual shareholders, sophisticated institutional investors can ensure that their voice is heard and can clearly affect decision-making processes within corporations. Indeed, there is ample evidence demonstrating this ability.[23] Why then are sophisticated investors

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[21] Regarding the relatively low impact of shareholders on board elections in comparison to management, *see* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L REV. 675, 679-94 (2007).)

[22] The assumption in this Article is that a larger participation of retail stockholders will reduce the clout of managers. This might be contested in light of data reflecting that retail investors tend to vote with managers to a greater extent than institutional investors. *See* Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 MINN. L. REV. 11, 15 n.24 (2017). *See also supra*, note 14. Yet current numbers most likely would not reflect the rate in which retail investors will support management after increasing participation of retail investors. In other words, the tendency of the infra-marginal retail investors to vote with management will be weaker than those currently voting. A survey of retail investors conducted by the Brunswick Group serves as a strong indication for such a gap. In a survey of 801 retail investors, it was found that most believe that activists add long-term value and may be more likely to support activists than generally thought. *See* Robert Moran and Kaylan Normandeau, *Retail Investors Cheer on the Activists*, BRUNSWICK REVIEW, 14 available at https://www.brunswickgroup.com/media/2140/shareholder-activism-issue.pdf; *see also* Fisch, 102 MINN L. REV., at 5-6.

[23] *See e.g.*, Samuel B. Graves & Sandra A. Waddock, *Institutional Ownership and Control: Implications for Long-Term Corporate Strategy*, 4 ACAD. OF MGMT. EXECUTIVE 75, 78 (1990) (providing the Council

reluctant to be involved in the active management of firms? The reason is two-fold. First, even though sophisticated investors are better situated than dispersed individual shareholders to engage in corporate activism, passivity may be a dominant strategy for them too. The cost of passive investment in a corporation is, by definition, lower than that of active involvement. Hence, sophisticated investors will elect to become active only if the expected returns from activism are greater than those associated with passive investments by a margin that justifies the extra cost.

Second, and relatedly, active involvement in firms gives rise to an externality problem. The phenomenon of externalities has preoccupied the minds of economists and legal scholars and has spawned a voluminous literature. The core insight that emerges from this literature has to do with the distortive effect of externalities on primary behavior.[24] In the case of negative externalities—defined as unaccounted for harms inflicted on third parties—we would witness too much of the externalities causing negative behavior, relative to the social optimum. A classic illustration of this problem is provided by the example of industrial pollution. In a world without regulation, polluters only bear a fraction of the cost they impose on third parties. Hence, acting as self-interested maximizers who equate private marginal costs to benefits, firms that do not need to pay for the cost of pollution, will produce too much. Activities that generate positive externalities—defined as unaccounted for benefits enjoyed by third parties—present the mirror image problem, that of under-provision. An example of an activity that generates positive externalities is the construction of a park on private land that is open to the public. The cost of creating the park and maintaining it will be shouldered by the private landowner; the benefit will be spread over the entire community. For this reason, we do not see many private parks that are open to the public.

Against this theoretical backdrop, it becomes apparent why the actions of sophisticated investors are beset by a positive externalities problem. Active shareholders bear the full marginal cost of monitoring a firm's management, analyzing its actions, and promoting changes. Unfortunately, they do not get to enjoy the full marginal benefits of their action. Instead, the benefits are shared by all shareholders, who receive higher yields on their investments, and to a lesser degree by society at large, in the form of better financial markets and higher tax revenues that can be used to further various social goals. In other words, sophisticated shareholders' active engagement with firms generates two forms of positive externalities: one for other shareholders and one for the market at large.

of Institutional Investors (CII), an organization founded by 20 pension funds in 1985 that seeks to influence corporate governance and public policy issues that affect funds' assets, as an example of the potential influence that institutional investors have to influence corporate decision-making).

[24] *See, e.g.*, Gideon Parchomovsky and Peter Siegelman, *Cities, Property, and Positive Externalities*, 54 WM. & MARY 211, 223 (2012) (providing an example of negative externalities in tort law, specifically the law of negligence, where "actors will deviate from the socially acceptable standard of behavior only if the benefit they derive from such deviation exceeds the expected harm they may cause to third parties").

It should be emphasized that the presence of externalities does not in and of itself calls for legal intervention.[25] This is so for two reasons. First, externalities are omnipresent in real life. Every time, a person drives her car to work, she creates a negative externality by increasing traffic congestion. Similarly, a farmer who chooses to grow flowers, creates a positive externality for bee keepers, flower lovers and passersby. Most externalities are too insignificant to justify intervention. Second, legal intervention comes at a cost, and its effectiveness is often limited.[26] Hence, only externalities of certain magnitude should attract the attention of lawmakers. As we demonstrate in the proceeding paragraphs, the magnitude of these positive externalities is significant and their potential impact on financial markets cannot be ignored.[27]

1. *Positive Externalities for other Shareholders*

Shareholder engagement can improve corporate governance in two ways: first, it can improve the quality of decision-making processes within the firm; and second, it can curtail the ability of managers to extract private benefits at the expense of shareholders. Another way of putting it is that shareholder engagement serves as an enforcement mechanism against violations of the two duties imposed on management and board members—the duty of care and the duty of loyalty.

Improved decision-making processes act as a safeguard against violations of the duty of care by lowering the risk of harmful business decisions. Moreover, it limits the ability of management to extract private benefits. In some instances, shareholder engagement can police against violations of the duty of loyalty by the management and the board by preventing them from engaging in self-dealing transactions. In other instances, it can serve to discipline management to behave more ethically, within the limits of the duty of loyalty—for example, by restricting its power to devise generous compensation schemes for itself in violation of the duty of loyalty.

While the duty of loyalty has been the epicenter of corporate law and has attracted close scrutiny from courts and legislators, the duty of care has largely evaded intense judicial review and has been subjected to the permissive business judgment rule.

[25] If transaction costs are relatively low, there is no need for a regulatory intervention—contractual arrangements can suffice for reaching the optimal level of the activity generating the externalities. *See* R. H. Coase, *The Problem of Social Cost*, 3 J.L. 1, 1-16 (1960) (arguing that when transaction costs are sufficiently low, private bargaining will solve the problem of negative externalities); Parchomovsky & Siegelman *supra* note 24, at 221-22.

[26] This is demonstrated in the public policy economics shift from a comparative institution approach, in which the relevant choice is between alternative real institutional arrangements, to a nirvana approach, where the relevant choice is between an ideal norm and an existing "imperfect" institutional arrangement. By looking to an ideal system, one can recognize the inefficiencies of the pre-existing system. See *Harold Demsetz,* Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1 (1969).*

[27] Some scholar have addressed the phenomenon that legislators and regulators have a greater tendency to ignore positive externalities. See: Ariel Porat, *Private Production of Public Goods: Liability for Unrequested Benefits*, 108 MICH. L. REV. 189, 190, 195, 197 (2009) (discussing unjust enrichment in positive externality terms); Saual Levmore, *Explaining Restitution*, 71 VA. L. REV. 65, 69-72 (1985) (rejecting possible reasons for such differentiation, such as the greater difficulty of evaluating a positive externalities). See also Parchomovsky & Siegelman, *supra* note 24, at 228-237 (2012) (discussing the various justifications for the differentiation between the legal treatment of positive and negative externalities).

Under the business judgment rule, the decisions and actions of boards and directors enjoy immunity from judicial intervention as long as they were adequately informed and were made in good faith and without conflicts of interest.[28] This means that the law consciously leaves business decisions to the discretion of management and boards. It is important to note that corporate law does not deal with bad decision making because it is a rare phenomenon. On the contrary, bad decision making is more prevalent than outright violations of the duty of loyalty.[29] Yet, the law gives a lot of leeway to management when it comes to business decisions in order not to exert a chilling effect on corporate directors and officers by reviewing their decisions retrospectively.[30] Shareholder engagement can be particularly valuable in this context. Sophisticated shareholders can fill the gap left by courts and can provide much needed quality control. Unlike courts whose review is primarily procedural, under the garb of the business judgment rule, sophisticated shareholders review the substance of managerial decisions and evaluate them on the merits.[31]

To be sure, even individual shareholders have the potential to improve decision making processes in a firm on account of the wisdom of the multitude. Owing to their large number, dispersed individual shareholders who review business decisions will likely identify strategies that dominate those employed by the management of the firm. Unfortunately, this mechanism is virtually irrelevant in practice due to the rational apathy of shareholders. Furthermore, the value of the wisdom of the multitude is questionable in intricate issues that require professional financial literacy, which most shareholders lack.[32]

The second option is engagement by sophisticated investors. Because the ability of regular shareholders to monitor managerial decisions is limited, management may violate its duty of care and act negligently. The more prevalent this phenomenon is, the

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[28] Lori McMillan, *The Business Judgment Rule as an Immunity Doctrine*, 4 WM. & MARY BUS. L. REV. 521 (2013).

[29] *See e.g.*, Dan Lovallo and Olivier Sibony, *The Case for Behavioral Strategy*, MCKINSEY QUARTERLY (March 2010) (reporting a recent *McKinsey Quarterly* survey of 2,207 executives, in which 72% of respondents said they thought bad strategic decisions either were as frequent as good decisions or were the prevailing norm at their companies).

[30] *See Gagliardi v. TriFoods Int'l, Inc*., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("[D]irectors will tend to deviate from [a] rational acceptance of corporate risk if in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to ex post facto claims of derivative liability for any resulting corporate loss. . . . [A] very small probability of director liability based on 'negligence', 'inattention', 'waste', etc., could induce a board to avoid authorizing risky investment projects to any extent!"); Joshua Mitts, Comment, *Recoupment Under Dodd-Frank: Punishing Financial Executives and Perpetuating "Too Big To Fail,"* 122, YALE L.J. 507, 513 (2012) ("The potentially crippling chilling effect of judicial second-guessing of directors' decisions is precisely what motivated the development of the business judgment rule in Delaware corporate law.").

[31] *See* Maria Goranova & Lori Verstegen Ryan, *Shareholder Activism: A Multidisciplinary Review*, 40 J. MGMT. 1230, 1241 (2014). ("Although both governance and hedge fund activists ultimately seek to improve firm performance, they employ different methods and time horizons, as well as different perspectives on managerial decision-making prerogatives. ").

[32] *See* Federal Research Division, Library of Congress, *Financial Literacy among Retail Investors in the United States* (Dec. 30, 2011) at 25, available at https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part2.pdf (reporting that American investors "lack essential knowledge of the most rudimentary financial concepts"). (Abramowitz)

more upside there is for sophisticated investors who can get involved in the management of under-performing firms and dramatically increase their value.

Sophisticated actors clearly reap some of the benefit of the improved performance of the firm, on account of the appreciation in their equity stake. Yet they only capture a fraction of the benefit generated by their actions. The remainder is captured by the other shareholders, whose share value increases as a consequence of the engagement of the sophisticated shareholder. Sophisticated shareholders cannot recoup a greater portion of the benefit they generate for three principal reasons. The first is liquidity constraints. The market cap of listed U.S. companies alone surpassed $32 trillion in 2017.[33] Activist hedge funds have deployed an aggregate capital of $62 billion in 2017, which amounts to a mere 0.002% of the market cap of the stock market. Activist hedge funds have deployed this sum over 193 engagements in 2017 – an average of approximately $320 million per engagement. Excluding the three largest engagements, in all other engagements the capital deployed was less than one billion dollars.[34] Out of the 145 campaigns in the first half of 2018, only five surpassed the billion dollar mark.[35] These sums do not enable activist hedge funds to obtain large stakes in the companies' in which they invest, given that the average value of a listed public company in the U.S. is $3.8 billion. The added value of activists' engagement is represented by the increase in a company's stock price after the activist announces its position. Yet, as we explained, only part of the increase, commensurate with activists' share of the stock, falls into their hands.

The second reason is risk. Unlike many passive institutional investors, activist hedge funds are not well diversified. A significant increase in their investment in one company would force them to decrease their investment in a small number of other companies in their portfolio. Most activist hedge funds hold positions in 8 to 12 companies.[36] Doubling their investments in companies would require them to limit the number of firms in their portfolio to 4 to 6, which would increase their risk significantly. Failure in one company might sink their entire portfolio.

The third reason is the prohibitive cost of purchasing a large equity stake in public companies. Such purchases, especially after the announcement of a hedge fund position in a company, have to be executed at a significant premium over the market price. Because the stake purchased is large, the premium over market price increases.[37]

[33] *Market Capitalization of Listed Domestic Companies*, THE WORLD BANK, https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?locations=US&name_desc=true.

[34] LAZARD'S SHAREHOLDER ADVISORY GROUP, *2017 Activism Year in Review* (Jan. 2018), https://www.lazard.com/media/450414/lazards-review-of-shareholder-activism-q4-2017pdf.

[35] LAZARD'S SHAREHOLDERS ADVISING GROUP, *Review of Shareholder Activism – 1H 2018* (July 2018), https://www.lazard.com/media/450655/lazards-review-of-shareholder-activism-1h-2018.pdf.

[36] Christopher M. Schelling, *Shareholder Activism as Private Equity Allocation*, 106 HEDGE FUND JOURNAL (2016), https://thehedgefundjournal.com/shareholder-activism-as-private-equity-allocation/./

[37] Brian F. Smith and Ben Amoako-Adu, *Relative Prices of Dual Class Shares*, 30 J. FIN. & QUANTITATIVE ANALYSIS 223, 223 (1995) ("The significant value of control is evidenced by the higher price paid for superior voting shares (SVS) relative to the price paid for restricted shares (RVS) during takeovers.").

Engagement by sophisticated shareholders add value in several ways. The most common engagement of hedge fund activists in the first half of 2018, which accounted for 37% of their engagements, came in the form of appointing board members.[38] In many of the cases—28% in 2017—activist strove to receive their own representation on the board, appointing an employee of the fund.[39] The greater exposure to company affairs that accompanies board representation enables the activist and others to find new strategies for the firm and to publicize their adoption in order to increase its value. The de-facto appointment of directors by outsiders enhances the ability of the board to monitor management effectively by reducing the number of directors appointed by the management itself. The highest value-enhancing engagements are those that push for the sale or merger of a company. In the first half of 2018, such engagements accounted for 34% of all activist hedge fund engagements.[40] In some of these engagements, activists strove to initiate such transactions. But, in others, activists' main goals were sweetening a deal that was already on the table. A related type of engagement consists of cases in which activists advocate for divestiture of some of a company's assets or units, which constituted 10% of activist hedge funds engagements in the first half of 2018.[41]

Another significant share of engagements—22% of all engagements in the first half of 2018—was directed toward reforming and improving governance structure.[42] This is done mainly through charter and by-laws revisions, such as eliminating staggered boards or poison pill provisions, enlarging or reducing the number of board members to enable more effective monitoring over managers or increasing the number of independent directors on the board.[43] These governance reforms increase the value of the company to shareholders by improving monitoring of management and decreasing management's ability to tunnel and extort private benefits from the company.

The remaining engagements included attempts to induce management to change its position regarding particular business issues. These issues ran the gamut of business decisions, ranging from business strategy to operational structure to capital allocation. In some cases, activists dug in their heels and were able to change the course charted for the company by its management. In most of these cases, however, activists did not explicitly state their objective, which makes it impossible to assess their success.[44]

The positive value of a hedge fund activists' intervention is reflected in the average increase in the stock price in the 40-day window around the announcement of

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[38]Lazard, *supra* note 35, at 9.
[39] *Id.* at 5.
[40] *Id.* at 9.
[41] *Id.* at 9.
[42] Lazard *supra* note 34, at 9.
[43] *See* Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 6 (2011) (stating that shareholders often seek to reform corporate governance by amending the bylaws, as shareholders can adopt, amend, or repeal bylaws unliterally, and this power cannot be taken away).
[44] *Supra* note 33.

the engagement. Lucian Bebchuk, Alon Brav and Wei Jiang estimated that the average increase at approximately six percent.[45] It should be added, though, that while there is consensus that engagements by activists lead to an increase in the share value of the target company in the short term, it is disputed whether such engagements actually contribute to the value of the firm in the long term.[46] Most academic authorities believe that the impact is positive even in the long run. Bebchuk et al. have addressed this critique and proved that hedge fund activism adds value in the long run.[47] It should be noted that even if one accepts the critique that hedge fund activism does not increase the value of the firm in the long run, this might not be true of all forms of engagement. Certain types of engagements, such as those concerned with corporate governance structuring, are probably value enhancing even in the long run.[48]

2. *Positive Externalities of Engagements on the Market at Large*

The positive externalities of engagements are not limited to shareholders of the target company. The involvement of sophisticated shareholders in the management of firms generate market-wide benefits that transcend the boundaries of individual firms. Specifically, they can improve governance norms and structures across the board. There are two ways in which engagements generate positive externalities for other firms in the market: ex-ante and ex-post.

a. *The Ex-Ante Effect*

The possibility of shareholder engagements exerts a disciplining effect on management and boards, even if it does not materialize. Most managements and boards negatively

[45] Lucian A. Bebchuk, Alon Brav, and Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1167 (2015) ("[T]he("the average abnormal returns observed during the twenty-day period before and after an investor files a Schedule 13D are approximately 6% "). For studies with similar results, *see*: A. Klein & E. Zur, *Entrepreneurial Shareholder Activism on Target Companies: A Survey of Empirical Findings*, 64 J. FIN. 187, (2008). (The exact figure is 5.7% for activist engagements of all funds, for hedge funds it is higher: the stock price increase in time of frame of the 60 day window reaches 7.2%. The 60 day window is defined according to the stock price 30 days before the announcement and 30 days after the announcement). Other studies have reached similar findings, see: Alon Brav, et al., Hedge Fund Activism, *Corporate Governance and Firm Performance*, 63 J. FIN. 1729,1730 (2008) (finding an increase in the range between 7%-8% in a 40 day window around the announcement for engagements of hedge fund activists); Becht et al., Hedge Fund Activism in Europe, ECGI Working Paper, no. 283/2010 (May 2010), 1 available at SSRN https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1616340 (finding an increase in share price of 6.9% for hedge fund activists engagements).

[46] *Id*. at 1087 ("Is hedge fund activism a catalyst of beneficial changes that legal rules and corporate arrangements should facilitate? Or are such activists short-term opportunists that are detrimental to long-term value creation and that legal rules and corporate arrangements should discourage?"). In addition, there can be a gap between the private gains to a firm and social gains. Private gains can increase as a result of accumulation of market power, but from a societal perspective such gain represents a net social loss. See William M. Landes and Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 953 (1981) (considering the problem from an antitrust point of view, where a high degree of market power can result in social losses). In such cases, there is no positive externality.

[47] Bebchuk, Brav, and Jiang *supra* note 44, at., page 1155 ("We also find no evidence that the initial positive stock-price spike accompanying activist interventions fails to appreciate their long-term costs and therefore tends to be followed by negative abnormal returns in the long term").

[48] Something about this intervention targeting the long run.

perceive shareholder engagements and strive to avoid them.[49] Such engagements are undesirable from the vantage point of managers and directors both because they present a threat to their continued employment and because it erodes their power to run the firm as they want.[50] Accordingly, managements and boards would be inclined to do whatever they can to fend off the perceived risk of shareholder engagement.[51] Sophisticated investors tend to converge on companies that adopt antitakeover clauses, such as staggered boards and poison pills, as potential targets for engagement.[52] In response to this tendency, managements and boards may refrain from adopting such mechanisms in order to minimize a company's exposure to engagements, even though such measures protect managements and boards against hostile takeovers and clearly would have been favored absent the threat of activist shareholder engagement.

Management would similarly be cautious regarding any type of corporate behavior that attracts activists, such as high expense levels, empire buildings, avoidance of merger or acquisition opportunities that stand to enhance shareholder value, and the appointment of unprofessional board members that have ties to management. As the incidence of sophisticated shareholders' engagement grows, managements and boards would become increasingly cautious to adopt such behavior. This, in turn, would benefit *all* shareholders.

The intensity of the ex-ante effect of shareholders engagements on managements and boards depends on the perceived likelihood of such an occurrence, which, in turn, is a function of the number of engagements in the market. Every additional engagement increases the ex-ante disciplining effect of the engagement on all the other firms in the market. While this effect may appear negligible relative to the effect of the company in which an activist actually engages with, this is not necessarily the case. Importantly, the impact of activists on the target company has the potential to create market-wide ripple effects. Naturally, the direct impact of an engagement may be limited in many cases to the target firm, but the indirect deterrent effect may impact hundreds of companies. Although, it is impossible to determine in the abstract which of the effects

[49] Bebchuk, Brav & Jiang, have examined separately engagements which their opponents were especially weary of their long-term negative impact – investment limiting engagements and adversarial intervention, but have even found a positive long-term impact for such engagements. *See id.* at 1135-1144.

[50] Even though the activists may have the same goal as the manager and even with the same time-horizon, management may justify to themselves not to listed to the activist due to their belief of an idiosyncratic value that the cannot transmit to the activists. Regarding the possibility of idiosyncratic value, *see* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560 (2015) (even though they discuss the idiosyncratic value of controlling shareholders, it is also possible that managers have some sense of idiosyncratic value that other outsider shareholders cannot observe).

[51] According to PwC's 2018 Annual Corporate Directors Survey, directors are increasingly indicating that shareholder activism has compelled companies to more effectively evaluate strategy, execution, and capital allocation. *PwC's 2018 Annual Corporate Directors Survey*, PwC (2018), https://www.pwc.com/us/en/governance-insights-center/annual-corporate-directors-survey/assets/pwc-annual-corporate-directors-survey-2018.pdf

[52] Bebchuk, Lucian A., *Why Firms Adopt Antitakeover Arrangements*, Harvard Law School, John M. Olin Center For Law, Economics, And Business, Discussion Paper No. 420 (May 2003), 3-4, available at https://www.nber.org/papers/w10190.pdf.

is more dominant, it cannot be disputed that the impact of activists' engagements goes well beyond the target firm and has a positive impact on the market as a whole.

b. The Ex-Post Effect of Corporate Governance Changes on Other Firms

An improvement in the governance regime of one firm may trigger a similar improvement in other firms. As long as the market is competitive and incorporates an effective share price mechanism, firms cannot remain idle when competitors improve. Hence, if one firm decreases managerial compensation or eliminates its staggered board, its rivals will be forced to follow suit.[53]

This positive externality can explain the surprising finding that the number of independent directors in a firm is not correlated with stronger performance.[54] Ronald Gilson has explained this result by pointing to the market-wide effect of independent directors, arguing that competitive pressures force firms to adopt value enhancing measures executed by their rivals even if they have weaker corporate governance structures.[55] Similarly, it can be expected that activist engagements that increase the share value of the target firm, will be adopted by its rivals, even though they do not face the threat of an activist engagement.

An additional reason why engagement related corporate governance changes in some firms may impact non-engaged firms is based on the force of social norms. Managers and boards care about market norms, not only about whether a certain practice serves their interest. They may be reluctant to adopt certain practices that may serve their interests, if they are uncommon among other market actors. Managers and board members do not want to be perceived as outliers in the adoption of certain aggressive measures, irrespective of market threats, such as activist engagements. Due to individuals' self-concept maintenance, i.e., their desire to maintain their ethical self-image, they are concerned with behaving in a socially accepted manner, even if they would have been able to increase their private payoffs otherwise.[56] A possible example of this is the adoption of antitakeover clauses such as staggered boards and poison pills. Managers and boards that have been willing to adopt anti-takeover provisions when such provisions are widely accepted in the market but may not be willing to do so when

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[53] Ronald Gilson, *The Rise of Independent Directors in the U.S., 1950-2005: of Shareholder Value and Market Prices*, 59 STAN. L. REV. 14 65, 1508 (2007)

[54] Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 *Bus. L.* 921 (1999); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 239 (2002) (examining the correlation between independence of boards and its impact years ahead, in order to address the argument that the impact of independence of the firm is mainly on the long-run). For similar results, see: P. M. Guest, *The Impact of Board Size on Firm Performance: Evidence From the UK*, 15 EUR. J. FIN. 385 (2009) (found a negative correlation between number of outside directors on the board in UK companies, and profitability measures, Tobin' Q and tock returns); Ozcan Isik & Ali Riza Ince, *Board Size, Board Compisition and Performance: An Investigation on Turkish Banks*, 9 INT'L BUS. RESEARCH, 74, 81 (2016) (finding a negative but statistically insignificant correlation between percentage of outside directors on the board and firm performance in the Turkish banking industry).

[55] Gilson, *supra* note 53.

[56] Jay W. Jackson, *Reactions to Social Dilemmas are Influenced* ***by*** *Group Identification Motives* (2002); Robert Cooter, Michal Feldman and Yuval Feldman, *The misperception of norms: The psychology of bias and the economics of equilibrium*, 4 REV. L. & ECON. 889 (2008)

the adoption of such measures will position them as an outlier. This may explain the steep decrease in the adoption of such measures between the beginning of the 21st century and a decade later.[57] Each shareholder engagement for the cancelation of such clauses not only affected the likelihood that the firm they engaged with would cancel such measures, but also the likelihood that another firm will maintain these provisions.

II. ENHANCING ENGAGEMENT BY SOPHISTICATED INVESTORS

A. Sophisticated Investors: Who are they?

Scholars propose various types of sophisticated shareholders as candidates whose engagement in corporate governance will generate positive externalities and thus the law should encourage their involvement. While there are many scholars in this vine of the literature, there is a great dispute among them regarding the identity of sophisticated shareholders that generate such an externalities.

1. Passive Funds

Bernard Black was one of the first scholars to point to the rise of institutional investors as a game changing factor for the agency problem that arises from rational apathy.[58] Other scholars such as Roberta Romano, Ronald Gilson and Reiner Kraakman have supported this view.[59] Investments by institutional investors are growing constantly, and they currently own over 70% of stocks traded in the U.S. stock markets.[60] The "big three" institutional investors—Blackrock, State Street and Vanguard—that most specialize in passive funds, manage over $5 trillion of U.S. corporate equities and collectively vote about 20% of the share in all S&P companies.[61] Since 2015, they constitute together the largest owner in nearly 90% of public companies in the S&P 500.[62] The largest 20 institutional investors in 2016 had a mean ownership in the largest 20 corporations of 33.4%, and the largest 50 institutional investors had a mean ownership of 44.2%.[63] According to the scholars noted above,

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[57] R. J. Guo et al., *Activism and the Shift to Annual Director Elections*, 14 J. ACCT. & FIN. 83, 83 (2014) (describing a decrease in the number of firm with staggered board from 60% of the S&P 500 in 2001 to fewer than 20% in 2014).

[58] Bernard Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 575–91 (1990); Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 795–853 (1992); Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991)

[59] Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 Col. L. Rev. 1599, 1607 (1989); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863 (1991).

[60] *See infra* note 143.

[61] Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 1 (2018) available on ssrn https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794

[62] Eric A. Posner et al., *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669, 687 (2017)

[63] Lucian Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problem of Institutional Investors*, 31 J. ECON. PERSPECTIVES 89, 93 (2017)

change in the structure of capital markets has a strong impact on fundamental principles of corporate governance. The Bearle-Means framework has pointed to dispersed ownership structures as the source of resulting rational apathy and agency problems which corporate law needs to address.[64] Given the significant rise in ownership of institutional investors, ownership is not as dispersed as Bearle and Means have assumed.[65] The ownership of the twenty largest shareholders in the twenty largest firms is over three times as high as Bearle and Means noted in their seminal article.[66] The greater concentration of shares in a limited number of shareholders reduces the rational apathy problem and the agency cost which follow. Each of the large mutual funds, such as BlackRock, Capital Research, Fidelity, State Street and Vanguard, have a position that exceeds $1 billion in a large number of public companies.[67] For example, at the end of 2017, BlackRock held $1 billion or more in 353 companies, Vanguard in 427 and State Street Global Investors in 242.[68] Such large positions eliminate the possibility that these funds suffer from rational apathy: it is certainly worth it for them to invest a significant amount in the supervision of the corporate governance of these companies, even if their intervention will increase the value of the company by a small margin. For example, in the companies in which these investors hold a position of one billion dollars, it is worth for these companies to spend up to half a million dollars in stewardship activities that have a 50% chance to increase the value of the company by 0.1 percent. Significant investment in monitoring these companies are rationally justified, and thus the rational apathy should not apply in these cases.

Passive funds are the primary driving force behind the growth of institutional investors enabling investors to overcome the rational apathy problem. Between 2008 and 2015, investors sold holdings of actively managed equity mutual funds worth roughly $800 billion while at the same time bought approximately $1 trillion in passive funds.[69] In 2017 alone, passive mutual funds have absorbed $696 billion, in contrast to the outflows from active funds that have reached $45 billion.[70] The reason for this growth in passive funds is that ample data shows that their performance is equivalent to or better than that of active firms, while their fees are substantially lower.[71] As of the end of 2017, the asset weighted average net expense ratio was 0.1% for U.S. equity

[64] *Id*. at 91
[65] *Id*. at 92
[66] *Id*. at 96
[67] *Id*.
[68] Bebchuk & Hirst., *supra* n. 61 at 15
[69] Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 319–20 (2017)
[70] Dani Burger, *Investing in Index Funds Is No Longer Passive*, BLOOMBERG (Feb. 28, 2018, 10:27) https://www.bloomberg.com/news/articles/2018-02-27/passive-becomes-the-new-active-as-indexing-rules-everything.
[71] Ben Johnson, et. al., MORNINGSTAR, *Morningstar's Active/Passive Barometer* (August 2018). https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Active_Passive_Barometer_2018_08.pdf?cid=EMQ_("The average dollar in passively managed funds has tended to outperform the average dollar invested in actively managed funds. . . . Investors would greatly improve their odds of success by favoring low-cost funds, which succeeded far more often than high-cost funds over the long term").

index funds, in contrast to actively-managed U.S. funds, in which the ratio was over six time more and stood at 0.73%.[72] The influx of investments in passive funds at the expense of active funds has caused traditional active funds such as Fidelity to enter aggressively into the passive fund sector with a zero-fee S&P 500 passive index fund.[73]

In addition to the sheer size of passive funds which enables them to effectively overcome the rational apathy problem, they have additional characteristics which place them in an especially promising position for monitoring companies for the benefit of all shareholders. Index funds constitute the most extreme example of passive funds. Because index funds do not have an "exit" option—they have to invest in the companies that comprise the index in which they are invested; they are more prone to use what Albert Hirshman called "voice" mechanism—influencing the companies they are invested in by voicing their grievances, especially through voting.[74] In other words, because they don't have the privilege to make the "Wall Street Walk" and sell the shares of a company with which they are dissatisfied, index funds are a good candidate for engaging with a company in which they are dissatisfied with its functioning.[75] An additional advantage of index funds as a monitoring entity is their long-term perspective. Because they do not have an exit option, by and large their investments in companies are for the long-term. This soothes the worries of judges and scholars about short-term engagements that could have a long-term adverse effect on shareholders.[76] Last but not least, because index funds have mostly cross-market investments, they also have an interest in contributing to market-wide rule making processes, such as comment letters on proposed SEC rules.[77] Their knowledge as major investors in most companies enables them to be valuable contributors to such processes.

2. *Active Funds*

The factor which positions active funds in a market disadvantage compared to passive funds is the same factor that enables them to serve a more effective role in the monitoring of companies: the fees. As stated in the previous subsection, fees of active funds are much higher than passive funds, which is the main reason for their limited market share in comparison to passive funds. Yet this same factor enables them to be a more effective entity in monitoring companies. The low fees of passive funds do not permit them to set aside resources for monitoring. Without analysts to evaluate corporate governance issues in the various companies that passive funds hold, they cannot provide the desired input. Bebchuk & Hirst provide evidence as to the low investments of passive funds in stewardship: The stewardship personnel of BlackRock, Vangaurd and SSGA are 33, 21 and 11 respectively, while the number of companies in

[72] Patricia Oey, *Fund Fee Study: Investors Saved More Than $4 billion in 2017*, MORNINGSTAR RESEARCH SERVICES (May 11,2018) https://www.morningstar.com/blog/2018/05/11/fund-fee-study.html.
[73] Owen Walker, *Fidelity's Zero-fee Campaign Spurs $6.6bn of Inflows*, FINANCIAL TIMES (Nov. 26, 2018) https://www.ft.com/content/d8569037-98fa-35bd-b3e5-861e8168161d.
[74] Bebchuk & Hirst, *supra* note 61 at 9
[75] *Id.*
[76] *Id.*
[77] Bebchuk & Hirst, *supra* n. 61, 49-51.

their portfolios range between 17,300 and 18,900.[78] Bebchuk & Hirst have calculated that even these large passive funds spend no more than 3.5 person-days each year to oversee a billion-dollar investment.[79] Active funds suffer from this problem to a lesser extent. Their fees are higher in order to be able to finance a staff of analysts, including those covering corporate governance issues. They well over compensate for smaller size compared to passive funds, by their greater level of sophistication.

Yet the difference between passive and active funds isn't as big as it may seem. Cremers & Petajisto have noted that many of the active funds are in essence "closet indexers" whose holdings substantially overlap with their benchmarking index.[80] Even though active funds have the resources at their disposal for investing in the monitoring of corporate governance, they do not have the incentive to do so. Active funds are mainly concerned with performance relative to other funds of the same type. The inflow of additional investment, which is their primary goal, depends not on the absolute return, but on their relative return in comparison to their peers. Because of the investment similarities of active funds of the same type, investing in corporate governance is disadvantageous for them, even if it succeeds: all funds invested in a company gain from the increase in value, while only the fund that invested in the corporate governance monitoring will bear the cost.[81]

3. Activist Hedge Funds

Activist hedge funds are small actors but much more sophisticated than even active funds. The capital deployed by hedge funds in 2017 stood at $62 billion, which is less than a tenth of the inflow of capital to passive funds alone, which stood at $692 billion.[82] Scholars have pointed to the disadvantages of passive funds which locate activist hedge funds in a much better position for monitoring and engaging with companies. However, Ronald Gilson and Jeffrey Gordon have noted that active hedge funds do not have a strong interest in monitoring companies in their portfolio. They are mainly concerned with their performance relative to their peers in order to attract more investors.[83] Because of portfolio similarities, including those with active funds, monitoring and enhancing the value of companies which an institutional fund holds, benefits also its peers, while it bares the entire cost. Thus, such monitoring not only will not improve its relative performance to peers, but also may diminish it.[84]

[78] *Id*. at 32.
[79] *Id*. at 34
[80] Martijn K. J. Cremers & Antti Petajisto, *How Active is Your Fund Manager? A New Measure that Predicts Performance*, 22 REV. FIN. STUD. 3329 (2009)
[81] 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 (2013)
[82] Investopedia.com (last updated February 2018), https://www.investopedia.com/terms/i/indexfund.asp; 2017 Activism Year in Review, Lazard, https://www.lazard.com/media/450414/lazards-review-of-shareholder-activism-q4-2017pdf.pdf. See also , Morningstar Asset Flows Commentary: United States, https://www.morningstar.com/content/dam/marketing/shared/Company/LandingPages/Research/Documents/Morningstar_Fund_Flows_Commentary_Dec_2017.pdf?cid=EMQ_
[83] *Id. supra* note 81at 889-90.
[84] *Id*.

In light of the weakness of institutional investors, including active funds, in monitoring management and directors of companies, Ronald Gilson and Jeffrey Gordon have pointed to a different actor that can monitor more effectively: activist hedge funds. Unlike institutional investors, activist hedge funds are not invested in a wide range of assets, but rather invest and focus on a few companies. As such, they have a much stronger incentive to invest in engaging and monitoring the companies in their portfolio.[85] Even though the resources they have at their deployment are limited, Gilson and Gordon have claimed that institutional investors should support engagements of institutional investors.[86] This is a win-win for both actors: institutional investors would be able to enhance the monitoring of companies without baring the costs and hedge funds will receive the much needed support so that their engagement with the companies have fruitful results.[87]

While there are many scholars who support the positive outlook on activist hedge funds and the monitoring role they perform that benefits all shareholders, some scholars argue that the interest of activist hedge funds diverge from the interests of most other shareholders.[88] Activist shareholders aim at increasing shareholder value in the short term. The average holding period of the shares of a company by AHF is slightly higher than a year.[89] Some scholars claim that the strategies that AHF employ for maximizing shareholder value in the short run may decrease shareholder value in the long-run. The most prominent example is an engagement for reducing corporate expenditures on R&D. Such cuts may increase a company's profits and as a result share value in the short run, but it may decrease the value of the company and its shares in the long run when R&D could have increased revenues exponentially. Cremers at al. have substantiated such claims with data demonstrating that over periods of five years, engagements decreased the average performance of such companies in comparison to other companies with the same characteristics.[90] This critique of AHF—that their primary concern of returns in the short run are at the expense of most other shareholders who are primary concerned with the long run—is voiced not only by academics, but

[85] Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 tbl.III (2008)
[86] *Supra*, Gilson and Gordon, note 81.
[87] *See also*: Lucian Bebchuk, *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39, 49 (2012); Alon Brav, et al., *Hedge Fund Activism, Corporate Governance and Firm Performance: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009)
[88] John C. Coffee Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 ANNALS OF CORPORATE GOVERNANCE, 1, 60-61 (2016) (reinforcing Lipton's claims and pointing that when focusing on the announcement of the successful outcome that the activist perused and no to the time that a block is announced, outcomes of payout changes-increasing dividends or stock buybacks had an average of a negative abnormal returns of -0.2%)
[89] *See* for example Roger L. Martin, Activist Hedge Funds Aren't Good for Companies of Investors, So Why Do They Exist? Harvard Business Review, August 20 2018 https://hbr.org/2018/08/activist-hedge-funds-arent-good-for-companies-or-investors-so-why-do-they-exist (referring to data according to which the average holding period of activist hedge funds is 423 days).
[90] K.J. Martijn Cremers et al., *Hedge Fund Activism and Long-Term Firm Value* (January 2016), available at https://ccl.yale.edu/sites/default/files/files/leo16_Sepe.pdf

also by judges on the Delaware Supreme Court.[91] Scholars supporting the positive impact of AHF engagement for all shareholders have reached the opposite results regarding their impact on firm performance in the long run, finding that they out-perform the firms in their sector also in the long run.[92]

4. Taking Stock

Although there is no universal agreement among scholars and judges about the desirability of engagements by institutional investors, the involvement of sophisticated investors in firms is generally viewed as a positive influence on the management of firms and key to improved corporate governance. As the discussion hitherto has demonstrated, there exists some disagreement about the precise identity of sophisticated investors who can best improve corporate governance. In terms of alignment of interests with individual shareholders, index funds are probably the best candidates, but on account of their portfolio diversification, they prefer to remain passive. Active funds, as their name implies, do not just sit on the sidelines of financial markets, but they get actively involved in firms. They also tend to take long investment positions and hence their interests are largely aligned with those of the individual shareholders. Active hedge funds are arguably the most effective change agents in the corporate world; in their case, the mere possibility of engagement can cause firms to improve their ways. But their short investment horizons may drive a wedge between their interests and those of individual shareholders.

At the end of the day, we believe that all three can usher new corporate norms and change the ways of the old world. Using them in tandem will expedite the transformation. Hence, policies seeking to improve corporate governance should, as a starting point, focus on passive funds, activist funds, and activist hedge funds. For this reason, our policy proposal begins with these three sophisticated investors and targets them for favorable tax treatment. It should be noted, however, that nothing in our proposal bars the addition of other sophisticated investors.

B. Solutions for Enhancing Engagement of Sophisticated Investors

To be sure, we are not the first to note the potential of sophisticated investors to improve corporate governance. A review of the existing literature reveals several proposals that seek to enhance engagements of sophisticated institutional investors with firms. In the paragraphs that follow, we review these proposals.

1. Mandatory Participation.

[91] 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. LAW, 1, 7-9 (2010)
[92] Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015); *See* also C. P. Clifford, *Value Creation or Value Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 2008 (finding that the formation of a block has a positive effect on the value of the company controlling for market performace and other factors, also three years after it was formed); R. Greenwood and Antoinette M. Schoar, *Investor Activism and Takeovers*, *92* J. FIN. ECOn. 362, (2009) (finding that in average 18 months after control block has been formed, the shares of the target companies increase by over 10%, controlling for market performance and other parameters).

Scholars have suggested a straightforward solution to the low participation of sophisticated investors in corporate governance: mandatory participation in the proxy voting process.[93] This suggestion has also been endorsed by policymakers, who require certain institutional investor to vote in shareholder meetings.[94] Other lawmakers have adopted a softer mechanism requiring institutional investors to consider matters that are up to a vote and then disclose whether they voted or not, without actually forcing them to vote. Forcing institutional investors to disclose whether they voted gives them a strong motivation to exercise their voting rights, lest they be perceived by their investors as shirking their duties.[95]

As several scholars have noted, the efficacy of such mechanisms is relatively low.[96] Although a direct mandate that forces institutional investors to vote its proxies can achieve meaningful involvement, forcing institutional investors to cast votes cannot in and of itself ensure a deliberative process leading up to the vote, let alone encourage the investment in resources to monitor management on an ongoing basis. The desired goal is not to increase the symbolic engagement of institutional investors, but, rather to guarantee continued high-quality, substantive engagement.

2. *Requiring a Certain level of Expenses on Monitoring Corporate Governance*

Lucian Bebchuk and Scott Hirst have proposed a different mechanism for enhancing sophisticated investor involvement in corporate governance: requiring index funds to allocate a certain percentage of the money they invest toward stewardship activities.[97] According to Bebchuk and Hirst, even a relatively low mandated expense of 0.0005% or 0.001 will double or even triple the existing expense level of passive funds on stewardship.[98] Such a mandated expense will put to a stop the “race to the bottom" in which funds, and especially passive ones, reduce fees, which, in turn, leaves virtually no resources to be spend on stewardship services. Bebchuk and Hirst have proposed

[93] M. See, *The Case for Compulsory Voting in the United States*, 121 HARV. L. REV. 591, 596–98 (2007) (listing benefits of compulsory voting).

[94] The first to do so, was the department of labor which serves as the regulator of defined-benefit pension plan, and has required institutional investors of defined-benefit plan to vote their proxies. For the origination of the voting mandate, see: Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, Pension & Welfare Benefits Admin. of the U.S. Dep't of Labor, to Helmuth Fandl, Chair of the Retirement Bd., Avon Products, Inc., 1988 WL 897696 *2 (Feb. 23, 1988); For the codification of this mandate, see: Interpretative Bulletin Relating to the Exercise of Shareholder Rights and Written Statement of Investment Policy Including Proxy Voting Guidelines, 29 C.F.R. § 2509.08.2 (Oct. 17, 2008), *superseding* 59 Fed. Reg. 32607 (June 23, 1994).

[95] Final Rule: Proxy Voting **by** Investment Advisers, Exchange Act Release No. IA-2106, 17 C.F.R. § 275 (Jan. 31, 2003) [hereinafter Investment Advisers Act Release], *available at* http://www.sec.gov/rules/final/ia-2106.htm. According to the rule "The duty of care requires an advisor with voting authority to monitor corporate actions and vote client proxies. Therefore, the advisor should have procedures in place designed to ensure that it fulfills these duties. We do not suggest that an advisor that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the clients best interest…We are requiring public disclosure as as a means of informing fund shareholders how the fund (or it adviser) voted proxies of the shareholder's fund."

[96] Richard L. Hasen, *Voting Without Law?*, 144 U. PA. L. REV. 2135, 2174–75 (1996).

[97] Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, evidence and Policy*, EUROPEAN CORPORATE GOVERNANCE WORKING PAPER 433/2018 (December 27, 2018) 56, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794

[98] Id at 57.

such a mandate in the context of passive funds, but it could potentially be expanded to all funds.

Bebchuk and Hirst's proposal has two potential drawbacks. First, the proposal essentially imposes a tax on investors of passive funds. The regulation suggested by Bebchuk and Hirst adds to the cost of funds and at least a part of it would roll over to investors. The equivalence between regulation and taxation is true in general, but in this case in which the expense is significant, there is also a high likelihood that its incidence would be barred by investors. The second and more central drawback of the proposal concerns its efficacy: it is questionable whether expenses that managers were not interested in incurring will generate effective stewardship services. There are strong grounds to believe that the outcome will be similar to that of a general participation mandate. Forcing funds to provide a service they were disinclined to perform when left to their own devices, will lead them to comply with the measure unenthusiastically and sub-optimally.

3. Pooling of Resources

Sharon Hannes has suggested that institutional investors pool their resources in order to detect underperforming companies, and then engage in the improvement of their management. Under his vision of a structure he labels a "super hedge fund," institutional investors form contractual agreements with a 'task force' whose job is to detect underperforming companies.[99] When the task force detects an underperforming company, it is able to make a 'capital call' on the institutional investors in proportion to their holdings in the target, in order to cover the costs of engagement.[100] The central idea behind this proposal is to overcome the collective action problem of institutional investors via the adoption of a contractual pre-commitment mechanism.

Hannes' proposal is extremely creative and ingenious, but it has several potential downsides. First, the same collective action problem that undermines coordination among institutional investors now would also undermine the contractual solution proposed by Hannes. Even if we force sophisticated investors to enter the agreements contemplated by Hannes' proposal, which may be very difficult to do in the current political environment, it is likely to be extremely difficult to get institutional investors to agree on the specific terms of the agreement that is supposed to bind all of them. And, the negotiation process will surely be very costly. Second, Hannes' proposal introduces a new player into the mix—the "task force." This, in turn, creates a new agency problem. Because the Super Hedge Fund that Professor Hannes wishes to set up is not directly invested in the engagement it directs, it will not be necessarily effective in choosing the best targets. Hannes points out that institutional investors would be able to monitor the task force's efficacy.[101] But, it is not clear that they would. The ability of institutional investors to monitor the activities of Super Hedge Funds is likely to be undermined by a collective action problem. Since monitoring is a costly activity and it can be performed by any institutional investor, each institutional investor

[99] Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163 (2015) 164-65
[100] *Id.* at 166.
[101] Hannes, *supra* note 99 at 166-67.

would prefer to let others do the monitoring. This, in turn, will lead to an equilibrium of no monitoring. An additional problem with the Super Hedge Fund solution is that separate agreements with each institutional investor may lead it to focus on certain assets of certain institutional investors. The institutional investors which would be willing to provide it with more generous terms will gain by having their assets scrutinized more carefully by the task force.[102]

4. Dual Stock Structure as a Means for Reinforcing Engagement power of Active Funds and Activist Hedge Funds.

In a recent article , Dorothy Lund has suggested utilizing a dual stock non-voting share structure as a mechanism for empowering active funds to engage in monitoring companies at the expense of other shareholders—especially passive funds.[103] A non-voting dual-stock structure has been much derided by both scholars and market actors in the context of the Snap IPO.[104] Lund's provocative argument underscores a positive and desirable element of non-voting shares: they enable an increase in the power of shareholders with a higher potential to engage and influence the company. In this respect, Lund groups together active funds and activist hedge funds, which she then

[102] This is an equivalent conflict-of-interest to that which arises in the current system in which proxy advisors provide service directly to companies, which may affect their recommendations on proxy voting in those companies. *See:* Tamara C. Belinfanti, *Proxy advisory and corporate governance industry: The case for increased oversight and control*, 14 STAN. J. L., BUS. & FIN. 384 (2008); Sagiv Edelman, *Proxy advisory firms: a guide for regulatory reform* 62 EMORY L. J. 1369 (2013); Assaf Eckstein, *Skin in the Game: Aligning the Interests of Credit Rating Agencies, Proxy Advisors, and Investors*, 7 HARV. BUS. L. REV. 222 (2017).

[103] Dorothy Shapiro Lund, *Nonvoting Share and Efficient Corporate Governance*, 71 STAN. L. REV. (forthcoming 2019) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3028173.

[104] See: Steven Davidoff Solomon, *Snap's Plan is Most Unfriendly to Outsiders*, N.Y. TIMES (Feb. 3, 2017) available at https://www.nytimes.com/2017/02/03/business/dealbook/snap-ipo-plan-evan-spiegel.html?_r=0 (describing the Snap IPO and anticipating the negative reaction it may arise). Many of the leading indexes, such as FTSE Russel and S&P 500 Dow Jones, have decided to exclude companies issuing non-voting stock, in reaction to the Snap IPO. See: *FTSE Russel Voting Rights Consultation – Next Steps* (July 2017), available at: https://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf (deciding it would bar companies issuing non-voting stocks from inclusion in the index, unles at leat 5% of the voting rights are in public hands); *S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rights* (July 31, 2017) (press release), available at: https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true (deciding to bar from the index companies issuing multiple-class shares from the time of the decisison onwards). Scholarly objections to Dual-Class Stock have predated the Snap Inc. IPO, but have gained wind thereafter and made use of the Snap IPO to support and reinforce their view. For the earliest critiques of dual stock IPOs, see: Lucian Bebchuk, Reinier Kraakman, & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control From Cash-Flow Rights*, CONCENTRATED CORPORATE OWNERSHIP 298- 99 (2000); Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 4 (1988); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 73 (1991). After the IPOs, scholars have refined to it as optimizing the problem of Dual-Class, see: Lucian Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 101 VA. L. REV. 585, 589 (2017). In a following recent article, Lucian Bebchuk and Kobi Kastiel addressed and emphasized the problem with especially small-minority controllers, a situation similar to the one that pertained the Snap case. See: Lucian Bebchuk and Kobi Kastiel, *The Perils of Small Minority Controllers*, (December 27, 2018) available on SSRN https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3128375.

distinguishes from passive funds. Activist hedge funds and active funds are willing to invest in the monitoring of companies in their portfolios.[105] Passive funds are not. Given their reliance on low fees and the fact that their portfolios are identical to those of their competitors, passive funds have neither the interest nor the resources to engage in the monitoring of companies in their portfolio.[106] Shifting voting power from passive to active funds is especially important, given the ongoing increase in investments in passive funds at the expense of active funds.[107] The existence of non-voting shares alongside voting shares enables efficient sorting to take place: informed shareholders would be willing to pay a premium for voting shares and non-informed investors such as passive index funds would prefer to purchase non-voting shares at a discount.[108] This efficient sorting would enhance the ability of informed shareholders to monitor the firm and lower the firms' cost of capital due to more effective monitoring by shareholders.[109]

The central problem with Lund's suggestion is that it may actually exacerbate the problem it is targeted to solve. One of Lund's main concerns is the increasing investment by uninformed shareholders such as passive index funds. Lund aims to decrease the power and voice of these actors, while their equity stake in firms rise, by separating equity rights and voting rights. Passive funds and their investors free-ride on the monitoring of other investors, including active investors. This free riding is one of the primary sources of the growth of passive index funds: their investors pay 80% less than the average fees of active investors, which is made possible by the higher fees charged by active investors. Lund’s proposal will only intensify the free-riding problem by increasing the gap between the costs of passive index funds and active index funds. Implementation of Lund’s proposal would force active funds to pay a higher price for the same equity rights that passive funds obtain. Passive funds will purchase non-voting shares at a discounted price, compared to the price of the voting shares that active funds the will purchase, while the equity rights associated with both types of funds are identical. Hence, Lund increases the power of non-sophisticated, uninformed shareholders at the expense of the informed-sophisticated shareholders.

5. Enhancing the Influence of Institutional Investors in the Voting Process

Many policymakers and scholars deem the participation of institutional investors in corporate governance matters as a highly desirable goal.[110] However, they have noticed that their actual participation in proxy voting regarding firm matters was rather low.

[105] Shapiro Lund, *supra* note 103 at 5-6
[106] *Id*. at 17-18.
[107] *Id*. at 18-19.
[108] *Id*. 30-31
[109] *Id*.
[110] For the first proponents of this view, see: Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991–1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991). One of the most recent scholarly works supporting this view is Bebchuk & Hirst, *supra*, note 61. For a recent more neutral view, that does not identify institutional investors as a vice that should be retrained, but neither as the Messiah for investors, see: Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders be Shareholders* (Dec. 5, 2018) available on SSRN https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3295098&download=yes.

Some scholars have suggested that a central barrier to the participation of institutional investors is their actual impact on the outcome of votes. Even in cases in which an institutional investor holds a sizeable block of shares which consists of close to 5% of a firm's voting shares and is willing to invest in informing itself about the issue at bar, its ability to impact the outcome is rather limited. After all, even if the absolute value of the block of shares is sizeable, it is only a small fraction of the votes necessary to form a majority. Hence, scholars have suggested that enhancing the impact institutional voters have on actual outcomes would increase their involvement in the firms in their portfolio. One proposal which sought to achieve this goal focused on enabling and facilitating cooperation among institutional investors. While each institutional investor holds a limited block of shares, which rarely exceeds five percent, if institutional investors collaborate on their voting, they would have a sizeable block of roughly 40% of votes in over 90% of the public companies.[111] This, however, requires abolishing regulatory restrictions on cooperation of institutional investors, mostly instituted for anti-trust purposes. Other scholars have suggested that companies adopt cumulative voting in order to increase the ability of institutional investors to secure board representation. Cumulative voting enables each voter to have a number of votes equal to the number of candidates. It opens up the possibility of using all votes for one candidate, which increases the ability of small shareholders to determine the identity of one director on the board.[112]

An additional idea, that has even been endorsed by the S.E.C. for a period of time, is to enable institutional investors' proxy access. A major barrier to increasing institutional investor engagements is the prohibitive cost of suggesting new directors for the board. In most cases, it requires a proxy fight. This means that the investor suggesting a new director must incur the cost of printing and mailing proxy notes to all shareholders, a cost of millions of dollars.[113] Proxy access rules enable dominant shareholders, holding a block of shares of over a certain threshold–mostly about of 3%––to have access to companies' proxies and to add their suggested candidate for the board on to the companies' own proxy ballot.[114] This significantly reduces the cost of suggesting a candidate for the board by institutional investors and other actors such as activist hedge funds. Following Dodd-Frank, the S.E.C actually adopted a rule that

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[111]Bebchuk et al., *supra* n. 63 at 93.

[112]Having a representative on the board can further deepen the involvement of institutional investors in the management of firms. *Cf* John C. Coffee Jr. et al., *Activist Directors and Agency Costs: What happens When an Activist Director Goes on the Board*, COLUM. BUS. SCHOOL RESEARCH PATER, no. 18-15 (Jan. 29, 2018) available at ssrn https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3100995 (showing evidence that activists hedge may be using board representation for inside trading).

[113] David Webber, THE WORKING CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON (2018), 47

[114] *Id*. at 53, 63-70

mandated proxy access,[115] but it was struck down by the D.C. Circuit.[116] Yet some institutional investors, backed by state pension funds, have pressed companies to adopt shareholder proxy access rules. Indeed, the number of firms that adopted this measure rose from 5% of the S&P 500 companies in 2014 to 35% by the end of the 2015 proxy season.[117] Yet, this development did not change institutional investors' pattern of behavior. There have barely been any cases in which institutional investors have suggested a new candidate to the board, even after the significant increase in companies with proxy access rules. [118]

III. NEGATIVE TAX FOR ENHANCING ENGAGEMENT OF SOPHISTICATED INVESTORS

The classic economic solution to the problem of externalities–both negative and positive–is to impose a tax or subsidy on the externality generating activity. Under this model that originated with Arthur Cecil Pigou, activities that generate negative externalities, i.e., harmful external effects, ought to be subjected to a positive tax. The tax should be commensurate with the marginal social harm caused by the activity in order to reduce the level of the harm causing activity to the social optimum. Otherwise, actors would fail to consider the full cost of their actions and we would face an excess supply of harm-causing activities. Activities that engender positive externalities, i.e., benefit others, call for the mirror image solution. Such activities will be under-supplied by the market since the actor captures only a portion of the benefit she produces. Hence, to induce an optimal supply of benefit engendering activities, the state should use negative taxes, i.e., subsidies, to make up for the shortfall in the incidence and quantity of such activities when they are left to the market.[119] Even though the activities of sophisticated institutional investors are widely believed to generate a myriad of positive externalities for other shareholders and the public at large, as we discussed in Part I., *supra*, and although a Piguvian subsidy is the classic policy response to the phenomenon of positive externalities, to date, no one has proposed the use of a negative Piguvian tax to encourage engagements by sophisticated institutional investors. In the proceeding paragraphs, we rectify this omission.

The gist of our proposal is to use tax benefits to induce sophisticated institutional investors to increase their involvement in corporate governance. As noted in the previous Part, our proposal focuses, at least initially, on the following three sophisticated institutional investors: passive funds, active funds and activist hedge funds. This does not mean, however, that all three must necessarily be subjected to the

[115] A section in the Dodd-Frank Wall Street Reform and Consumer Act of 2010, entitled "Proxy Access" authorized the S.E.C. to include a "nominee submitted by a shareholder to serve on the board of directors." *See* 15 U.S.C. §78n(a)(2)(A). The proxy access rule the S.E.C had adopted a rule that permitted diversified long-term shareholders that own 3% of its stocks alone or combined with others, to nominate candidates on the company's ballot. They can do so to up to a quarter of the outstanding board seats. See: FACILITATING SHAREHOLDER DIRECTOR NOMINATIONS, EXCHANGE ACT REL. NO. 62,764 at 108 (Aug. 25, 2010).

[116] *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011)

[117] WEBBER, *supra* note, 113 at 70

[118] *Id*. at 77

[119] See *supra* notes 25-27 and accompanying text.

same tax treatment. If, for example policymakers deem engagements by activist hedge funds especially desirable, they can increase the tax credits granted to this group or lower the credits given to the two other groups.

Our proposal differs from most prior proposals that seek to enhance the involvement of institutional investors in corporate governance in that most the extant proposals rely heavily on sticks—coercive regulatory measures that are at odds with the interests of sophisticated investors—whereas ours employs a carrot—favorable tax treatment that is optional in nature. Another advantage of tax credits is that they provide policymakers with a flexible and multi-faceted tool that can be applied differently to different market actors, depending on the context. We initially divide our discussion of tax benefits into two broad headings: effort-based tax credits and result-based tax credits. We then show how the two types can be combined.

A. *Effort-based Tax credits*

The most straight-forward tax credit is one that directly subsidizes the activity we wish to enhance. If we want institutional investors to invest more in stewardship, we could subsidize the expenses of the activity. For example, the federal government can give them a 50% tax rebate, on top of the standard deduction, on expenses incurred on employing analysts that monitor corporate governance, as opposed to portfolio building analysts. Providing an additional tax credit, will most likely increase the institutional investors' investment in stewardship personnel as it would reduce the net cost of such personnel for institutional investors.

One may argue that institutional investors, especially large ones would be apathetic to the actual costs of such personnel. As noted above, "the big three"– BlackRock, State Street and Vanguard—alone have under $5 trillion under their management and, hence, the proposed tax rebate will have no direct effect on them. Yet a careful examination of their costs suggests that our tax rebate will affect them indirectly. The big three's expenses on stewardship services constitute 0.00018% to 0.00029%, of their assets under management.[120] Hence, from their perspective, our proposed rebate translates to estimated cost savings of millions of dollars, given *current* investment in stewardship services. This is no small amount even for the big three; and if our proposal is implemented, it would have the effect of inducing greater investment in stewardship services, and, correspondingly, greater tax credits.

A subsidy of stewardship expenses can also help narrow the gap between active and passive funds. As we discussed in Part II.B., *supra*, some scholars view this gap as problematic: passive funds are free-riding on the monitoring services provided by active funds.[121] As a result, they can afford to charge lower fees and attract more investments. On average, active funds are more than six times more expensive than average passive funds.[122] Affording a favorable tax treatment to active funds can help level the playing field. First, it would reduce the expenses of active funds and enable them to charge

[120] Bebchuk & Hirst, *supra*, note 61 at 33
[121] See Lund, *supra* note, 105
[122] See *supra*, note 72

lower fees. Second, it may increase the number of active funds both by inviting new entry and by converting some passive funds into active ones.

A tax credit for expenses on stewardship services does not have to be uniform. A uniform tax credit may cause "leakage," namely, subsidization of behavior that would have occurred even without the favorable tax treatment. Such subsidies are wasteful from a social perspective as they implicate significant transaction costs for the government without affecting the behavior of the target group. To avoid this problem, we propose that the tax credit would only apply to expenditures in excess of the institutional investors current spending on stewardship. In other words, if we know that currently, without a subsidy, large passive funds spend at least 0.11% of their aggregated fees and expenses on stewardship services, the subsidy should apply only to expenditures that surpass that percentage.[123] In order to limit the ability of investors to manipulate the threshold by decreasing fees and expenses in response to our proposal, it is possible to determine the threshold of expenses for purposes of calculating the credit as a percentage of assets under management.[124]

The use of assets under management as a baseline also favors active funds, relative to passive ones. Passive funds, after all, have more assets under management and would therefore need to invest significantly more than active funds in stewardship services in order to pass the threshold. It is noteworthy that requiring expenditures on stewardship to exceed a certain percentage of assets under management as a precondition for receiving the credit forms a progressive tax benefit. This is because our proposed credit mechanism favors the smaller funds at the expense of the largest funds.

An expense-based credit is less suitable for incentivizing activist hedge funds to engage with a company. The main reason is that in activist hedge funds the division between portfolio building analysts and corporate governance analysts tends to break down.[125] Because activist hedge funds are much smaller entities, their analysts perform a myriad of functions and it is hard to isolate expenses on analysis performed for the purpose of engagement. In other words, in the case of hedge funds it is hard to distinguish between portfolio analysts and stewardship analysts. For this reason, as we discuss below, outcome-based credits may more be more suitable for activist hedge funds.

With that said, some effort-based credits can readily be applied to activist hedge funds. So far, our analysis has focused on monitoring expenses. Monitoring, however, is not the only form of stewardship; it is a mere component thereof. Voting is even more important than monitoring. Indeed, it is the holy grail of engagements. Hence, expenses on proxy fights would also qualify for our proposed tax credit. In fact, the

[123] Bebchuk & Hirst, *supra* note 61 at 33 (revealing that the spending of BlackRock is 0.12% from the total of its fees and expenses; for Vanguard it is 0.18% and for SSGA it is %0.11, which is the lowest and could be used as a reference point).

[124] An additional alternative that would disable such manipulation, is setting the threshold in accordance to a certain absolute level of spending on stewardship services. Yet this is not desirable on different grounds: it provides an advantage to large institutional investors that could more easily reach the threshold without spending a large share of their fees and expenses on stewardship services.

[125] This may be the case in other small funds. *See*: Rock & Kahan, *supra* note 6 at 8.

credit may even be larger than that given for monitoring. In this case, activist hedge fund should have no problem demonstrating their expenses on proxy fights and will be credited accordingly.

The central disadvantage of effort-based tax credits is that they may fall short of bringing about the desired outcome because spending more on monitoring does not necessarily result in better corporate performance.

So what reason is there to institute effort-based tax credits? Isn't it always dominated by result-based tax credits that tie a subsidy to certain desirable outcomes occurring? While there are certainly advantages to result-based tax credits, effort-based credits have an important virtue: they spur actors to try to bring about change when success is uncertain. In our case, it is especially important to offer effort-based tax credits because sophisticated investors often operate under conditions of uncertainty. Yet, whether they are ultimately successful or not, they have to sink considerable costs in the quest for their desired result. Furthermore, as we demonstrated in part I.B.2.a, supra, even failed engagements generate positive externalities. The threat of engagement in and of itself affects managerial behavior. Hence, it is very important that efforts, too, would entitle sophisticated investors to receive tax credits. It should be born in mind that even though sophisticated investors are mostly flush with cash, they may still not be highly motivated to take the risk. As noted earlier, monitoring corporate governance is not their bread and butter, and thus when such activities involve risk, they may be less willing to open up to such a strategic change, even given the incentive scheme. For this reason, they may be much more sensitive to an effort-based tax credit scheme that offers them a reward for performing a certain desirable activity. There is a vast literature in mechanism design on this very issue and in personnel economics as well.[126]

B. Result-Based Tax Credits

The second form of credit we propose is a result-based credit. The result-based credit is conditioned on the occurrence of a certain predetermined result. The use of result-based tax credits requires policymakers to address two distinct questions. First, they must determine which results would entitle sophisticated investors to claim the credit. Second, they must decide how to calculate it. Our discussion will address both issues.

1. Defining Desirable Outcomes

Although one might think that the list of outcomes that should entitle sophisticated investors to a result-based credit is potentially infinite, this is far from the case. In fact, there is broad consensus among corporate scholars about the enumeration of desirable interventions. And, while there may be some disagreement on the margin, it should not detract from our proposal for a simple reason. We do not need to come up with a closed list (numerus clausus). As a starting point, we can utilize the list of agreed interventions

[126] *See e.g.:* Edward P. Lazear, PERSONNEL ECONOMICS IN PRACTICE 109-170(2nd ed., 2009); Canice Prendergast, *The Tenuous Trade-off Between Risk and Incentives*, 110 J. POL. ECON. 1071 (2002). For a similar discussion regarding the optimal design of a Pigouvian Tax, see Adi Libson, *Confronting the Retirement Savings Problem: Redesigning the Savers' Credit*, 54 HARV. J .ON LEGIS. 207, 240-44 (2017).

and, if necessary, we can expand it in the future. The list we compile below is, therefore, non-exhaustive.

a. Representation on the Board

The first outcome policymakers can use is board representation. A seat on the board provides sophisticated investors with two important advantages: unmediated access to non-public information about firms and the power to influence decision-making within a firm. A board seat also enables a sophisticated investor to ask questions and receive answers from a company's management. Her participation in board meetings allows for direct access to firms' top management and an opportunity to provide valuable input. In addition, board representation may motivate sophisticated investors to get more involved with a firm.

b. Proxy Fights

Another result that would entitle sophisticated investors to receive tax credit is a victory in a proxy fight. Engagement in a proxy fight is an activity with a high impact on corporate governance. Proxy fights have intrinsic value: they function as a very powerful check on management and the board. They serve as a reminder to corporate directors and officers that their central accountability is toward the shareholders. In fact, proxy fights are so important to corporate governance that even the *initiation* of a proxy fight should entitle sophisticated investors to a result-based credit. Naturally, if the sophisticated investor ultimately prevails, she should be rewarded by a result-based credit of greater magnitude. It is important to differentiate between the two scenarios – initiation and success – in order to give sophisticated investors an incentive not to settle for initiating proxy fights, but to follow through and ensure success. More importantly, success in a proxy fight generates greater positive externalities and is therefore should be rewarded more handsomely.

c. Acceptance of proposal

Shareholder proposals can also improve the performance of firms. Unlike proxy fights, however, shareholder proposals do not require significant investment of resources. Thus, they are more open to manipulation: shareholders may execute proposals just for the sake of the credit. Yet this could be curtailed for two simple responses. First, the applicable credit would be relatively low. Second, unlike the credit for proxy fights, the credit in this case would be limited to proposals that receive a majority.

d. Elimination of Anti-Takeover Mechanisms

Arguably, the most valuable engagements are those that fall under the category of structural engagements. Such engagements enhance the market for corporate control and facilitate future changes in management. The two classic results that arise in this context are the de-staggering of boards and the removal of poison pills.[127] Although not all corporate scholars agree that anti-takeover mechanisms are undesirable, the weight

[127] *See supra*, note 57. For a description for the how the Shareholder Rights Project headed by Professors Lucian Bebchuk and Scot Hirst significantly decreased the number of on public companies with staggered boards and poison pills, see WEBBER, *supra* note, 113 at 76-77

of the authority suggests they are.[128] Here we do not need to take sides, however. We do not propose a regulatory intervention that would make anti-takeover devices illegal. We leave the decision as to the desirability of these measures to the market and allow it to select on a firm-by-firm basis. There is not a priori reason to believe that sophisticated investors would seek to eliminate anti-takeover measures when they enhance firm value. Such measures will be targeted by sophisticated investors only when they are value reducing.

e. Pro-Shareholder Voting Rules

Another desirable result is the institution of pro-shareholder voting rules. In this category, we include proxy access rules,[129] cumulative voting rules[130] and majority voting rules (instead of plurality voting rules).[131] These goals are achieved by amending a corporation's charter. All such reforms aim at increasing the ability of shareholders to engage and influence a company's future decisions. Thus, these reforms are very valuable from a corporate governance perspective and should entitle those who affect them to tax credit.

2. Setting the Credit

There are two possible ways to determine result-based credits. First, it can be assessed in absolute terms based on the cost of the engagement. For example, policymakers can decide that the success in a proxy fight entitles a sophisticated investor to receive full or partial reimbursement of its expenses in addition to a deduction of the expenses. Alternatively, it is possible to set the credit as a certain percentage of the increase in firm value. In the proceeding discussion, we analyze the pros and cons of each method. Result-based tax credits can be pegged to share prices .Because we focus on public companies, it is possible to estimate the value of the engagement based on the change

[128] See: Olubunmi Faleye, Calssified Boards, *Firm Value and Managerial Entrenchment*, 83 J. FIN. ECON. 501 (2007) (proving that classified board are associated with a significant reduction in firm value); Lucian Bebchuk & Alma Cohen, *Recent Board Declassification: A Response to Cremers and Sepe*, available on SSRN https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2970629&download=yes; (critiquing a prior study, and claiming that it had not proven that declassifications are value reducing, and may even provide evidence that they are value increasing); Lucian Bebchuk et al., *Staggered Boards and the Wealth of Shareholders: Evidence from Two Natural Experiments*, NBER WORKING PAPER 17127 (June 2011), available at https://www.nber.org/papers/w17127; Lucian Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. Fin. Econ. 409 (2004) (claiming that staggered boards reduces firm value). But *see*: Martijn Cremers et al., *Staggered Boards and Long-Term Firm Value, Revisited,* 126 J. FIN ECON. 422 (2017) (point to findings that staggered boards do not affect firm value); David Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431 (2011) (arguing that staggered board is a value-maximizing choice).

[129] Bebchuk, *supra*, note 1. *But see*: Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347 (2011) (foreseeing that proxy access rules would have low impact on nomination of new directors); Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L. J. 435 (2011) (arguing that even if proxy access rules may have significant advantages, they should still be left for private ordering and not be mandated).

[130] Black & Krackman, *id*.; Gordon, *id*.

[131] See: WEBBER, *supra*, note 113 at 74-75. *But See*: Stephen Choi et al., *Does Majority Voting Improve Board Accountability*, 83 U. CHI. L. REV. 1119 (2016) (expressing a skeptical view whether the adoption of majority voting rule has significant impact on firms); Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 489 (concluding that majority voting rule does not have any real impact and "is little more than smoke and mirror").

in price of the share after the engagement, while controlling all other relevant factors. For example, if institutional investors' representation on a company's board is estimated to have a positive impact on the value of the company, that positive value should be reflected in the company's share price.

Using changes in share price as a measure of the value of an engagement has a clear advantage .One of the central challenges of Pigouvian taxes and subsidies is quantification. The use of Pigouvian taxes necessitates an estimation of the magnitude of the externality Absent an accurate estimation ,Pigouvian taxes and subsidies could generate large positive and negative errors .In our case ,however, the market provides a potential mechanism for quantifying the positive externality. Yet, the market may not be as effective a tool as may first seem for estimating the economic value of engagements. There is much evidence to suggest that the stock market is not efficient in the strong sense.[132] Hence ,it may not necessarily reflect immediately the full value of an engagement.

While we are fully cognizant of this problem ,the change in share prices may serve as a useful, albeit imperfect ,measure for estimating the positive effect of sophisticated shareholder engagements .Tying the credit to changes in share price also requires policymakers to decide whether to rely on short term or long-term effects . There is a heated debate among corporate law scholars as to which effect should dominate. According to the short-termism view, the relevant date should be closer to the date of the announcement of the engagement. According to the view maintaining that there is gap between a target company's performance in the short term and in the long term, the effect of the engagement should be assessed 2-3 years after its occurrence.

Fortunately, we do not need to take sides. The tax credit mechanism we provide can be applied in the short term or long term. As we pointed out, it is a flexible tool that is perfectly adaptable for both scenarios. If policymakers are concerned with the long-term effect of engagements, they can calculate the credit based on the share price several years after the intervention. If, by contrast, they wish to intensify the rate of engagements, they can select a much shorter horizon, say of 40 to 60 days. Since the decision as to the appropriate measurement point is a highly contested issue that is infused with complex policy considerations, we will not attempt to settle it here. Suffice it for our purposes is to illustrate how the tax credit can be implemented to reflect short term and long-term price effects.

An original solution to the short-termism versus long-termism dilemma that can be employed in the present context is to give sophisticated investors both options and let them decide. This approach would allow sophisticated investors to self-select. It would also provide valuable information to the market. The preferences of sophisticated investors reflect their estimations of future market trends and, moreover, is indicative of their future plans. Sophisticated investors that plan to take long term positions in

[132]For a review of this literature, see: Lynn A. Stout, *The Mechanism of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2002). For some of the classical studies on this issue, see: Andrei Shleifer, INEFFICEINT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000); Michael Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95 (1978).

firms and be actively involved in them may choose the long-term tax credit, especially if there is a cumulative effect to the engagements. Those that plan to make one off engagements would probably prefer to accept a credit that is based on short-term performance.

It should be noted that the proposed measurement technique does not fully capture the positive externality of the engagement. As noted above, there are two elements that comprise the positive externalities of sophisticated investors. The first is its positive impact on the other shareholders of the firm. The second is its positive impact on shareholders of other firms and society at large. The increase in share price captures only the first element of the externality, not the second. Hence, the actual externality is greater than the estimation on which the credit is based. As a result, the credit we propose will only approximate the socially optimal level of engagements.

Even though the appreciation in value method does not capture the full externality of the engagements of sophisticated investors, it provides a useful benchmark that serves as a proxy for the full social value of the engagement. It is always possible to add a premium to be decided by the Securities and Exchange Commission (SEC) in appropriate cases. At the end of the day, therefore, even if the credit does not precisely reflect the social value of an engagement, it clearly represents a prima facie Pareto improvement over the current legal regime.

A final note is in order. One may wonder why shouldn't sophisticated investors receive credit for the full appreciation in share prices; after all, under our proposed scheme, they would receive credit only for a certain percentage of the appreciation. The reason is simple. The actions of sophisticated investors are not the only cause for the increase in firm value. As Ronald Coase famously pointed out external effects – both negative and positive – result from the interaction of the various actors involved. The other shareholders, as well as the board and management, also play a role in generating the externality .They ,too ,should receive partial credited for the price increase.

We demonstrate how our proposed credit would work via an example. Assume a company, A, has a market value of $10 billion. An activist hedge fund purchases 10% of the company's stock and proceeds to initiate a campaign to nominate a new director. The immediate impact of an engagement of an activist hedge fund is well documented in the literature. The average increase in share price in the 40 day window period around the disclosure of their position is estimated at around 6%.[133] This figure reflects the markets estimation of the impact of the activist's engagement on the firm's value. In keeping with this figure, we will assume that the stock of company A, in our example, has appreciated by 6% in the 40 day window around the announcement of the engagement, while the index of companies similar to A in market cap and sector has not changed at all. Since the value of the activist hedge fund's holdings in company A totaled $100,000 (10% x $1 billion) its direct profit from the engagement is $6 million . The engagement also generates a positive externality of $54 million (6% x $900 million) for the other shareholders .Our mechanism would entitle the hedge fund with a portion of this value, say 8%. It will therefore receive a tax credit of $4.32 million.

[133] *See supra* note 45.

Assume now that a long-term perspective is the preferred one. Imagine that three years later that value of the shares of company A has appreciated by 3%. The increase in the value of firms in the same sector over same period has increased by only 1%. Under these revised assumptions, the direct profit of the activist hedge fund would now amount to $3 million (3% of $100 million), while the externality for other shareholders equals $27 million (3% of $900 million). Accordingly, the hedge fund would be entitled to a tax credit of 2.16 million (8% of $27 million).

It bears emphasis that even though the tax credit aims at capturing the positive externality of the engagement, it does not do so fully. As we explained, there are two elements that comprise the positive externalities engendered by sophisticated investors. The first is its positive impact on the other shareholders of the firm. Our mechanism of tax credits captures this element. It does not capture the market wide external effects. Hence, the tax credit should in theory be larger. However, in the absence of a precise measurement mechanism is going to be very difficult task to put a value on this effect.

It is critical to note that without the preferable tax treatment we propose many interventions will simply not take place. Up to this point, we have ignored the cost of interventions for sophisticated investors and uncertainty regarding the successful outcome of the engagement. Adding costs and uncertainty to the analysis illustrates that the credit may be a sine qua non in many interventions. To return to the previous example, now assume that intervention comes with a price tag of $3 million and the probability for the success of the engagement is 0.3. Under this scenario the expected value of the engagement for the hedge fund is negative, absent a tax credit: the expectancy of the benefit is $1.8 million (0.3 x 6), which is less than the cost of the engagement, which is certain (1 x 3). As such the hedge ffund will decide not to engage with company A, even though from a social perspective, it has a high expected positive value of $13.2 million ((0.3 x 54) – 3). The subsidy changes the entire picture. It transforms the hedge fund's expected value of the engagement to a positive $0.55 million ((0.3 X (6 + 2.16) - 3) and enables the socially desirable engagement to actually take place.

IV. ADVANTAGES OF THE TAX MECHANISM

A. *Efficacy of Tax Incentive in Altering Behavior*

Tax incentives are one of the most powerful tools for altering behavior, especially when the desired form of behavior is complex and cannot be reduced to a simple maxim. This is certainly the case in the context of enhancing activism: policy makers do not necessarily have a concrete desired behavior in a specific context. They do not necessarily want activist to push for a certain resolution in the context of a specific firm. They have a more general goal: that shareholders will increase their level of engagement with a firm but will do so when they see fit. In such cases, tax incentives constitute a much more effective way of altering behavior in the corporate context, than regulatory alternatives.

Furthermore, tax incentives are especially effective when applied to sophisticated actors. While tax incentive can influence all actors, the calculative mode they might

require may cause them to be less effective in the case of non-sophisticated actors.[134] In the case of sophisticated actors, such as corporations and other financial entities, there is much evidence that they are especially effective. Evidence suggests that corporations are sensitive to even the slightest tax benefits.[135] The subjects of our proposal are by definition highly calculative sophisticated actors, and as such are prone to be especially responsive to tax incentives. A closely related implication is that the cost of implementing our proposal is likely to be much lower than the cost of effectuating regulatory measures that will not likely elicit the same response as tax benefits.

B. Flexibility

Tax credits have another virtue: flexibility. Tax credits are not necessarily binary and, more importantly, do not have to be uniform. Lawmakers can employ tax credits in a continuous fashion, in a way that distinguishes among different types of socially desirable activities. As we demonstrated, tax credits can target effort or outcome and can be used to differentiate among various outcomes based on their social importance. Moreover, tax credits can target specific sophisticated investors, whose involvement in corporate governance is especially valuable. More importantly, perhaps, tax credits can be adjusted over time. If we decide that we are approaching the socially optimal level of engagement, we can reduce the tax credit. If, on the other hand, we believe that we have not reached the full market effect, we can make the credit larger.

C. Macro-Economic Stability

The budgetary impact of the credit is likely to be negligible. Even though it may seem, at first glance to impose a significant cost on the federal budget by transferring billions of dollars to sophisticated investors, its net effect on the budget will most likely not be negative. In fact, we believe that it would create a virtuous cycle. The credits we propose are intended to improve firm governance. If successful, they will dramatically increase the profit of firms, and correspondingly, tax revenues.[136]

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[134] For example of sizeable tax incentive that have failed to alter significantly behavior, even when it is a pure gain for tax payers, see: James Choi et al.,*$100 Bills on the Sidewalk: Suboptimal Investment in 401(k) Plans,* 93 REV. ECON & STAT. 748 (2011) (pointing to the phenomenon of many individuals over the age of 64.5, who will have a net gain from depositing funds into a 401(k) plan do not do so). For a more general discussion on low sensitivity to tax incentive in the context of tax credits for retirement saving, see; Adi Libson, *Confronting the Retirement Savings Problem: Redesigning the Saver's Credit*, 54 HARV. J. LEGIS. 209, 226-33 (2017)

[135] For studies regarding the strong impact of tax incentives on corporations, *see*: K. Klassen et al., *A Cross-national Comparison of R&D Expenditure Decisions: Tax Incentives and Financial Constraints*, 21 CONTEMP. ACCOUNTING RESEARCH 639 (2004); S. Gupta et al., An Analysis of the Availability and Incentives effects o the R&D Tax Credit After th Ominibus Budget Reconciliation Act of 1989 (2006); Michelle Hanlon & Shane Heitzman, A review of Tax Research, 50 J. Accounting & Econ. 127, 148 (2010); N. Rao, Ending the R&D Tax Credit Stalemate; Ming-Chin Chen & Sanjay Gupta, *The Incentive Effects of R&D Tax Credits: An Empirical Examination in an Emerging Economy*, 13 J. CONTEMP. ACCOUNTING & ECON. 52 (2017) (find a strong positive effect for hi-tech firms and a weaker effect for low-tech firms)

[136] The ability of the decrease in the tax burden to fund itself in this case, is distinctive from the general ability of tax reduction to fund themselves, as expressed by the Laffer Curve. The Laffer Curve focuses on conventional taxes that their main purpose is raising revenue. Laffer pointed out that a reduction in the tax rate may increase revenues by incentivizing a higher level of economic activity. See: J. Wanniski,

Taxation has three main functions: revenue raising, redistribution and impacting behavior.[137] It is important to bear in mind that the function of our proposed tax credit is not plain impacting behavior. As other Pigouvian taxes or subsidies, its goal is to achieve internalization of the positive externalities generate by the activities of sophisticated investors and thereby increase the rate of these activities. Enhancing the number and level of sophisticated investors' engagements with firms will reduce the agency costs generated by management. Specifically, it will allow firms to spend less resources on inefficient compensation packages, sub-optimal self-dealing transactions and shirking by management. At the end of the day, enhancing the net profit of companies, increases the corporate taxes they pay, and increases the capital gains taxes investors pay, as a result of higher increases in value of their portfolio. The increase in tax payments caused by enhanced engagements of sophisticated investors is, therefore, likely to far outweigh the budgetary cost of the tax credit.

Real-world financial facts and assessments lend support to our position. The financial literature rough estimate of agency costs in public companies is approximately 5% of their value.[138] Enhancing engagements of institutional investors will not eliminate agency costs, but should clearly reduce them. Even on the very conservative assumption that an enhanced engagement level will reduce agency costs by roughly 10%, given that the total value of public companies is 32 trillion,[139] it would represent a $160 billion in the total value of firms. A $1 increase in market cap is estimated to increase tax revenues by roughly $0.4,[140] which translates to $72 billion in additional tax revenues. This means that even a 1 percent reduction in agency costs will generate $7.2 billion in additional taxes.

D. Surpassing Political Economy Barriers

One of the most important aspects for the implementation for any policy proposal is its ability to pass through the political process, which is required for its implementation.

Taxes, Revenues, and the Laffer Curve, 50 THE PUBLIC INTEREST 3 (1978). In this case, because of the Pigouvian function of the subsidy, its impact on revenue does not arise from incentivizing more economic activity, but rather from reducing an element of the cost companies incurred, increasing their net revenue. Not every Pigouvian Tax could fund itself in this way. A Pigouvian tax subsidy may increase social welfare, but not every increase in social welfare could be monetized easily. In our case, it can – the benefit to the companies increases their revnues which directly translates to higher revenues from corporate taxes, capital gains taxes on shareholders and income taxes of workers in the company which their salaries and bonuess may increase.

[137]Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV., 1, 3 (2006-2007).

[138] James S. Ang, Rebel A. Cole & James Wuh Lin. *Agency Costs and Ownership Structure*, 55 J. FIN. 81 (2000). It should be noted that their assessment is based on companies in which the largest stockholder owns only 1%, while currently, in most public companies the largest shareholders, mostly institutional investors, hold close to 5%. Yet as noted earlier in the paper, the fact that the institutional investor hold a relatively large block of share in not effective in terms of monitoring and curbing agency problem, because of the specific agency problem that pertain institutional investors. *See* Gilson and Gordon, *supra*, note 83).

[139]*Market Capitalization of Listed Domestic Companies* (current US$), WORLD BANK, available at https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?locations=US (last visited Feb. 9, 2019)

[140] This figure represents the increase in revenues from corporate taxes (21%) and the increase in revenues from capital gains (15%-28% on long term capital gains, higher for short-term, depending on income). See: 26 U.S.C. §11(b); 26 U.S.C. §1(h).

The public choice scholarship informs us that certain proposals may have extremely strong justifications for its implementation and have a promising significant potential positive impact on social welfare, but it may have a very low chance of passing through the political process. Its ability to pass through the political process mainly depends on the identity of the winner and losers and not necessarily the net impact of the proposal on social welfare. This aspect of the ability to overcome barriers and pass through the political process, is one of the central advantages of the proposal to provide tax credit for sophisticated investors.

Mancur Olson famously identified the factors that determine whether a certain policy proposal would be adopted.[141] One factor is the formation of a lobby advocating for the adoption of the proposal. Olson has underscored that the size of the group is critical in this context: in contrast to the intuition that large pressure groups are more powerful, small interest groups have a higher tendency to form lobbies. This is because their coordination costs of are lower–both in terms of real costs and in terms of strategic costs, such as confronting free-riding problems. In addition, policy proposals that benefit groups that have a prior form of institutional cooperation mechanism stand a better chance of being adopted. For example, one of the explanations for the political influence of the NRA is that gun owners have a preexisting institutional mechanism for facilitating cooperation in the form of common military service, tournaments and shooting ranges.[142] An additional determinant is funds that the group has at its disposal–the more money it has, the more it can spend on lobbying.

In light of Olson's analysis, it is easy to understand why sophisticated investors constitute such a powerful political lobby. It may be even possible to claim that some of the sophisticated investors have the most powerful lobby in Washington. Sophisticated investors, whether institutional investors or activist hedge funds, are a very small group of actors. In the case of institutional investors, three actors practically dominate the market of institutional investors: Vanguard, State Street and BlackRock.[143] The sector of activist hedge funds is less centralized, but it is still comprised of a limited number of central actors. The total number of activist actors that have engaged in activism in the first half of 2018 totaled 104.[144] Out of the $24.8 billion that have been deployed in activist engagements, $17.5 billion have been deployed by the top 3 actors: TCI, Elliot and ValueAct.[145] The top 9 actors have deployed $23.2 billion, that constitute 93.5% of the aggregate capital deployed.[146]

Beside for the small number of actors and the level of concentration in these sectors, they also have preexisting institutional settings for cooperation. It is well-

[141]Mancur Olson, THE LOGIC OF COLLECTIVE ACTION 2 (1965)

[142]JOSH SUGARMANN, NATIONAL RIFLE ASSOCIATION: MONEY, FIREPOWER AND FEAR, 25-44 (1992) (describing the emergence of the political power of the NRF).

[143] For example, the growing ETF market is dominated by these three actors, who together own over 70% of the market: BlackRock with 36.9%, Vanguard with 18.5% and SSGA with 15.4%. See: Bebchuk & Hirst, supra note 61 at note 30.

[144] LAZARD, *supra* note 35at 2.

[145] *Id*. at 4

[146] *Id*.

documented that cooperation is an inherent feature of activist hedge funds who operate in "wolf packs"—teams of hedge fund activists that converge on a target, with of them assuming the lead and the others assisting.[147] Because each player holds only a small portion of the target's equity, it must constantly contact the other actors and convince them to cooperate in the engagement to realize its goal.[148] This mode of operation requires a high level of communication between the actors, who also facilitate their cooperation in the political arena.

The upshot of the discussion is straightforward. Policies seeking to coerce the investment industry to act in ways that are incompatible with their interests stand very little chance of being passed. Furthermore, even if such proposals are ultimately adopted, it will happen after long and bitter battles involving massive expenditures on both sides. These expenditures benefit no one; they constitute pure waste.[149] Our proposal, by contrast, does not seek to force the investment industry to do anything. Instead, it employs a carrot in the form of a tax benefit. For this reason, it is unlikely to be opposed by the industry and will clearly not lead to socially wasteful political battles. As with all optional measures, our proposal will generate a separating equilibrium. Industry members who wish to take advantage of our proposal will engage in corporate activism; those who do not will remain passive at no cost at all.

CONCLUSION

In this article we examined the possibility of using a tax credits to enhance the involvement of sophisticated investors with firms in which they own shares. Engagements by sophisticated investors generate positive externalities for other shareholders and the market at large. The standard economic solution to the presence of externalities is the institution of a Pigouvian tax that would lead to the internalization of the external effect. Since the external effect is positive in our case, it should be dealt with via the grant of tax credits. In response to the positive externalities created by sophisticated investors, we proposed two types of tax credits: effort-based tax credits and result-based tax credits. Tax credits, by virtue of their effectiveness and malleability, can succeed where other measures failed and can prompt sophisticated investors to assume a more active role in corporate governance. This, in turn, would produce innumerable benefits to our economy, in general, and financial markets, in particular.

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[147] Alon Brav et al., Wolf Pack Activism, ECGI Working Paper 501/2017, April 2017, available on ssrn https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2840704 (modeling shareholder activism mechanisms)

[148] *Id.*

[149] *Id.*