

STEWARDSHIP 2021: THE CENTRALITY OF INSTITUTIONAL INVESTOR REGULATION TO RESTORING A FAIR AND SUSTAINABLE AMERICAN ECONOMY

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INTRODUCTION

The important topic of stewardship is belatedly coming to the forefront of the corporate governance debate. This is a positive development, because it is long past due for a serious consideration of the obligations institutional investors owe to their investors and society.

For far too long, corporate governance commentators have ignored the separation of ownership from ownership¹ and the reality that institutional

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1. See Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 6 (2007); Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L.

investors, and therefore marginal traders and daily stock prices, have gained enormous power over our public companies and thus our economies. This has been true in the U.S. for some time, but is also becoming a trend throughout the OECD.²

In this article I spell out my view of what it takes for stewardship to be a meaningful concept in our 21st Century economy. The article will also address why any serious effort to rebalance our corporate governance system and tackle growing economic insecurity and inequality must include regulating the power of all classes of institutional investors: pension funds, mutual funds, and hedge funds.

Put simply, this regulation must make institutional investors do what is required of any faithful fiduciary and any good citizen of a republic — take seriously their own obligations of fidelity by aligning their conduct with the real interests of those whose capital they hold and by making money for themselves in a way that does not cause societal harm.

For many years, stewardship has been more a name for the investment industry blaming those who manage real companies for every problem, when as a matter of linguistics, stewardship requires something more inward and responsibility-accepting. True stewardship involves undertaking meaningful obligations yourself. In this context, it requires coherent investing, engagement, and voting policies that emphasize sustainable growth, and recognize that human investors need — as an economic matter — companies to pay workers fair wages and treat them with respect, to avoid externalizing costs to other companies, taxpayers, and consumers, and to be environmentally responsible. This does not involve talk and inconsistent walk. It requires discipline and focus.

The article also explains what a positive move toward genuine stewardship of this kind could mean now that a new Administration committed to making our economy function more fairly is in power, and why

673, 687 (2005); Leo E. Strine, Jr., *Human Freedom and Two Friedmen: Musings on the Implications of Globalization for the Effective Regulation of Corporate Behaviour*, 58 U. TORONTO L. J. 241, 262 (2008).

2. See European Commission, *Study on Directors' Duties and Sustainable Corporate Governance* (July 2020), <https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en> [<https://perma.cc/92Y5-5BVA>]

Evidence collected over the 1992-2018 period shows that there is a trend for publicly listed companies within the EU to focus on short-term benefits of shareholders rather than on the long-term interests of the company. Data indicate an upward trend in shareholder pay-outs, which increased fourfold, from less than 1% of revenues in 1992 to almost 4% in 2018. Moreover, the ratio of CAPEX and R&D investment to revenues has been declining since the beginning of the 21st century.

this movement is vital to creating an economic system that works for all.

To frame these recommendations, the article first identifies the differences between today's corporate governance system and the system that existed when most of our key regulatory structures addressing institutional investors were created. The article then touches on the unsatisfactory outcomes that have resulted during the last forty years when the power of institutional investors and the stock market over American public companies grew enormously, and the protections for other stakeholders, particularly workers, shrunk substantially. After that, the article discusses why trusting the institutional investor community to reform itself is not an adequate answer to channeling its conduct to be more consistent with the best interests of our society and of diversified worker investors. Finally, the article concludes with what a sensible framework for updated industry regulation might look like, emphasizing that this reform, while essential to restoring greater economic equality and fairness, is not sufficient in itself.

I. NOT YOUR GRANDFATHER'S: THE CORPORATE GOVERNANCE SYSTEM WE NOW HAVE

Any effective initiative to improve institutional investor stewardship must be grounded on a recognition of the profoundly different corporate governance system we now have, and how it has outgrown the regulatory structure in which it functions.

As I have noted elsewhere,³ much of the current regulatory structure for our corporate governance system reflected some implicit assumptions, including that:

- stockholders had a long-term stake in the company's best interests; most stockholders were affluent and owned their shares directly, for their own benefit, and held them for lengthy periods;
- the stockholders who were most active and vocal were those who had the longest-term stake in the corporation;
- most stockholders invested because they liked the companies and their management, and did not interfere in their strategic direction;
- certain wealthy investors had so much money that they could, without harm to society, invest in opaque vehicles on a caveat emptor basis, that was denied to less affluent investors;

3. See Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh and Blood Perspective On Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L. J. 1870, 1871-72 (2017) [hereinafter Strine, *Who Bleeds When the Wolves Bite?*].

- workers depended largely on pension funds and social security for their retirements, and did not form a large segment of the investor class;
- most public companies had long-term lenders, who had a deep relationship with the company and kept a sharp eye on the company's ability to pay its debt and weather tough times;
- when corporations became more profitable, they tended to create more jobs, pay workers better, and give back to their communities of operation;
- corporations had a national, and often regional, focus, and their managers, directors, employees, lenders, and even stockholders often had ties of loyalty to those communities; and, finally,
- corporate managers were well but not lavishly paid, a plan of internal succession was common, and corporate managers tended to live in the community where the corporation was headquartered and be engaged in community affairs.

In recent decades, these assumptions have been undermined and often turned upside down:

- corporate stockholder bases turn over rapidly;
- most stock is owned by institutional investors, but represents the capital of largely silent human investors, and many of these institutional investors engage in much greater portfolio turnover;
- the actual human investors whose capital is ultimately at stake are largely bystanders and do not vote;
- the most vocal and active stockholders tend to have investment strategies most in tension with the efficient market hypothesis, and often involve hedge funds who only became stockholders after deciding to change the company and who have no prior or long-term interest in the company's well-being;
- Even institutional investors who represent diversified worker-investors, such as index funds, have pushed manage to the market policies and for companies to put immediate returns first, even if that involves harm to other stakeholders;
- The growth of hedge funds and private equity funds has been fueled not primarily by rich individual investors who bear the risk of losses themselves, but by other institutional investors like pension funds, charities, university endowments, and other institutions whose soundness is important to ordinary Americans and society as a whole;
- The voice of lenders as a stabilizing and risk reducing factor has

declined as corporate debt has been securitized, but without any corresponding increase in stewardship on the part of mutual funds and others who represent the investors who hold the risk of insolvency or downgrades;

- the tie between increasing corporate prosperity and the best interests of corporate workers has been sharply eroded, with corporations not sharing productivity gains with workers and instead, at the behest of market pressures, focusing on offshoring and job and wage cuts as methods to increase profits;
- corporations increasingly have no national, much less community, identity and are willing to not only arbitrage their communities against each other, but also to abandon their national identity for tax savings; and, finally,
- top corporate managers have been promised pay packages way out of line with other managers, but in exchange must focus intently on stock price growth and be willing to treat other corporate constituencies callously if that is necessary to please the stock market's short-term wishes (and reap their personal rewards).

Under this radically different system, human investors are not citizens of the corporate governance republic, they are the voiceless and choiceless many whose economic prospects turn on power struggles among the classes of haves — institutional investors — who directly control the stock of the companies upon which our nation depends for its continued prosperity. Attention to this institutional investor sector lagged well beyond its power.

Old tropes — such as stockholders good and management bad — persisted despite the change in identity of who stockholders were. The focus of academics, the business media, and, ironically, democrats tended to be on what bad managers were not doing for either stockholders, society, or stakeholders with little attention on the increased pressures public companies were facing from institutional investors. The obsession with agency costs that infatuated key academics like Lucian Bebchuk and Dan Fischel about company managers did not catch their fancy as to institutional investors.⁴

4. In fairness to Professor Bebchuk, he has written some articles that could be considered to address the agency costs of institutional investors. See, e.g., Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B. U. L. REV. 721 (2019); Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017). But, the bottom line is that Professor Bebchuk does so mostly to support his argument that mainstream institutional investors are not pushing public companies to manage to the market strongly enough, and thus that policy makers should not regulate the activities of activists, even to require more timely disclosure. See, e.g., Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 105 CORNELL L. REV.

The assumption among many academics associated with the law and economics movement, despite their protestations to the contrary when things went wrong, was that ECMH meant that whatever increases the current stock price is optimal, that the market will price any externality risk, and that if there is any harm, that is government's responsibility. In focusing on individual companies, they ignored the fact that most investors are long the economy, not one company, and that the sum total of externalities at specific companies and downward pressures on wages was less money for working investors to save, more economic insecurity, more taxes to pay, and more environmental and public health harm.

That institutional investors voted all their funds in one way did not bother them, even though funds had very different objectives. That retirement investors got the same voting policies as quarter-to-quarter day traders did not matter.

Admittedly, some, including me, harbored some hope that greater institutional investor/pension power could have some positive benefits. Perhaps:

- mutual and pension funds would put up directors as owner-directors, given that many of the funds — i.e., index funds — were stuck in long term;⁵
- funds with long-term horizons would align voting policies to the long-term nature of their investments;

(Forthcoming 2020)

The business corporation has proven itself to be a powerful and adaptive mechanism for producing economic growth and prosperity. As a result, some of those who wish to protect stakeholders might be attracted to stakeholderism as a way to do so by harnessing corporate power through private action and without resort to costly regulation. However, the past success of corporations has been based on the presence of effective incentives for corporate decision-makers. Therefore, with corporate leaders having incentives not to benefit stakeholders at shareholders' expense, delegating the guardianship of stakeholder interests to corporate leaders would prove futile. The promise of pluralistic stakeholderism, we conclude, is illusory.

Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 40 (2012) (arguing that the SEC should *not* adopt new rules that would enhance the disclosure required of stockholders taking a large and active stake in public companies).

5. See William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 993-96 (2003); see also generally Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 905 (1991).

- funds would monitor and check excessive management pay;⁶
- funds would focus on seating directors who added business value;
- funds would prosecute representative litigation actions that were legitimate, seek real relief for stockholders, and discourage suits that only had value for the lawyers involved;⁷
- funds would push corporate governance policies that optimally balanced efficiency and accountability, taking into account their own limitations in terms of stewardship capacity;
- mainstream funds would referee and fairly decide disputes between activists and management, and ensure that activist plays were only supported when they made long-term business sense, and were not just short-term financial engineering.⁸

What we got instead was less edifying and can be fairly summarized as pushing companies to respond to shifting whims of the stock market and to become corporate Californias where constant stockholder plebiscites put pressure on company managers to squeeze other stakeholders, lever up, and engage in constant rounds of stock buybacks, acquisitions or divestures (whatever is pleasing in the moment in the market). Certain segments of the pension fund space also seemed to just enjoy being players, and fomented proposals and meritless litigation.

Thus ensued:

- Paying CEOs with options and other forms of equity tied to total stock return;
- Ending classified boards;
- Turning withhold votes into pressure tools;
- Insisting on annual Say on Pay votes as a pressure tool, not a reasoned input on sensible, long-term pay plans focused on sustainable growth;
- Spicing up the board ISS voting policies that made it easy for activists to gain board seats;
- Voting index funds and socially responsible funds in line with active funds to save money;

6. This was the obvious hope behind mandated Say on Pay. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §951, 124 Stat. 1376 (2010) (codified at 15 U.S.C. §78n-1).

7. This was the obvious hope of the Private Securities Litigation Reform Act of 1995 (“PSLRA”), Pub. L. 104-67, 109 Stat. 373 (codified at various section of 15 U.S.C.).

8. *E.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 897-99 (2013).

- Pressuring companies to cut worker pay and offshore jobs;
- Pressuring companies to operate without prudent reserves to permit as much capital as possible be returned to stockholders;
- Ignoring that these pressures for immediate returns were encouraging companies to pollute our politics to secure regulatory advantages and externalize risks;
- Supporting inversions of American companies to tax havens with less protective corporate governance;
- Failing to focus on risk management structures or financial prudence at companies, but instead obsessing over immediate returns and access to sell-side premiums in M&A;
- Proliferating representative litigation that did not produce any benefits for stockholders or companies, but just for the plaintiffs' lawyers involved, their favored political candidates, and their friends who served on the staffs of certain public pension funds.

What has resulted from the use of institutional investor muscle in this manner?

- Growing inequality as a result of a profound shift in gain sharing at the expense of workers;⁹

9. An important new paper by Professors Summers and Stansbury illustrates the effect that increased institutional investor and stockholder power and decreased protection for worker has had on American inequality. Anna Stansbury & Lawrence H. Summers, *The Declining Worker Power Hypothesis: An Explanation for the Recent Evolution of the American Economy* (NBER Working Paper 27193), <https://www.nber.org/papers/w27193> [<https://perma.cc/THE2-QXZS>]. Their paper confirms the important work done by Lawrence Mishel of the Economic Policy Institute over many years. See e.g., Lawrence Mishel, *The Decline in Unions Has Hurt Nonunion Workers Too*, ECON. POL'Y INST. (Sept. 1, 2016).; Lawrence Mishel & Jori Kandra, *CEO Compensation Surged 14% in 2019 to \$21.3 million*, ECON. POL'Y INST. (Aug. 18, 2020) (observing that as stockholders have tied CEO pay to stock returns, CEO compensation has increased while worker wages have stagnated); Lawrence Mishel, Lynn Rhinehart & Lane Windham, *Explaining The Erosion of Private-Sector Unions*, ECON. POL'Y INST. (Oct. 7, 2020), <https://files.epi.org/pdf/211305.pdf> [<https://perma.cc/2K24-PQ88>]; Josh Bivens, Lawrence Mishel & John Schmitt, *It's Not Just Monopoly and Monopsony: How Market Power Has Affected American Wages*, ECON. POL'Y INST. (Apr. 25, 2018), <https://files.epi.org/pdf/145564.pdf> [<https://perma.cc/TP32-J2QB>]; see also Andy Green, Christian E. Weller & Malkie Wall, *Corporate Governance and Workers*, CTR. AM. PROGRESS (Aug. 14, 2019), <https://www.americanprogress.org/article/corporate-governance-workers/> [<https://perma.cc/PXV5-JYAX>]; Lenore Palladino, *Corporate Financialization Hurts Jobs and Wages*, ROOSEVELT INST. (Sept. 27, 2017), <https://rooseveltinstitute.org/2017/09/27/corporate-financialization-hurts-jobs-and-wages/> [<https://perma.cc/VR45-LEHL>]; And, a new report from the European Commission warns that moves toward similar power dynamics in the EU in this century are starting to manifest themselves in growing inequality and stagnant wages in Europe. European Commission, *Study on Directors' Duties and Sustainable Corporate Governance*, (July 2020), <https://op.europa>.

- Resulting economic insecurity and opportunities to exploit this insecurity through divisive and immoral racial and ethnic appeals;
- Exacerbating, not closing, the racial inequality gap because black people only gained labor rights recently and are more likely to be working and lower middle class;
- Corporate influence over regulation and the political process generally grew, with the result that protections for stakeholders and the environment were eroded, and important developments like climate change were not addressed effectively;¹⁰
- The need to repeatedly bail out Wall Street and the financial sector, which has reaped the gains of excessive risk while shifting the costs to the American public;
- A corporate America that lacked resiliency in face of emergencies because of inadequate reserves, and supply chains built on the cheap rather than on the basis of quality and reliability, as illustrated by the need for companies to lay off workers so soon in the face of the pandemic despite ten years of recovery and a massive corporate tax cut and by our failure to produce needed supplies in a timely manner; and
- A wave of wasteful litigation that cost companies money that could have been more productively used to pay workers or invest in future growth.¹¹

To be fair, the institutional investor community now bemoans some of these realities. In recent years, important voices have emerged acknowledging that diversified, human investors need companies that produce sustainable wealth, respect the environment, and treat stakeholders

eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en [https://perma.cc/92Y5-5BVA].

10. John C. Coates, IV, *Corporate Speech & The First Amendment: History, Data and Implications*, 30 CONST. COMMENT. 223, 224 (arguing that corporate influence “risks the loss of a republican form of government” or as Coates terms it, “the risk of Russia”); see also Leo E. Strine, Jr., *Corporate Power Ratchet: The Courts’ Role in Eroding “We the People’s” Ability to Constrain Our Corporate Creations*, 51 HARV. C.R.-C.L. L. REV. 423 (2016).

11. Strine, *Who Bleeds When the Wolves Bite?*, *supra* note 3, 1912-13 (gathering sources showing that much of the litigation brought by institutional investors resulted in settlements of no meaningful value to investors); Quinn Curtis & John Morley, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don’t Work in Mutual Funds*, 120 YALE L. J. 84, 117-18 (2010); Donald C. Langevoort, *Private Litigation To Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L. Q. 1017, 1032 (2005); Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV. BUS. L. REV. 1, 13-17 (2016).

well,¹² and institutional investors have started to echo them.¹³ Human

12. The Business and Society program at the Aspen Institute and B Lab have been in the vanguard of this movement and, of course, Marty Lipton has long been a full-throated voice for stakeholder governance. See *American Prosperity Project: A Nonpartisan Framework for Long-Term Growth*, ASPEN INST. (Dec. 2016), https://assets.aspeninstitute.org/content/uploads/2017/01/American-Prosperity-Project_Policy-Framework_FINAL-1.3.17.pdf?_ga=2.171024224.1135763021.1603475164-1326506324.1603475164 [<https://perma.cc/543R-AEDR>]; *Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management*, ASPEN INST. (Sept. 9, 2009), https://assets.aspeninstitute.org/content/uploads/files/content/docs/pubs/overcome_short_state0909_0.pdf?_ga=2.109117125.1135763021.1603475164-1326506324.1603475164 [<https://perma.cc/UH9F-8Z4P>]; Frederick Alexander, et. al., *From Shareholder Primacy to Stakeholder Capitalism: A Policy Agenda for Systems Change*, B Lab (Sept. 7, 2020), <https://bcorporation.net/stakeholder-capitalism> [<https://perma.cc/8KYX-4ZC2>]; Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979). For instance, Senator Warren's Accountable Capitalism Act would essentially require that every American business with over \$1 billion in sales become like a Delaware public benefit corporation and have a duty to "manage or direct the business and affairs of the . . . corporation in a manner that seeks to create a general public benefit and balances the pecuniary interests of the shareholders of the . . . corporation with the best interests of persons that are materially affected by the conduct of the . . . corporation." Accountable Capitalism Act, S.3348 (115th Cong.), <https://www.congress.gov/bill/115th-congress/senate-bill/3348> [<https://perma.cc/7UZN-PNF9>]; see also 8 Del. C. § 365

The board of directors [of a Delaware public benefit corporation] shall manage or direct the business and affairs of the public benefit corporation in a manner that balances the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in its certificate of incorporation.

And the BRT issued a revised statement on corporate governance moving in this direction in 2019. *Statement on Corporate Purpose*, BUS. ROUNDTABLE (Aug. 19, 2019), <https://opportunity.businessroundtable.org/wpcontent/uploads/2020/03/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf> [<https://perma.cc/UL4B-Q2AB>]. Likewise, other thought leaders have called for corporate governance reform to require corporations to give more weight to sustainable, ethical growth and more consideration to corporate stakeholders, like workers, and not just stockholders. See, e.g. Marc Benioff, *We Need a New Capitalism*, N.Y. TIMES, (Oct. 14, 2019), <https://www.nytimes.com/2019/10/14/opinion/benioff-salesfor-ce-capitalism.html> [<https://perma.cc/NTB7-Y2J9>]; Lynn Stout, *THE SHAREHOLDER VALUE MYTH* (2012); Lenore Palladino, *The Economic Argument for Stakeholder Corporations*, ROOSEVELT INST., (June 2019), <https://rooseveltinstitute.org/publications/economic-argument-for-stakeholder-corporations/> [<https://perma.cc/8M33-F4NU>]; Judith F. Samuelson, *Did the Business Roundtable Sound the Death Knell for Shareholder Primacy?*, ASPEN INST., (Aug. 26, 2019), <https://www.aspeninstitute.org/blog-posts/did-the-business-roundtable-sound-the-death-knell-for-shareholder-primacy/> [<https://perma.cc/89Q3-JCNX>]; COLIN MAYER, *PROSPERITY: BETTER BUSINESS MAKES THE GREATER GOOD* (2018); FREDRICK H. ALEXANDER, *BENEFIT CORPORATION LAW AND GOVERNANCE* (2017).

13. Larry Fink, *A Sense of Purpose: Larry Fink's 2018 Letter to CEOs*, BLACKROCK, <https://www.BlackRock.com/corporate/investor-relations/2018-larry-fink-ceo-letter> [<https://perma.cc/682M-BMCT>] ("To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."); John

investors themselves are becoming more long-term oriented and rational, and gravitating toward index funds.¹⁴ Admirably, some, like State Street, are even stepping up to constrain corporate political spending that is often at odds with the interests of stakeholders,¹⁵ and to vote for reasonable forum selection provisions to constrain rent-seeking by the plaintiffs' bar.¹⁶ And grudgingly, the reality that most American investors depend on quality jobs for their ability to invest is being acknowledged, and with the events of this year shining a light on racial inequality that they cannot blind themselves to,¹⁷ these institutions are now voicing a concern not just about gender inclusion, but finally also admitting the need to address how our nation has mistreated black people.¹⁸ But there is a problem. Most of this rhetoric

C. Bogle, *Bogle Sounds a Warning on Index Funds*, WALL ST. J. (Nov. 29, 2018); State Street Institution U.S. Equity Fund, Prospectus, (Jan. 31, 2018), <https://www.sec.gov/Archives/edgar/data/0001040061/000119312518028506/d533731d497.htm> [<https://perma.cc/6KRT-DDPD>] ("Well-developed environmental and social management systems generate efficiencies and enhance productivity, both of which impact shareholder value in the long-term."); Vanguard, *Policies and Guidelines Environmental and Social Matters* (2018), <https://web.archive.org/web/20180224173653/https://about.vanguard.com/investment-stewardship/policies-and-guidelines/> ("[W]e believe our approach strikes the appropriate balance between corporate responsibility and our fiduciary obligations.").

14. See, e.g., John C. Coates, IV, *The Future of Corporate Governance Part I: The Problem of Twelve* (Working Paper, Mar. 14, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337 [<https://perma.cc/DR2J-B8RS>]; Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721,727 (2019) (documenting the growth of index funds and their rising popularity with investors).

15. Bruce Freed & Dan Carroll, *Mutual Fund Support for Corporate Political Disclosure Continues Steady Rise*, CTR. POL. ACCOUNTABILITY (Dec. 17, 2019) ("Going against this trend were the Big Three institutional investors – BlackRock, Vanguard and Fidelity – which continued to oppose the Center's political disclosure resolution. In contrast, the other institutional investor behemoth, State Street, increased its support over last year.").

16. See *Proposed ISS Benchmark Policy Changes for 2021*, INST. S'HOLDER SERV'S, <https://www.issgovernance.com/file/policy/proposed-benchmark-policy-changes-2021.pdf> [<https://perma.cc/4PT2-AZXV>] (proposing to modify ISS's guidelines to generally recommend approval of forum selection clauses in corporate bylaws).

17. For an excellent overview of how the coronavirus pandemic has further exposed our economy's severe racial inequality, see Elise Gould & Valerie Wilson, *Black Workers Face Two of the Most Lethal Preexisting Conditions—Racism and Economic Inequality*, ECON. POL'Y INST. (June 1, 2020), <https://www.epi.org/publication/black-workers-covid> [<https://perma.cc/V7LA-RXQE>].

18. See, e.g., Blackrock, *Our Actions to Advance Racial Equity and Inclusion* (June 22, 2020), <https://www.blackrock.com/corporate/about-us/social-impact/advancing-racial-equity> [<https://perma.cc/6VRZ-F8J9>]

While we are still refining our efforts and goals, our focus is on . . . [p]romoting workforce and leadership diversity by engaging with and seeking reporting by the companies in which we invest. . . . We also will continue to emphasize the importance of diversity in the board room, considering personal characteristics

remains that, rhetoric, and even more, most of it is directed at companies, and does not involve self-reflection.

Most of all, it does not yet involve acknowledging that money managers' success in making American public companies playthings of the stock market was a substantial cause of these suboptimal outcomes for our nation and its citizens.

II. THE REASONS WHY THE GOVERNMENT MUST PLAY A ROLE

We are thus at a moment too common in our history. Substantial inequities have led to calls for action to provide greater fairness and opportunity for the many, in part by checking excesses of the privileged few. At these times, the privileged often say — our bad, sorry, we've got it now — leave it to us. For corporate scholars, the Merrick Dodd response.

But when a powerful interest has had generations to “get it,” the public should be rightly skeptical. Had the interest gotten it, things would not be the way they are. And for realists, poor outcomes are not usually evidence that the privileged are bad people, but that the rules of the game are not well tailored, thus promoting movement toward the worst angels of our nature. Realists demand effective external constraints promoting socially responsible conduct. For corporate scholars, the Adolph Berle approach.

I am firmly of the good Adolph school and believe that we are in the current predicament because of our failure to remember the lessons of history and to address new phenomenon to ensure that they are not exploited to unbalance the New Deal/social democratic consensus that saved us from fascism and communism, and provided a sound framework for a fair market economy.¹⁹ As applied to the institutional investor segment, there is even more reason to believe that government action to address new market dynamics and their effects on society are long overdue.

For starters, it is striking how much pressure there has been for government action to regulate public companies that make real products and deliver real services,²⁰ when the market checks on public companies are so

like gender, as well as race and ethnicity, in addition to professional experience.

Saijel Kishen, *State Street to Press Companies on Boasting Racial Diversity*, BLOOMBERG (Aug. 27, 2020), <https://www.bloomberg.com/news/articles/2020-08-27/state-street-to-press-companies-on-boasting-racial-diversity> [<https://perma.cc/X45T-NXGJ>].

19. Leo E. Strine, Jr., *Made for this Moment: The Enduring Relevance of Adolf Berle's Belief in a Global New Deal*, 42 SEATTLE U. L. REV. 267 (2019).

20. Consider, for example, the provisions of Sarbanes-Oxley, Pub. L. 107-204, 116 Stat. 745 (July 30, 2002), and Dodd-Frank, Pub. L. 111-203, 124 Stat. 1376 (July 21, 2010), almost all of which addressed operating companies, without addressing in any meaningful way the

much more substantial than those faced by institutional investors. Distinguished friends of mine like Lucian Bebchuk have long bemoaned that there are not enough proxy contests, hostile takeover attempts, and derivative suits against public company boards. For that reason, they have argued that government should change the rules of the game to facilitate direct democracy at public companies, incent CEOs to manage to the market, require certain board committees, and other important measures — such as disclosure policies — to channel corporate behavior in the direction they favor.²¹ They do so because they argue that the old Wall Street rule — exit to another company in the Russell 3000 — or the potent tools stockholders have under state law, are not enough. No, much more must always be done to check the excessive “agency costs” of public company managers and directors.

But, for some reason, these manage to the market advocates never apply the same thinking to institutional investors. For workers lucky enough to have a pension, they have no rights to replace their trustees or exit, they must depend on the prudence of their trustees, and suits against such trustees are far less common than suits against public companies. For 401(k) worker-investors, the Wall Street rule is far less helpful, because they are stuck with moving from one fund to another in the fund families chosen by their employer and their money is stuck in until age 60. Mutual fund proxy fights and derivative suits are rarer than sashimi. Furthermore, the existing governmental regime is much more outdated than the Delaware General Corporation Law or even the federal securities laws, and involve at best an adequate 1970’s-relevant governance regime confronting an industry that has grown in complexity and sophistication far more rapidly than almost any segment of the economy, except perhaps tech, since that time.

Key developments — such as intermediaries like charities, university endowments, and pension funds putting the public at risk by investing in opaque hedge funds without track record information or knowing what special deals are being cut with more favored investors — the rise of synthetics and derivatives and their important effects — the changes in how corporations use debt capital and their implications for the relative voice of

institutional investors whose pressures inflated the balloon of bubble capitalism.

21. Leo E. Strine, Jr., *Can We Do Better By Ordinary Investors? A Pragmatic Reaction To The Dueling Ideological Mythologists Of Corporate Law*, 114 COLUM. L. REV. 449 (2014); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006) (both discussing Professor Bebchuk’s support for direct democracy at American corporations, and his view that stockholders have too little influence); *see also generally*, Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637 (2013); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

equity and debt capital — the interaction of demands for mutual funds to act as stewards and the cost constraints they are under to compete with each other — the payment of money managers on horizons that do not match that of their underlying investors — have not been factored adequately into regulatory action. On many fronts, no action has been taken at all. On others, it has been done with a blinkered view of the full implications.

The overall effect of this inaction is clear: virtually all institutional investor sectors have pushed management to the market policies. The sectors combine to pressure public companies to favor immediate returns to stockholders as the first priority of corporate governance, to push corporations to minimize reserves, restrict worker pay, offshore and cut jobs, take on more risk, and to be open at all times to sale. In response, corporations have done all these things, and have also acted on the political process to make it easier for them to please stockholders, by externalizing risk to society and other stakeholders. Corporations have used treasury funds and other resources to seat candidates and to lobby for policies that undercut unions, wages, climate change response, consumer protection, and help industries externalize their costs to society.

The bottom line is when one arrow goes way up — stockholder power — and one other goes way down — stakeholder voice and power, in particular that of workers — the more powerful interest wins. This has been vividly illustrated in the returns to stockholders and those paid to serve them — top executives whose pay is tied to total stock return — in comparison to American workers. This is not about the pie not growing. There has been plenty o’ new pie. It is about the have’s taking a much bigger share of the pie.

Similar power imbalances have resulted in the failure to address climate change, opioids, financial risk-taking by the banking sector, the anticompetitive effects of big tech, and shifts in risk from the wealthy investor class and the companies that caused these externalities to the public, in the form of recessions, unemployment, huge bailouts, and public health and consumer harm. The overall cost of these externalities is a drag on overall economic efficiency, a cost borne by real working investors who own the whole economy.

That this phenomenon involves hurting the economic interests of pension and 401k investors — who depend on quality jobs for their wealth and ability to save for retirement, are dependent on the whole economy, and who pay for externalities as taxpayers, air breathers and water drinkers, and consumers — has for far too long been ignored by institutional investors.²²

22. In a prior paper, I gathered the economic evidence that shows how much Americans

Their recent recognition of what their human investors actually need is welcome but remains blinkered. Rather than accept responsibility for themselves, they continue to mostly externalize responsibility by urging public companies to do better to protect stakeholders and the environment.

But, that is not stewardship in its fullest sense. That is shirking.

What stewardship involves is accepting your own fiduciary responsibility to align your behavior with the legitimate interests of those you are charged with protecting.

It's good to call on companies to address climate change. But can they do so unless you show, not by words, but deeds that you support them in doing so?

It's useful to call on companies to address racial inequality and growing economic insecurity. But can they do so unless you recognize that the best way for companies to help close these gaps is to pay their workers more, because this will disproportionately benefit black people and all suffering economic insecurity? If you do not support companies in giving fair wage increases and putting worker well-being first in recessions, how can companies do so?

It's helpful to call for more equality and diversity at companies, but do you mean it? Was the failure to consider racial diversity until the murder of George Floyd a signal that the prior focus on just gender diversity was a marketing strategy? And are you going to follow up and actually focus on racial equality in reality or just in words?

It's understandable that you react when there is an environmental catastrophe, such as an oil spill, a consumer injury, such as opioids or a data breach, that hits the stock price hard and causes public outrage, but do you use your voting power to focus on whether companies have effective risk management structures at both the management and board level? Or do you just pressure them to manage to the market and then opportunistically complain when something goes wrong, so that you are not exposed to criticism for supporting industry policies that put stockholders' demand for immediate returns over fairness to society?

Do you call for woke company policies but abdicate in considering whether companies are using investors' money to elect candidates and lobby for policies that undercut causes like racial fairness, worker fair pay and safety, and environmental responsibility?

depend on their access to a good job and wages for their wealth. See Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?* *supra* note 3, at 1876-1882 (2017). In that same piece, I also cited evidence that black Americans were far less likely to have retirement savings and when they had them, they were at much lower levels than white Americans. Strine, *Who Bleeds When the Wolves Bite?*, *supra* note 3, at 1882.

Put bluntly, there is a large gap between what even high-minded institutions are asking of companies and what they are asking of themselves. Ultimately public companies cannot treat their workers, consumers, taxpayers, communities, and the environment more fairly than their investors will support.²³ If investors talk woke in public, but obsess over TSR and buybacks in private meetings and in voting their shares, TSR and buybacks will win out.

For these and other reasons I don't have time to discuss, effective stewardship must involve government regulation that requires all institutional investors with power in our society to use it responsibly. This is also essential to help those trying to do it right become the industry standard, because it will prevent them from continuing to be undercut by competitors who use their own failure to be good stewards as a chance to compete on cut rate pricing and short-term returns.

III. INSTITUTIONAL INVESTOR REFORM: AN ESSENTIAL BUT NOT SUFFICIENT CONDITION OF A 21ST CENTURY NEW DEAL

Before setting forth what reforms might foster greater stewardship and positive social impact by institutional investors, I underscore the obvious. Institutional investor reform alone cannot restore fairness to our economy. Reforms to increase the wages and voice of labor, protect consumers, tackle climate change, and invest in basic research and infrastructure are indispensable, as are moves to make the rights of workers and the protection of the environment central to the international trading regime.²⁴ And of course, companies themselves, and large private companies, must be required to give greater consideration to sustainable growth, fair treatment of workers and other stakeholders, and environmental responsibility. But although stewardship-promoting regulation of institutional investors alone is not adequate, it is essential.

Unless the powerful interests that control the voting of public companies are required to align their conduct with the needs of the human

23. Rebecca Henderson, *What Would It Take To Get Businesses To Focus Less on Shareholder Value?* HARV. BUS. REV. (Aug. 21, 2018), <https://hbr.org/2018/08/what-would-it-take-to-get-businesses-to-focus-less-on-shareholder-value> [https://perma.cc/32QT-FPEJ] (noting that it is not corporate law, but the power dynamics and stock market pressure under which public companies operate that make it difficult for them not to focus on immediate returns to stockholders as the priority, rather than more responsible, sustainable approaches to long-term growth).

24. For my own ideas along these lines, see Leo E. Strine, Jr., *Toward Fair and Sustainable Capitalism*, ROOSEVELT INSTITUTE (Aug. 2020), <https://rooseveltinstitute.org/publications/toward-fair-and-sustainable-capitalism/> [https://perma.cc/62EC-Q246].

beings they serve, public companies and our economy will not be able to do so. Pretending otherwise is naïve and injurious to economic security and fairness.

For that reason, any 21st Century New Deal must include bold action to update the regulatory structure within which institutional investors operate. That involves requiring all the key sectors — mutual funds, pension funds, and hedge funds — to accept their responsibility as faithful fiduciaries, or in the parlance of this conference, as good stewards. And it involves a variety of techniques, such as requirements for institutional investors to align their use of power with the interests of their human clients and society, and to make fairer disclosure about their behavior and interests.

Key steps to encourage more alignment toward sustainable returns, fair treatment of workers, and environmental responsibility should include:

- Requiring institutional investors to consider—as part of the fiduciary duties they owe to their clients—their ultimate beneficiaries’ investment objectives and horizons, such as saving for retirement or education, and require institutional investors to consider their ultimate beneficiaries’ economic and human interest in having companies create quality jobs and act responsibly toward their consumers and the environment as part of their decision-making process.
- Specifically, institutional investors who take human investors’ money, including mutual funds and pension funds, should be required to consider the investment objectives and horizons of their ultimate beneficiaries, such as saving for retirement, saving for their children’s education, or investing in a socially responsible manner, when making voting and other stewardship decisions. Specific obligations would be imposed on index and pension funds to consider their investors’ interests in sustainable, long-term growth and the diversified nature of their portfolios.²⁵ In particular, that would require index funds and other funds that hold a broad swath of the economy, to recognize their fiduciary duty to support governance policies that foster overall economic growth and minimize externalities, thus fostering the most sustainable portfolio

25. This would, for example, have the effect of promoting voting on key issues — such as a public company’s desire to become a public benefit corporation — that aligns the interests of investors in sustainable wealth creation with company-level corporate governance that does the same thing. And by these means, the relative influence of those institutional investors, such as index funds, pension funds, and socially responsible funds, will grow, providing for more balance and a greater focus on responsible, durable wealth creation than is currently the case.

and overall wealth creation for their investors.²⁶

- Prohibiting institutional investors from relying on proxy advisory firms unless the proxy advisor's recommendations are tailored to the fund's investment style and horizon. This would create incentives for proxy advisory firms to do better, and encourage them to develop voting recommendations and policies tailored to index investors, who depend on economy-wide, sustainable wealth creation.
- Requiring all institutional investors to consider their ultimate beneficiaries' overall economic and human welfare, in determining how to prudently invest their funds for sustainable, ethical portfolio growth. This plain authorization for all investment funds to consider EESG factors will eliminate any fear, heightened by the Trump Administration DOL's recent actions, that any institutional investor cannot take into account the moral and ethical factors that human investors can consider. Notably, the United Kingdom has already embraced the idea that institutional investors should factor in the real world effects of important EESG issues on their human investors into its stewardship policies, which were updated in 2020 to make this plain.²⁷
- Requiring institutional investors to disclose how their voting policies and other stewardship practices ensure the faithful discharge of their new fiduciary duties and take into account information reported by large companies on employee, environmental, social, and governance matters. If we want operating companies to act in a sustainable and ethical fashion, then institutional investors must make consideration of key EESG issues a central factor in their approach to stewardship and their investors and the public deserve information to determine if they are doing so. This requirement should parallel new EESG disclosure obligations that should be imposed on all large companies, private or public, but be shorter in length and focused on how institutions factor these issues into their stewardship decisions.
- Requiring institutional investors to align their voting on corporate

26. Cf. Rebecca Henderson, *Shareholder Value in a Burning World*, PROJECT SYNDICATE (Oct. 1, 2020), <https://www.project-syndicate.org/onpoint/shareholder-value-corporations-and-climate-change-by-rebecca-henderson-2020-10?barrier=accesspaylog> [https://perma.cc/R5D3-ADNF] ("At the level of the entire economic system, there is no fundamental incompatibility between maximizing profits and addressing climate change. But there is a massive collective action problem . . .").

27. See The UK FRC Stewardship Code 2020 available at https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf [https://perma.cc/4CHW-V49S].

governance policies, such as the frequency of say on pay votes, with their EESG policies and their own stewardship capacity: Currently, institutional investors support more votes on everything, even when they realize that they cannot focus on all of them. This is evidenced by annual SOP votes, where proxy advisors are the key determinants of outcomes, because there are too many votes for thoughtful consideration. Real stewardship demands ensuring that investors and society are not hurt by making companies spend scarce resources on votes that institutional investors cannot responsibly consider and by using votes on specific issues as a sideways tool to express discontent in a bad year, rather than to give reasoned input on the company's strategic approach.

- Requiring a certain level of stewardship by all institutional investors: My friends Professors Bebchuk and Lund are not wrong that the leading index funds do not have enough stewardship resources to adequately consider all the votes that occur. That is why fewer, more meaningful, votes should occur. But another problem must be addressed: the big index funds do way better than most. If we are going to encourage institutions to vote, then all of them must be expected to invest in stewardship, so that perverse pricing pressures do not inhibit stewardship. Absent a return to the Wall Street rule, an industry-wide expectation of stewardship is essential, so that those trying to do things right are not undercut by free-riders and the benefits of greater alignment are lost.
- Requiring investment funds invested in corporate debt securities to develop and act on stewardship policies to protect investors, reduce excessive corporate risk, and provide needed balance to our corporate governance system: In the last two generations, institutional investors managing equity funds have been pressured to use their voice, and this has manifested itself in a tilt toward stockholders at the expense of other stakeholders. Evidence exists that activism largely results in transfers of wealth from stakeholders like workers and debt holders to equity holders.²⁸ But most human

28. A few years ago, I pulled the then-extant evidence on this topic together. See Strine, *Who Bleeds When the Wolves Bite?* *supra* note 3, at 1870 (citing scholarly studies coming to the conclusion that gains from activism to stockholders often involved shifts in wealth to stockholders from workers and creditors), and was also associated with a decline in research and development). For a reader interested in a balanced and accessible discussion of the literature, the following article by Professors Coffee and Palia remains essential. John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016).

investors do not just invest in equities, they also invest in debt, and especially in the years when they need their portfolio to pay for college for their kids or retirement for themselves. As we have encouraged equity investors to use their voice, we have not required funds holding debt securities to do the same, and to put in place stewardship policies that encourage systemic practices that discourage excessive leverage and risk in American corporations, and thus protect their investors and in the course of doing so also help American workers and communities who suffer harm from avoidable corporate insolvencies caused by risky balance sheet practices.

- Requiring all corporate political spending be under plans approved by a super-majority of stockholders and that institutional investors align their voting on political spending with their EESG policies and ensure that companies do not invest in dark money political action committees, multi-candidate committees, or in the campaigns of candidates whose policy views are not consistent with the company's stated EESG commitments or the investors' own policies. One of the major reasons for the imbalance in power that now exists is that companies have been able to use their resources to act on the political process to externalize costs (such as of environmental compliance or worker safety) to society and stakeholders like workers, and to undermine regulatory protections for workers, consumers, and the environment. Institutional investors, with the exception of certain institutions, have abdicated on this important subject and must be forced to step up. Investors do not invest with institutional investors so that their capital can be deployed by public companies for political purposes.²⁹

29. For a further discussion of my own perspective on these phenomenons, see Leo E. Strine, Jr., *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending*, 97 WASH. U. L. REV. 1007 (2020); Leo E. Strine, Jr., *Corporate Power Ratchet: The Court's Role in Eroding "We The People's" Ability to Constrain Our Corporate Creations*, 51 HARV. C.R.-C.L. L. REV. 423 (2016). For a recent empirical report demonstrating the use by public companies to support candidates and committees whose values were inconsistent with stated company EESG policies, see *Conflicted Consequences*, CTR. POL. ACCOUNTABILITY (July 21, 2020), <https://politicalaccountability.net/hifi/files/Conflicted-Consequences.pdf> [<https://perma.cc/A5FM-M8BH>]. Respected scholars have warned that the effect of individual companies and industries in wielding their wealth to bend regulatory policies to their wills is more likely to hamper overall economic growth and to reduce social welfare. John C. Coates IV, *Corporate Speech & The First Amendment: History, Data, and Implications*, 30 CONST. COMMENT. 223 (2015); Rebecca Henderson and Karthik Ramanna, *Do Managers Have A Role to Play in Sustaining The Institutions of Capitalism?*, 4, 7-14, BROOKINGS INSTITUTION, (Feb.

- Requiring pension funds and other investment funds to have all litigation authorized by the board, not staff, before filing, and to make a determination that the benefits of the litigation, in terms of recovering financial losses caused by a potential breach of fiduciary duty or corporate governance principles, is worth the cost to the fund and the company's stakeholders. Likewise, any settlement should be authorized by the board on the same criteria, and in supporting any fee, the board should have to determine that the benefit to the fund's investors and the other stockholders justifies the fee.

These requirements should be accompanied by voluntary action by mutual and pension funds to bring their own stewardship practices into closer alignment with the real interests of their worker-investors. By way of example, leading mutual funds are now voicing support for sustainable growth and stakeholder governance. They need to match this rhetoric by a stated willingness to support public companies that wish to become a public benefit corporation under Delaware law, and commit themselves to a mandatory “shall” duty of respect to stakeholders and to sustainable wealth creation for their stockholders.³⁰ Furthermore, they need to do more to

9, 2015), <https://www.brookings.edu/research/do-managers-have-a-role-to-play-in-sustaining-the-institutions-of-capitalism/> [<https://perma.cc/5MY9-H6D3>] (warning of the “real risk that private sector engagement with the political process will fundamentally distort the institutions of capitalism and managers have a responsibility to the system itself” and that this risk is heightened because businesses exert influence on subjects involving “thin political processes” where countervailing interests are less likely to be effectively represented and heard).

30. Delaware has now made it possible for an existing public company to convert by a majority vote. See H.R. 341, 150 Gen. Assemb., (Del. 2020), <https://legis.delaware.gov/json/BillDetail/GenerateHtmlDocument?legislationId=48122&legislationTypeId=1&docTypeId=2&legislationName=HB341> [<https://perma.cc/C4SR-BS6K>] (removing the requirement in § 363(b) that a two-thirds majority of stockholders is required for a Delaware corporation to convert to a public benefit corporation). Notably, this year, Lemonade and Vital Farms went public as benefit corporations with favorable pricing. Form S-1, Lemonade, Inc. (June 8, 2020), <https://www.sec.gov/Archives/edgar/data/1691421/000104746920003416/a2241721zs-1.htm> [<https://perma.cc/KD2Z-7KNP>]; Form S-1, Vital Farms, Inc. (July 9, 2020), <https://www.sec.gov/Archives/edgar/data/1579733/000119312520190455/d841617ds1.htm> [<https://perma.cc/8JWR-S8EV>]. And, Danone became the French equivalent of a benefit corporation without adverse effect to its stock price or the price at which its ADRs sell in the U.S. Maitane Sardon & Cristina Roca, *Danone to Place Greater Focus on ESG*, WALL ST. J. (May 20, 2020), <https://www.wsj.com/articles/danone-to-place-greater-focus-on-esg-11590004975> [<https://perma.cc/E4QN-HUWQ>]. As scholars have noted, there is reason to believe that companies, like benefit corporations, that embrace a purpose of making profits in a socially responsible way that is respectful of all stakeholders cannot only succeed as profitable businesses, they are likely essential to tackling challenging problems like climate change. E.g., Rebecca Henderson & George Serafim, *Tackling Climate Change Requires*

ensure they have adequate information when activists pressure companies to take actions with long-term consequences for stuck-in stockholders and company workers. For starters, that would include refusing to support any activist that does not: 1) fully disclose its entire ownership position, long, short or otherwise hedged, in a clear way, revealing its true net long position; 2) disclose the terms of its fund arrangements that bear on how long the activist can and is likely to hold its shares in the target company; 3) promise to have one of its representatives serve on the company's key risk management committee; and 4) making a binding promise not to exit its investment in the company on preferential terms and to accept any market discount that is required of other investors in unwinding their position.³¹ By means like this, mainstream investors would understand how truly committed activists are to living with the long-term consequences of their own strategy for the company, or whether they are just telling other stuck-in investors that they will be better off if they listen to the helpful hints of a momentary visitor in their ranks.³²

To fully address the lack of accountability and information about hedge funds and other private investment funds, however, regulatory action of the following kind must be taken:

- Close loopholes so that activist hedge funds must make a full and timely disclosure of their economic interests in the companies they seek to influence, and bring America's regulation into line with the other major market economies.
- To this end, the SEC should revise its rules governing Schedule 13D disclosure so that: (i) the definition of beneficial ownership includes ownership of any derivative instrument that provides the opportunity to profit from an increase in the value of the subject security and any contract or device that allows the person to control the voting power

Organizational Purpose, AM. ECON. ASS'N Papers and Proceedings, 110: 177-180 (May 2020); see generally, COLIN MAYER, PROSPERITY: BETTER BUSINESS MAKES THE GREATER GOOD (2018).

31. The empirical evidence is that activist hedge funds typically hold their shares for one to two years at most, and many for less than a year. Alon Brav et. al, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1749 (2008); Coffee & Palia, *supra* note 28, at 572; Strine, *Who Bleeds When the Wolves Bite?*, *supra* note 3, at 1892.

32. Others have noted that the compensation structures for fund managers are often short term in nature, and do not align with their investors' horizons. Strine, *Who Bleeds When the Wolves Bite?*, *supra* note 3, at 1915- 1917 (compiling studies and commentary to this effect). Much attention has been paid to CEO pay at public companies and the efforts to "reform" it to date have been, in my judgement, dismaying in their effect. For that reason, I am reluctant to tinker in this area for mutual fund managers, but do note that the lack of alignment puts pressure on managers to focus on results over a time frame that does not match their investors', especially those saving for retirement.

of the equity security; (ii) disclosures of any short interest or ownership of a derivative instrument that allows the investor to profit from a decrease in the security's value are required; (iii) 13D filers could not acquire additional shares (or derivatives) once the investor crosses the 5% threshold (for large-cap companies) or a 10% threshold (for smaller companies) until a 13D has been filed and available to the public for 24 hours; (iv) disclosure is required of contractual or other arrangements that affect the filer's commitment or ability to hold the subject security, including the ability of the filer's investors, if any, to redeem or withdrawal their capital; and (v) a standard form is developed that activists must use to disclose, in clear understandable terms, their net long position and keep it updated as that changes by more than one percent in any direction.

- Strengthen the securities laws to make it illegal for activists to tip others during the period before they file under Section 13(d): There is abundant evidence of abnormal trading by pack members before the alpha wolf files makes public disclosure of its stake. This allows for the possibility of creeping takeovers at the expense of other stockholders and stakeholders, and is unfair to other traders in the marketplace. Given the power activists have to move stock prices just by their presence, they should be prohibited from leaking to other investors during this period and if they do so and trading results, they should face liability.³³
- Address the investor and societal risks caused by private funds that are subject to only limited disclosure requirements. Although hedge funds and private equity funds should not be required to disclose proprietary information about their trading strategies that would inhibit their ability to conduct their unique approach to investing, it is long past time when they should be permitted to cloak their track records, their terms of investment, special deals to their favorites, and other important information because their investors should be presumed able to operate on a caveat emptor basis. The accredited investor and qualified purchaser exceptions were not intended to allow pension funds, universities, or charitable institutions to put money in risky investments not backed up by appropriate disclosures and standards of integrity. But many have been harmed by investing in private equity and hedge funds without adequate information.

33. See Coffee & Palia *supra* note 28 at 562-566; see also Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?* 124 HARV. L. REV. 83 (2010).

These losses hurt workers and society and can require taxpayers to fill the resulting holes. Pension funds and charities lack enough reliable information to prudently assess whether these investments are appropriate for their portfolio on both a risk-return basis and on a cost basis. The SEC and Congress should work together to fix this important problem.

Finally, to promote more thoughtful, rational investing by both human customers of the institutional investor community, and the institutional investors themselves, the tax policies affecting the industry should be reformed. In particular, a financial transactions tax should be adopted that would not only discourage destabilizing and risky speculative trading without economic substance, but discourage fund-hopping by mutual fund investors. Likewise, the long-standing abuse of the carried interest loophole should be shut, and capital gains for holdings of less than five years should be taxed like income earned by sweat.

By these means, the incentives for productive investing that is positive for society will be increased, and the revenues raised in this Pigouvian manner can help fund clean infrastructure to address climate change and create quality jobs, basic research to fuel long-term growth and American competitiveness, and investments in the ongoing training and education of American workers.

* * *

None of these reforms will harm the institutional investment industry in the long term. Rather, they will legitimize an industry whose power has long outgrown its expected responsibilities. And done in concert with a 21st Century New Deal to focus our economy on sustainable growth, environmental responsibility, and, most of all, the fair treatment of the workers who make capitalism a success, these measures will create a more equitable and prosperous America, and by doing so, expand the class of Americans who have the means to invest with the industry for college for their kids, retirement for themselves, and enjoy genuine economic security. All that this involves is making sure that a powerful segment of our economy's responsibilities be aligned with its power. Put another way, all that is required is that the have's do a little for the common good. That is not much to ask.