

Exit, Voice and Loyalty from the Perspective of Shareholder Activism in Corporate Governance

Alessio M. Paces (*)

Preliminary & incomplete version (4 November 2015)

Abstract

This article discusses the policy response to hedge funds activism in corporate governance based on Hirschman's classic: *Exit, Voice and Loyalty*. From that perspective, the article argues that hedge funds do not create concerns of loyalty because the arbiters of their activism are typically institutional investors that cannot exit strategically. Nevertheless, the voice activated by hedge funds can be excessive for a particular company.

Although the empirical evidence does not support the claim that the gains from hedge funds activism are short lived, the short-termism debate cannot shed much light on the desirability of shareholder activism. Neither theory nor empirical analyses can tell us whether the existence of hedge funds activism leads to some sort of short-termism and whether this is efficient for corporate governance. The real issue with activism is a conflict of entrepreneurship, namely between the opposing views of the activists and the incumbent management regarding how the target company should look like in the future. Leaving the choice between these views to institutional investors is not efficient for every company at every point in time.

Consequently, this article argues that regulation should enable individual companies to limit the impact of activism when this is efficient for them, while refraining from curbing the power of activists across the board. As revealed by the recent European experience, loyalty shares operate as dual-class shares in disguise. This outcome could be improved by allowing dual class recapitalizations explicitly, but subject to a majority of minority vote. This 'sticky default' solution would screen for the companies for which limiting the influence of activists is efficient and induce these companies to negotiate time-bound restrictions with institutional investors.

1. Introduction

Shareholder activism in publicly held companies is much in the news, particularly hedge fund activism.¹ Activist hedge funds engage the management of an underperforming listed

(*) Professor of Law & Finance, Erasmus School of Law, and Research Associate, European Corporate Governance Institute. I wish to thank Luca Enriques, Joe McCahery, Arkadiusz Radwan and participants in the 2015 European Forum on Securities Regulation (EFSR) at Bucerius Law School in Hamburg for helpful comments. Usual disclaimers apply.

¹ Add definition based on Kahan & Rock (2007). Flag that only a small subset of hedge funds are activists.

company in which they have bought a significant stake. Hedge funds seek to determine a change in governance or in the managerial strategy, from which they will profit, eventually, by selling their shares at a premium after performance has returned to full potential. Recently, the U.S. hedge fund Value Act Capital has become the largest shareholder of the UK engineering company Rolls Royce, supposedly seeking to persuade the management to restructure the company.² Engagements by activist hedge funds include, among others, pharmaceutical U.S. companies such as DuPont and Allergan.³ Hedge funds activism has not spared giant corporations, such as Microsoft and Apple. And, the phenomenon is not limited to U.S. or UK companies. Activists have targeted several companies in continental Europe, such as the Swedish automotive company Volvo, the German steel company ThyssenKrupp, the Dutch chemical maker Royal DSM, the French media company Vivendi, and the Italian largest telecom operator Telecom Italia.⁴ Importantly, activism appears to have an impact also in concentrated ownership structures, where one or more dominant shareholders are in control.⁵ Equally important, even in dispersed ownership structures, hedge funds activists do not always manage to obtain from management all they want.⁶ Because hedge fund activists have become one of the most powerful influencers of corporate governance worldwide, they have attracted significant attention by policymakers who, in most cases, are concerned with how to curb such power.

This essay aims to discuss the policy response to hedge funds activism from a law and economics perspective. The analysis is based on a seminal study of feedback mechanisms in large organizations, ranging from governments to corporations: Albert Hirschman's book, *Exit, Voice and Loyalty*.⁷ The problem Hirschman tried to address in his 1970 book is rather similar to activist hedge funds' concern: How to bring a company's performance back to full potential.

According to Hirschman's framework, activism the quintessence of voice. Voice of shareholders (but equally of customers, employees and other stakeholders) serves the

² Cite to news (<http://www.bloomberg.com/professional/blog/rolls-royce-volvo-replace-ceos-as-activist-investors-gain-clout/>).

³ John Coffee (2015), Lessons of DuPont: Corporate Governance for Dummies, CLS Blue Sky Blog (<http://clsbluesky.law.columbia.edu/2015/06/01/the-lessons-of-dupont-corporate-governance-for-dummies/>).

⁴ Cite to news (<http://www.skadden.com/insights/new-barbarians-shareholder-activists-have-europe-their-sights>).

⁵ See e.g. Poulsen, Strand, Thomsen (2010) on Sweden; Bessler, Drobetz, Holler (2013) on Germany; and Belcredi & Enriques (2015) on Italy.

⁶ Statistics by Becht et al (2015).

⁷ Hirschman (1970).

important function to alert the management about the decline of a specific company.⁸ Voice is, in this respect, alternative to exit. Exit of shareholders also alerts the management about a company's decline, but more indirectly, through the price mechanism.⁹ As a result, exit may postpone the realization of decline until it is too late to do something about it. Takeovers are a good illustration of how the exit mechanism impacts corporate governance. Because takeovers are expensive, they operate as feedback mechanism only in case of severe underperformance.¹⁰ The third, often neglected, item of Hirschman's framework is loyalty.¹¹ The ability of shareholders to exit normally disincentivizes them from exercising voice. This is not the case if loyalty exists. By raising the cost of exit, loyalty commits shareholders to voice. Loyalty has become very popular in today's policy debate, but not quite in the same sense as Hirschman's. While to Hirschman loyalty meant anything inducing shareholders to use voice instead of exiting an organization they are dissatisfied with, for policymakers loyalty distinguishes 'good' voice from 'bad' voice in corporate governance – hedge funds activism being an illustration of the latter.¹²

Loyal shareholders differ from hedge funds in one key respect. Instead of entering and exiting target companies, they stick with a given company for a while. Because of this, they are supposed to have better incentives to care for the company's well-being in the long run. Voice by loyal shareholders – the narrative continues – is welcome to guide a company's management. Voice by hedge funds activist is not, for it is aimed to extract short-term gains from target companies while disrupting them in the long run. Following this approach, several policy measures have been proposed. A group of those aims at reducing hedge funds impact through disclosure obligation.¹³ Another group aims at tilting the balance of powers towards more loyal shareholders.¹⁴ This discussion is reminiscent of

⁸ Id. at 30.

⁹ Id. at 22-24.

¹⁰ Bolton, Becht & Roell (2007: 879-880).

¹¹ Hirschman (1970: 77-79).

¹² Cite to various Loyalty Initiatives. Aspen Institute (2009), "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management" (Sept. 9, 2009) (hereinafter Aspen Institute 2009); Kay, John, "The Kay review of UK equity markets and long-term decision making." Final Report (July 2012) (hereinafter Kay Review 2012); Internal Market Commissioner Barnier (FT "Brussels aims to reward investor loyalty" – 23 January 2013); Cofferati Report of the Committee of Legal Affairs to the European Parliament (12 May 2015) (hereinafter Cofferati Report 2015).

¹³ See Letter from Wachtell Lipton Rosen & Katz to Elizabeth M. Murray, Sec'y, U.S. Securities & Exchange Commission (May 7, 2011), available at <http://www.sec.gov/rules/petition/2011/petn4-624.pdf>; see also Emmerich, Mirvis, Robinson & Savitt (2013).

¹⁴ Fox & Lorsch (2012) + Cofferati Report (2015).

the regulatory reaction to hostile takeovers, save that it is about voice, not exit. Hedge funds voice is supposedly as bad as raiders exploiting exit of shareholders in a tender offer.

At first sight, concerns with shareholder voice being disruptive are puzzling. Vocal shareholders are doing other investors a favour. If managerial accountability to investors is what one wants in corporate governance, this is precisely what activist hedge funds stand for. Similarly, in concentrated ownership structures, hedge funds are guarding minority shareholder protection, which all investors welcome. But the issue with hedge funds is that they are supposedly short-termist. Short-termism is a popular way to characterize stock market imperfection: Stock markets overweigh the short-term income of a company at the expenses of its long-term profitability.¹⁵ So the complaint about hedge funds is based on market failure. Because hedge funds are guided by the stock market, where they realize the gains from activism, hedge funds must be short-termist too and induce management to sacrifice long-term shareholder value for short-term performance.

Albeit popular among policymakers, the short-termism objection to hedge fund activism is regarded with scepticism by academics.¹⁶ This is because the empirical evidence does not support at least the more radical formulation of the short-termism claim, namely that activism induces managers to go for the ‘quick buck’ and destroy long-term shareholder value.¹⁷ On average, hedge fund activism brings about a substantial short-term increase in shareholder value, which is not reversed in the aftermath of the engagement. Although the empirical evidence also supports the view that managers occasionally engage in long-term value destruction to cater to short-term investors’ sentiment,¹⁸ hedge funds activism seems not to be responsible for this.

Nevertheless, in this essay, I will argue that the short-termism debate does not shed much light on whether hedge funds activism should be regulated and how. I will discuss several reasons. For one, short term and long-term horizon are ill defined. Any action can be characterized as short-term depending on the definition of the long term. This is obviously not very helpful for policy purposes. Secondly, whatever the (conventional) definition of short term as opposed to the long term, which horizon is preferable for the purpose of managing a company is not obvious.¹⁹ Efficiency may require managing for the

¹⁵ See Dallas & Barry (2015) for an informal illustration.

¹⁶ Bebchuk et al (2015).

¹⁷ See infra text accompanying notes ____.

¹⁸ Bushee (1998) and Bushee (2001).

¹⁹ Fried (2014).

short term, for instance because, according to Hirschman's framework, in highly competitive markets feedback must be immediate in order to allow for timely "recuperation" from underperformance. But Hirschman was very clear that what is efficient recuperation mechanism for a firm may be inefficient for another, and this circumstance is susceptible to change over time.²⁰ Therefore, efficiency may require as well managing for the long term, at least to the extent that the definition of long term allows for feedback to intervene timely.

More importantly, the conflict between the short-term and the long-term view of profit maximization is impossible to resolve empirically. Companies are not alike and they are dynamic, namely they react to the challenges from the outside environment. The positive abnormal returns associated with shareholder activism say nothing about whether the hedge fund view is superior to the incumbent management's view. To validate that claim one would need to compare the target's performance not with a market index, as in a typical event study, but rather with an identical, counterfactual firm that hasn't capitulated to activism *and* is insensitive to activism's threat.²¹ Although the most recent studies of activism have made significant progress in approximating such research design,²² the fact remains that firms that are (or can be) targeted by activism are radically different from those that aren't (and cannot be). Consequently, the activists' views on, for instance, innovation cannot be compared with that of companies that are not susceptible to targeting by hedge funds. Most likely, their different performance over the same horizon – whether long or short – will be a reflection of the different kinds of innovation they engage in.

The debate on the right horizon for managing a listed company confounds the effect – short-termism – with the cause – uncertainty. The truth is that nobody, whether in business, in finance or in daily life, knows how a distant future, call it 'long term', will look like. As a reaction to this uncertainty, stock markets process information with a short-time horizon. Similarly, investors make decisions based on the best aggregation of known information available: The short-term market price. Whether and to what extent this circumstance influences corporate governance is another story. According to two prominent students of uncertainty – Frank Knight and John Maynard Keynes – financial

²⁰ Hirschman (1970: 124).

²¹ See Atanasov & Black (2015), Shock-Based Causal Inference. See also Angrist & Pischke (2012), Mostly Harmless Econometrics.

²² Brav et al (2014) using propensity score matching.

markets are but one way to deal with an uncertain future.²³ Another way is entrepreneurship. Entrepreneurship is based on long-term expectations, which incorporate all information available to markets plus something else: a guess about forthcoming change.²⁴

Coming back to the corporate governance context, entrepreneurship can be characterized as a bet on forthcoming change, which will be profitable if the change happens as predicted and unprofitable otherwise. The size of the bet shows the entrepreneur's commitment to the project. This, in turn, affects the funds that can be raised from the financial markets.²⁵ Markets, however, are not anticipating the change the entrepreneur is betting on, which is a precondition for the change to be profitable if it ever occurs. Investors leave corporate control with the entrepreneur so long as they trust her judgment. When this is no longer the case, investors would rather hand control over to another entrepreneur, by exiting and letting somebody else take over or by directly raising their voice and voting for a new management.

From this perspective, hedge funds activism is a form of entrepreneurship.²⁶ Hedge funds aim to change the strategy, the management or the governance of a target company and profit from the unanticipated market gains from such changes. But in so doing, hedge funds get in conflict with the managers or the dominant shareholders who control the target company. These people may oppose the activist's demands because they are entrepreneurs, too, and genuinely believe they have a superior view about the company's strategy, or because they derive private benefits from running the company below its potential. Whether the incumbent management's opposition to activism stems from genuine entrepreneurship or not, let alone whether the management is right or wrong, is hard to say when the conflict occurs. But the conflict is not really about whether a company should be managed for the short term or the long term. It is rather a conflict between two views of entrepreneurship, namely about how the company should look like in the future (including the scenario in which managers benefit from running it inefficiently). Relative to market price, these are all 'long-term' views although they may

²³ Cite to Knight (1921) and Keynes (1936).

²⁴ Keynes (1936) Chapter 12.

²⁵ Paces (2012: ____).

²⁶ Klein & Zur, J Fin (2009).

involve different time horizons. The real policy issue is which view should prevail and whether the law should do anything to help companies to make the right choice.

Extending the approach developed by professors Enriques, Gilson, and myself for takeover regulation,²⁷ this article argues that individual companies should decide ‘who decides’ when there is a conflict of views between an activist investor and the incumbent management or controlling shareholder. In the remainder of this article, I will articulate this claim as follows. In section 2, I will start by reviewing theory and empirical evidence about hedge funds activism. As illustrated by professors Gilson and Gordon,²⁸ support by the institutional owners is the key to activism’s success. In view of this insight, I will revisit Hirschman’s framework in section 3. While optimizing individual companies’ exposure to exit and voice – including activism – remains crucial for efficiency, the desirability of loyalty is today more nuanced than in the world of dispersed individual owners Hirschman was living in. The real issue about shareholder activism is not whether it is long-term or short-term, but whether a company should commit to insiders’ or outsiders’ entrepreneurship. In section 4, I will argue that none of the main regulatory proposals to screen for efficient shareholder activism – enhanced disclosure obligations and the so-called loyalty shares – helps companies to make that choice. On the contrary, a “sticky” one-share-one-vote (1S1V) default²⁹ would enable individual companies to select the efficient regime and to alter it when it becomes inefficient down the road. Section 5 concludes.

2. Entrepreneurial Shareholder Activism

Shareholder activism is not new. Activists have always been prompting corporate managers to act on some issue, even loosely related to the conduct of the company’s business, such as social policy. Particularly in the U.S., activists have typically availed themselves of the possibility to add items on the agenda of the general meeting at the company’s expenses, by filing a so-called shareholder proposal.³⁰ Traditionally, however, this activism has not been very effective and, before the advent of hedge funds activism,

²⁷ Enriques Gilson Paces (2014).

²⁸ Gilson & Gordon (2013).

²⁹ Cite to Ayres (2011).

³⁰ Note on 14a-8 proposals.

investors seemed unable to achieve concrete outcomes through this channel.³¹ Despite the regulatory differences, a similar conclusion could be made about comparable channels for traditional activism in Europe.³²

Hedge funds activism is different.³³ It does not simply aim to alert management on some issue by triggering a shareholder vote on it. It aims at achieving a change in the way the company is managed. Such change can be – although not necessarily is – quite radical, such as the departure of the CEO or some other executives, if not the restructuring of the company. Likewise, activist hedge funds may seek to stop a change wanted by the management, for instance an acquisition. For this reason, hedge funds activism is called “entrepreneurial activism” and this is how I will refer to it in the remainder of the article. Differently from traditional activism,³⁴ the mark of entrepreneurial activism’s success is not so much the level of shareholder support at the general meeting, but whether the desired change(s) happens or not.³⁵ The reason for this is the business model of activist hedge funds. Differently from other institutional investors, hedge funds managers charge a performance fee in addition to a percentage of the asset under management.³⁶ This aligns their incentives with investors having a relatively high appetite for risk and accepting restrictions to liquidity. Hedge funds profit from investing in stock that they can buy, hold and resell at a higher price. The purpose of entrepreneurial activists’ engagement with the management of the target company is to achieve meanwhile a change that will boost stock market performance.

Two factors are key for the success of entrepreneurial activism. First, the hedge fund needs to be able to buy the bulk of its stake in the company while the stock market does not anticipate the engagement. The moment the engagement is revealed, investors will anticipate gains and, discounting those for the probability that the engagement fails, stock price will rise. Second, the activist needs to be able to persuade the management to implement the desired changes. To increase its leverage with the management, the activist can use several techniques, ranging from news campaigns to threatening a lawsuit, but the last resort is to wage a proxy contest. Reached that point, the success of the engagement

³¹ Yermack (2010). But note the change with staggered boards (Coates, Handbook, 2015)

³² See Abe de Jong et al (2006)

³³ Cite to Partnoy (2015) and Macey (2008).

³⁴ Kobi Kastiel (2015) on the distinction.

³⁵ Becht et al (2015).

³⁶ Gilson & Gordon (2013).

will depend on whether the activist has managed to attract sufficient support from other shareholders to get a favourable vote.

To understand successful engagement, two remarks are in order. First, the typical hedge fund stake in the target company is substantial, but not nearly a controlling one.³⁷ In the U.S., the engagement purpose must be revealed within ten days from the crossing of a 5 percent ownership threshold. In that time window, activist investors can increase their stake without overpaying for the stock, but they hardly ever cross the 10 percent threshold.³⁸ As a result, activists must persuade institutional investors and their advisors to vote for them. The second point is that engagement may succeed based on the sheer threat of winning a contested vote (or any other opposition with the management).³⁹ The likelihood of winning the battle can be estimated while the investing public is still in the dark about the engagement. This is in the interest of both contestants.⁴⁰ From the moment the hedge funds formulate their demand to the management, both parties start to speak with the largest institutional investors. Management will give in to the activists' demands when it is clear they are going to lose the vote, whereas hedge funds will withdraw from engagement when they realize that not enough institutional investors will vote for them. Most of the times, however, the parties will settle somewhere in the middle. The fight becomes public only when no agreement can be reached at this stage. Consequently, a substantial portion of hedge funds engagement takes place behind closed door, which, as I will explain shortly, has important consequences for empirical analysis.

Institutional investors play a key role in this game. In a recent article, professors Gilson and Gordon explained how the tremendous influence activists have gained in corporate governance lately mainly depends on the reconcentration of ownership occurred in the past few decades.⁴¹ Activists would not have much chance to gather support from the myriad of dispersed shareholders of the typical Berle-Means Corporation because individual stockholders would not bother voting, particularly against the management of a company they decided to invest in. However, the Berle-Means Corporation does no longer exist, not even in the U.S.⁴² Gilson and Gordon report that, in 2009, institutional investors

³⁷ See Coffee & Palia (2014).

³⁸ Add cite to evidence.

³⁹ Becht et al, Handbook (2015).

⁴⁰ Explain briefly why confidentiality is a win-win.

⁴¹ Gilson & Gordon (2013:___).

⁴² Flag that some commentators (Holderness) cast doubts as to whether it ever existed (references from Paces 2012).

held 73 percent of the equity of the thousand largest U.S. corporations.⁴³ A recent study by the OECD provides similar results for the UK.⁴⁴ Moreover, concentration of non-controlling ownership is a documented phenomenon also in countries where dominant shareholders are frequent, such as Sweden and the Netherlands.⁴⁵

If roughly two dozens of institutional investors hold the majority of votes in the typical management-controlled company, and a substantial portion of the voting rights also in companies with dominant shareholders, why aren't institutional investors, rather than hedge funds activists, leading the charge against the incumbent management? The reason, according to Gilson and Gordon, is agency costs.⁴⁶ Institutional investors manage other people's money and do so with a business model that disincentivizes monitoring of individual companies. Institutional investors are very different from each other – a point on which I will return shortly – but, for reasons of law, profiling and investment culture, they all hold a diversified portfolio of stock. They charge flat fees based on assets under management, and the latter mainly depends on the institution's ability to attract funds from the competitors – that is, relative performance. Relative performance is unaffected by improving the returns of a particular portfolio company, because most of the competitors will free ride on that, while it is adversely affected by the costs of becoming informed about underperforming companies to engage with. Therefore, institutional investors are “rationally reticent.”⁴⁷ They are not proactive in influencing corporate management, but they are responsive to other, entrepreneurial actors, who bring the case for engagement to their attention.

According to Gilson and Gordon, the activists' teaming up with institutional investors is undoubtedly beneficial for corporate governance. On the one hand, activists lower the agency costs of institutional ownership. On the other hand, institutional investors screen activists' proposals and likely sanction only those that increase shareholder value. Empirical evidence supports the conclusion that activists give other shareholders what they want.⁴⁸ Several studies document the association of shareholder activism with an average increase in shareholder value.⁴⁹ Importantly, this increase mainly stems from the activists

⁴³ Id. at ____

⁴⁴ Who cares, OECD (2013).

⁴⁵ SNS study (2015) and De Jong et al (2010).

⁴⁶ Gilson & Gordon (2013: ____).

⁴⁷ Id. at ____.

⁴⁸ Becht et al (2015).

⁴⁹ Klein & Zur (2009), Brav, Partnoy et al (2008), Clifford (2008).

achieving outcomes of sort, namely garnering broad support from institutional investors, and the increase is larger for outcomes more related to changes than for others.⁵⁰

If that were the end of story, the policy implication would be straightforward: Leave the activists alone and let the institutional investors police the merits of their campaign. However, apart from policymakers, a few commentators have been sceptical regarding whether activists can be trusted to win only the right battles.⁵¹ While, on review, some of these objections are not really supported by the empirical evidence, others deserve some closer inspection, if anything, because the empirical evidence does not and – I will argue – cannot reject them.

The first objection that one can raise about a screening mechanism based on institutional investors is that the latter do not really exercise judgment, but rather blindly follow the recommendations of proxy advisors, notably including global market leaders such as Institutional Shareholders Services (ISS) and Glass-Lewis.⁵² The argument echoes policymakers' scepticism about proxy advisors and has a theoretical basis.⁵³ Because the institutional investors' business model does not encourage monitoring individual companies, institutions tend to be passive about voting. Recently, however, particularly U.S. legislation has compelled major categories of investors – mutual funds and pension funds – to disclose their voting policies.⁵⁴ Hence, to avoid embarrassment, institutional investors purchase professional advice from ISS and similar companies and – the argument runs – mechanically follow their advice. Short of the debate about the quality of proxy advice following from this argument,⁵⁵ the empirical evidence suggests that the influence of proxy advisors could be overstated.

Virtually all mutual funds, which are the largest U.S. corporate owners taken together, subscribe to one or more proxy advisors, normally including ISS. However, only 25 percent of mutual funds always vote in line with the proxy advice and, on an asset-weighted basis, reliance on management is higher than reliance on ISS.⁵⁶ Reliance varies

⁵⁰ Becht et al (2015).

⁵¹ See esp. Coffee & Palia (2014). But sceptics include, among others, Bolton & Samama (2013), Martin Lipton (2013), “Important Questions about Activist Hedge Funds” (<http://corpgov.law.harvard.edu/2013/03/09/important-questions-about-activist-hedge-funds/>).

⁵² Coffee & Palia (2014)

⁵³ European Commission (2012) “Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies.”

⁵⁴ Rock (2015: 13-14).

⁵⁵ See Daines et al. (2010)

⁵⁶ Iliev & Lowry (2015).

greatly among institutional investors because they differ considerably too, especially in their size, investment strategies and horizons. Funds that are more dedicated to portfolio companies and have larger dollar-value stakes – i.e. are larger or less diversified – do vote actively, particularly on issues of interest to them, such as directors’ elections and corporate governance matters.⁵⁷ Not only the largest U.S. asset managers vote independently from ISS, but in some circumstances they are even more influential.⁵⁸ Even indexed funds, which passively track market indices, seem to vote actively on a number of issues.⁵⁹ Finally, proxy advisors cater to their customers’ tastes and expectations, in such way that it is ultimately impossible to determine with precision how much advisors influence asset managers or are influenced by them.⁶⁰ According to one study, an ISS advice against the management shifts at most 10 percent of votes in U.S. uncontested elections.⁶¹ Although there are no studies on the influence of ISS on activists’ success, such influence seems to be not as overwhelming as the standard narrative suggests.

Activist hedge funds could still avoid a thorough scrutiny by institutional investors if they used a strategy that made them win most of the times. This is a second powerful objection to hedge funds activism and is based on the so-called “wolf pack” strategy.⁶² A wolf pack is a coalition of hedge funds aimed at maximizing the impact of engagement. As mentioned, in the U.S., activists have to disclose their intentions within 10 days of crossing a 5 percent ownership threshold. In that time window, hedge funds can profitably increase their ownership, but they do not usually go above 10 percent. To improve the odds of the engagement, they can ‘tip’ other hedge funds. Because their ownership remains below 10 percent and they are not seeking control, such a tipping qualifies neither as insider trading nor – more relevant for the European context – as acting in concert for purpose of takeover regulation. Wolf packs often operate below the radar, which makes it difficult to estimate their incidence and impact empirically. Still, according to a recent international study, wolf packs account for 22 percent of the engagements, increase the success rate from 46 to 78 percent, and are more profitable than individual engagements.⁶³ Based on this and other evidence, Professor Coffee and Palia have argued that wolf packs are a nearly risk-free

⁵⁷ Id. at ____.

⁵⁸ Choi et al (2013).

⁵⁹ Appel et al (2015).

⁶⁰ McCahery et al (2015).

⁶¹ Choi et al (2010).

⁶² Coffee & Palia (2014).

⁶³ Becht et al (2015).

strategy for hedge funds to succeed, which suggests that they will tend to over-engage corporate management.⁶⁴ Apparently, wolf pack can barely be stopped. If the wolf pack puts together about one-third of the votes, as for instance in the Sotheby's case,⁶⁵ they need to get on board another 7 to 10 percent to win. This is about as much as, on average, depends on the recommendation of proxy advisors.

Wolf packs are important, but their impact should not be overestimated. Firstly, in more than one-fifth of cases, they lose. Second, although wolf pack members greatly increase the success rate by buying from dissatisfied investors, whether the investors remaining are those most likely to blindly follow ISS is a matter of speculation. Actually, the presence of large investors in the ownership of engaged companies, like in the Sotheby's case, suggests that institutional investors may still be the ones calling the shots.⁶⁶ Third and most important, 78 percent of engagements are *not* wolf packs. There is obviously self-selection here. Hedge funds choose their battles. They decide to join the wolf pack only when it is more likely that they are going to win. Likewise, the leading hedge fund, who is getting the lion's share of the wolf pack gains, bears two sorts of risk: first, the risk that others will not join; second, conditional on the previous event, a higher risk to lose the engagement. Engagements without outcomes, with or without wolf packs, deliver insignificant to negative shareholder returns.⁶⁷

The third and most common objection to hedge funds activism is that it nurtures short termism in corporate governance. Because hedge funds profit from targeting underperforming companies, changing or influencing their management, and reselling the stock at a premium, they may induce the managers to destroy long-term value to maximize short-term stock returns. This argument has several dimensions, which are often confused with each other. The more common (and extreme) version of the short termism argument is that the sizeable shareholder gains brought about by activism on average are short lived.⁶⁸ As I am going to explain, for at least some reasonable definitions of long term, the empirical evidence does not support this part of the claim. However, the empirical

⁶⁴ Coffee & Palia (2014).

⁶⁵ *Id.* at ____.

⁶⁶ Gilson & Gordon (2014), "The Sotheby's Poison Pill Case: The Plate Tectonics of Delaware Corporate Governance" CLS Blue Sky Blog (<http://clsbluesky.law.columbia.edu/2014/05/15/the-sothebys-poison-pill-case-the-plate-tectonics-of-delaware-corporate-governance/>).

⁶⁷ Becht et al (2015).

⁶⁸ See Martin Lipton (2013) "Current Thoughts About Activism" (<http://corpgov.law.harvard.edu/2013/08/09/current-thoughts-about-activism/>) and Coffee & Palia (2014) for an overview.

evidence can neither support nor reject the short termism claim in another important dimension. Managers and dominant shareholders subject to market pressure, including shareholder activism and the threat thereof, may be reluctant to invest in projects whose value cannot be incorporated in stock market prices before a few years hence. The merits of this argument can only be evaluated in theory, which I will do in the next section.⁶⁹

Two studies, in particular, reject the argument – frequently heard in the policy circles – that hedge funds activism make managers go for the ‘quick buck’ while destroying long-term value. In the first study, professors Bebchuk, Brav, and Jang show that, in the U.S., the short-term gains stemming from the announcement of the engagement are not reversed later on.⁷⁰ On the contrary, they document that short-term gains are correct anticipations of the consequences of engagement up to five years hence.⁷¹ The second study by professors Becht, Franks, Grant, and Wagner, which includes also non-U.S. activism, confirms that the positive stock returns associated with engagement are not short term.⁷² Activists have an average holding period of 1.7 years, but more important, their buy-and-hold returns are abnormally positive only if outcomes are realized. Therefore, hedge funds are not short termist in the conventional sense of ‘cutting and running’, although this says nothing about whether the stock markets itself is myopic relative to some other definition of the long term.⁷³

The empirical evidence also tells us that, although most of hedge funds activism occurs in the U.S., activism is a broader phenomenon. Particularly in Europe, activism is sizeable and the success rate is only slightly lower than in the U.S.⁷⁴ The style of engagement, however, varies considerably because country-specific institutions – most importantly, the legal rules and reputation – affect it. Although for reason of space I cannot

⁶⁹ A slightly different version of this argument is that hedge funds activism undermines the long-term relationship of managers and controlling shareholders with other stakeholders. See e.g. Mayer (2013). Because this article deals with shareholder feedback in corporate governance, stakeholders are quite out of its scope; but I will nonetheless discuss this part of the argument briefly at the end of the next section.

⁷⁰ Bebchuk et al (2015).

⁷¹ Such long-term consequences are estimated based on accounting and market data for time windows up to five years long. Both tests confirm that the returns are abnormally positive for companies subject to engagement. Bebchuk et al (2015).

⁷² Becht et al (2015). They study the long-term results from the announcement to the exit of activist hedge funds and compare them with the returns of a matching, counterfactual portfolio with no engagement. Such returns are positive so long as there are outcomes of engagement.

⁷³ See *infra* text accompanying notes_____.

⁷⁴ Cite to Becht et al (2015), flagging, however, how the UK drives the result.

discuss activism in different countries, two aspects of the comparative picture are worth emphasizing.

First, the impact of entrepreneurial activism depends on the strength of shareholders' rights.⁷⁵ These rights may be too weak to sustain activism, but also too strong, giving activism too much impact. For instance, shareholder rights are stronger in the UK than in the U.S., but activism is much less frequent in the UK and has a negative long-term performance.⁷⁶ This result is difficult to interpret because a great deal of activism in the UK occurs behind closed doors,⁷⁷ although it does suggest that activism in Britain is less beneficial than in the US. The importance of legal rights can be generalized to other institutional contexts. Wherever non-controlling shareholders can achieve outcomes, there is room for activism. The second lesson from the comparative picture is, therefore, that activism may work even in companies with a dominant shareholder, so long as activists have a channel to make their voice heard. Such channels exist in several countries. For instance, in Sweden, activists can influence board appointments through the nominations committee;⁷⁸ in the Netherlands, activists can have a court decide on a contentious issue they have with the board;⁷⁹ and in Italy, activists can steer the appointment of a minority representative to the board.⁸⁰ As a result, dominant shareholders cannot ignore the activists' demands, especially if they do not control the majority of the votes. Although, differently from the management of a freestanding company, controlling shareholders cannot easily be ousted, they have still much to lose, including their reputation and the value of their large stakes. Aggressive activism could undermine both.

As the foregoing discussion reveals, a great deal of entrepreneurial activism is based on the credible threat of engagement.⁸¹ This creates a fundamental problem for the empirical analysis. Whether activism is desirable or not *across the board* cannot be inferred from the performance of observable activism. The problem is twofold. For one, we only observe a portion of the true activism, the public part. This would not be a problem if the distribution between public and private activism were random, but it is not.

⁷⁵ This point applies in general to activism by all institutional investors. See survey evidence by McCahery (2015).

⁷⁶ Buchanan et al (2012).

⁷⁷ Becht et al_Hermes (2010). UK shareholders can replace directors at any time. Therefore, activists can be so powerful that they do not even need to flex the muscles to make a credible threat.

⁷⁸ SNS book (2015).

⁷⁹ Cite to NL.

⁸⁰ Belcredi & Enriques (2015).

⁸¹ Becht et al_Handbook (2015).

Activists go public when it is in their interest to do so. As mentioned, keeping the engagement confidential is in the interest of both contestants. The management and particularly the controlling shareholders have less to lose from non-public concessions to the activists, while the latter can make larger profits from those. However, activists may have to make their campaign public precisely when the targeted is more mismanaged, which overestimates the observable returns from engagement.

The second part of the problem is that companies that are or can be targeted by activists differ in several respects from those that are not and cannot be targeted.⁸² Consequently, showing that companies successfully engaged outperform a market index, on average, does not really prove that activism improves performance.⁸³ It only shows that target companies were undervalued relative to a market benchmark and that activism brings performance back in line with that benchmark. These studies cannot rule out the possibility that a target company would outperform the benchmark by a larger extent, if not engaged, because this counterfactual company does not exist and, if it existed, it would be a different firm.

From this perspective, the crucial conflict underlying shareholder activism is between two views of the target firm, one by the activists and another by the incumbent management. I will return to this conflict shortly. Because the empirical evidence cannot tell us conclusively which of the two views should prevail, we need to turn to theory for a cost-benefit analysis of hedge funds activism.

3. Hirschman and the Trade-Off between Entrepreneurship and Market Feedback

In his classic, *Exit, Voice and Loyalty*, Albert Hirschman was concerned with how organizations recover from temporary lapses in their efficiency – what he called *recuperation* problem. As revealed by the subtitle of this oft-cited book, Hirschman’s problem was how to avert organizations’ decline.⁸⁴ Focusing on the listed companies discussed in this article, Hirschman’s problem corresponds with the motivation of

⁸² Mention matching and why it’s not enough.

⁸³ Cite to Atanasov & Black (2014) on the general counterfactual problem.

⁸⁴ Full cite to Hirschman (1970) including subtitle.

shareholder activism – restoring the target firm’s efficiency. Therefore, Hirschman’s framework can shed light on the conditions that make shareholder activism desirable.

Hirschman distinguished between two feedback mechanisms in organizations. Disgruntled members and customers can *exit* their organization or they can *voice* their disagreement. The relative desirability of exit and voice depends on whether they can alert the organization’s management about the need for recuperation. Business firms are normally more sensitive to exit (e.g. of customers), whereas governments respond more to voice (e.g. of citizens).

One of Hirschman’s points is that each kind of organization would benefit from the feedback mechanism to which it is normally less sensitive. This is because every organization has an optimal level of exposure to exit and voice, which varies with time. For instance, at some point of their lifecycle, business organizations may suffer from excessive exit, particularly in highly competitive contexts that give companies not enough time to realize decline from the exit of customers and shareholders.⁸⁵ In those situations, decline may be averted timely if the management listens to voice. Voice, on the other hand, can be excessive too, particularly when exit is costly or impossible. Here managers’ concern with voice by ‘captive’ customers, members, or voters may distract them from the pursuit of efficiency particularly when uncertainty about the outlook of business is high (as opposed to protest being present and concrete).⁸⁶ Hirschman did not believe that the recuperation problem warranted a one-size-fits-all solution.

Another important point made by Hirschman is that economic theory often neglects voice as a recuperation mechanism.⁸⁷ Exit has traditionally received much more emphasis in the corporate governance literature. In a seminal article, professor Manne famously argued that takeovers, which are based on exit, are superior to proxy fights, which are based on voice.⁸⁸ The underling reasoning goes back to Adam Smith’s invisible hand.⁸⁹ While markets, including the market for corporate control, are powerful coordination mechanisms, voting is plagued by free riding problems. To be sure, free riding affects takeovers too,⁹⁰ but more important, decades of experience with takeovers have revealed

⁸⁵ Id. at 24-25.

⁸⁶ Id. at 70.

⁸⁷ Id. at 19.

⁸⁸ Manne (1965).

⁸⁹ Smith (1776).

⁹⁰ Grossman & Hart (1980).

that they are too expensive to guarantee recuperation from temporary lapses in efficiency.⁹¹ Takeovers seem to be able to address only severe underperformance. The power of takeover threat to discipline management may be likewise overstated, particularly considering that management will always achieve some degree of insulation from hostile takeovers.⁹² Hirschman's intuition that business corporations would benefit from more sensitiveness to voice was therefore correct. Hirschman, however, was not hopeful to see more voice from investors, who as individuals had rationally a strong preference for the Wall Street Walk.⁹³ To be able to avert decline timely, the management of business corporations should have paid more attention to customers' feedback.

Hirschman did not consider shareholder activism a suitable mechanism for recuperation because he wrote before the reconcentration of ownership by institutional investors, which eventually made entrepreneurial activism possible. Entering hedge funds into Hirschman's framework produces interesting results. Hedge funds are obviously an expression of voice as they lead a campaign to change a company's management style or strategy. Their incentives, though, are based on exit, namely on the purchase from previous shareholders and the sale to future shareholders. As Gilson and Gordon put it, hedge funds are "governance entrepreneurs" who profit from purchasing rights undervalued by "rationally reticent" institutional investors.⁹⁴ But institutional investors still vote their shares in an activist's campaign. Because the success of activism depends on the support by institutional investors, what makes a difference as feedback to the incumbent management is the voice of institutional investors. When can such voice be trusted to provide efficient – that is, value increasing – feedback? To answer this question, we need to dwell into the incentives of institutional investors to screen and decide on hedge funds' proposals.

According to Hirschman, the undermining of voice depends on the availability of exit options. That is, voice works at its best when it is costly to exit.⁹⁵ Because institutional investors differ considerably from one another, this principle still tells us nothing about whether, in general, they have the right incentives to decide between two conflicting strategies. But now we can distinguish institutional investors based on their propensity to

⁹¹ Bolton et al (2007).

⁹² Talley_Perils (2003).

⁹³ Hirschman (1970: 46).

⁹⁴ Gilson & Gordon (2013). See also supra text accompanying notes_____.

⁹⁵ Hirschman (1970: 80).

exit. One long-standing distinction of this kind is the classification by professor Bushee. Bushee divided institutional investors based on portfolio turnover and the size of their stakes in portfolio companies.⁹⁶ Investors are transient when their turnover is high and the stakes are small. Dedicated investors are the opposite. As they focus on specific companies, their stakes are relatively large – although they are still diversified – and they trade relatively infrequently. Quasi-indexers are well exemplified by funds that track market indices, although they include more than strictly indexed funds. Because they mimic the indices they are tracking, such funds trade infrequently and have small stakes in portfolio companies. For the period 1983-2002, Bushee reports that transient investor accounted for 31 percent of U.S. institutional investors whereas dedicated investors and quasi-indexers amounted respectively to 8 and 61 percent.⁹⁷

Although the above percentages are not asset-weighted and thus do not reflect the ownership of a typical U.S. corporation, they show the importance of transient investors. These are the investors least committed to voice. Transient investors are ready to exit and cash in the announcement gains from engagement. If a company were owned primarily by them, hedge funds could easily have their way with management through a wolf pack strategy.⁹⁸ Even prior to the advent of entrepreneurial activism, disproportionate ownership by transient investors was associated with short-termist managerial behaviour.

Nevertheless, not all companies are owned primarily by transient investors. Other investors may be more ‘loyal’, that is, in Hirschman’s terms, more committed to voice by the high cost of exit. In this sense, dedicated investors may be not as loyal as their definition suggests. Exit is costlier for dedicated than for transient investors as the former cannot profit from short-term price movements, but this is not enough to commit dedicated investors to voice because they are still better off exiting the companies they are dissatisfied with. Dedicated investors use their informational advantage to threaten managers with exit and execute the threat when they are persuaded that the company is actually underperforming. So they do screen hedge funds activism, but if they agree with it, they will rather sell than vote their shares.⁹⁹ That leaves us with just one category of loyal institutional investors according to Hirschman’s framework. These are the quasi-

⁹⁶ Bushee (1998).

⁹⁷ Bushee (2004).

⁹⁸ See supra text to notes_____.

⁹⁹ Recent theory, field data, and survey evidence, all confirm that dedicated investors participate in corporate governance through exit. Edmans (2014), Edmans & Manso (2011), McChaery et al (2015).

indexers, which cannot exit strategically, but only to rebalance their index-tracking portfolios. Fortunately, they are also the largest category of investors. The whole question about the desirability of hedge funds activism could be resolved in the affirmative if one could trust quasi-indexers to always determine, with their voting, whether hedge funds are right or wrong.

Part of the answer depends on whether the aggregate stake of quasi-indexers is sufficiently large for them to decide who wins. Although I am not aware of any study providing this information, let us assume that this is the case for the typical target company. As suggested by the recent DuPont case, where indexed investors such as Blackrock, Vanguard and State Street made the engagement fail, this assumption is at least plausible, and most importantly allows us to focus on the most important issue: Can indexed fund be trusted to make the right choice?

What constitutes right choice in terms of profit maximization is notoriously difficult to say. Stock markets are an impressive source of information in this respect, but alas, they imperfect¹⁰⁰ – they overreact to news, misprice risks, and are prone to asset bubbles.¹⁰¹ As a result, stock market prices may temporarily fail to incorporate the value of profit opportunities. Such failure may stem from underestimation as from overestimation of the future.¹⁰² The relevant issue for corporate governance is whether short-term mispricing has an impact on managerial choices.¹⁰³ Because the hedge funds business model relies on stock price differentials, they are suspected of acting based on the market sentiment. If indexed funds were likewise guided by the stock market, one could not trust their judgment to screen hedge funds activism. Conversely, if indexed investors looked beyond stock market prices to make their decisions, they could stop activism precisely when it is more likely to result in short-term choices that destroy long-term firm value. Therefore, the previous question can be rephrased: Can the judgment by quasi-indexers be trusted to be superior to the stock market sentiment?

In a sense, the answer to this question is a trivial yes. As shown by the empirical evidence reviewed in the previous section, the short-term gains of successful hedge funds

¹⁰⁰ Note limited informational efficiency of markets. Gilson & Kraakman (1984), Grossman & Stiglitz (1980).

¹⁰¹ Note on limits of arbitrage (Shleifer & Vishny 1997), excess volatility (Fuster et al 2011), bubbles (Bolton et al 2006).

¹⁰² See Dallas & Barry (2015) citing Bebchuk & Stole (1993).

¹⁰³ Roe (2003).

activism are not subsequently reversed, whereas there are no gains from unsuccessful engagements. That is to say, the screening by quasi-indexers works. But in another sense, namely whether the sheer threat of activism induces short-termism in management and whether this is desirable, the question can be answered neither empirically nor in theory.

For one, there is no straightforward way to define long term. Other than being in the eye of the beholder, long term is only defined by what it is not: the market price. Secondly, even if one could settle on a conventional definition, companies oriented to the short term would be radically different from those oriented to the long term. Comparing their returns for horizons different from what they have chosen is not very meaningful. Thirdly, whether managing for the long term (whatever that means) or the short term is preferable is theoretically unclear. Professor Fried has shown that, under certain conditions, pursuing the interest of long-term shareholders can lead management to destroy more value than if they managed in the interest of short-term shareholders.¹⁰⁴ The crucial point is that, assuming that the company's objective function can be predetermined, management will react to it and whether the reaction is efficient will depend on company-specific circumstances.¹⁰⁵

Hence, the discussion whether activism should be for the short term or the long term leads us nowhere. The problem is another one, namely, which of two conflicting, potentially entrepreneurial views of the target company should prevail – the view of the activists or the one of the incumbent management? Such views are entrepreneurial in that they reflect a shortcoming of stock price: the latter cannot fully account for the future because it is uncertain.¹⁰⁶ Uncertainty is for entrepreneurs, not for markets to bear.¹⁰⁷ From this perspective, conditional on hedge fund engagement, quasi-indexers are decisive between two entrepreneurial views on how the target company should move forward. Whether they are the right arbiters for this choice depends on context.

One strategic issue on which the views of activists and incumbent management often collide is quality and quantity of R&D expenses. Activist hedge funds typically want the companies to be leaner and more focused on developing specific products, which

¹⁰⁴ Fried (2014).

¹⁰⁵ Id. at ___ on transacting U.S. companies. Explain that assumption is incorrect, though – choice of objective function endogenous to the management's view of the company.

¹⁰⁶ Keynes (1936) Chapter 12.

¹⁰⁷ See Knight (1921).

usually results in cuts of R&D and personnel expenditures.¹⁰⁸ Here it is important to note that an overall reduction of R&D expenditures does not necessarily imply that the company is less innovative.¹⁰⁹ A recent study shows that activism can improve productivity and R&D output on several counts.¹¹⁰ Still, granted that activism tend to reduce R&D input, this may be not the right choice for a number of companies. Another theoretical study, unrelated to activism, reveals that different kinds of innovation benefit from different organizational forms.¹¹¹ In particular, complex innovations with long lifecycles benefit from conglomerate structures in which resources can be redirected internally from a project to another. These are precisely the structures that activists seek to break up.

Whether indexed funds are likely to stop hedge funds when saving on R&D expenditures appears to be the wrong strategy is unclear. The empirical evidence suggests that, although institutional investors support R&D investments on average, this support does not stem from quasi-indexers.¹¹² This aligns with theory. Quasi-indexers are highly diversified investors that do not benefit from firm-specific screening. Because their income depends on absolute as well relative performance,¹¹³ they vote for policies that the market appreciates overall, including good corporate governance or just good practice in a particular industry, and decide whether to support hedge funds based on these criteria. Whether the target company should engage in linear or non-linear innovation is a much more idiosyncratic question that quasi-indexers are not interested in answering.

Relying on the judgment by quasi-indexers is undoubtedly efficient in other situations. Not all instances of stock market underperformance that trigger hedge funds activism, and institutional investors' voting on it, depend on strategic choices. Often the matter is much simpler, namely whether the controlling management is wasting resources. There the advantage of quasi-indexers' voting in a standardized, predictable fashion is that they can commit the company's management to certain behaviours towards investors. This commitment is valuable, because it makes investors more willing to invest in the first

¹⁰⁸ See Coffee & Palia (2014:___).

¹⁰⁹ Bebchuk et al (2015).

¹¹⁰ Brav et al (2014).

¹¹¹ Belenzon Bolton Tsolmon (2013).

¹¹² See Aghion et al (AER 2013). Emphasize the causality in research design (index composition). Another study reports statistically insignificant impact of quasi-indexers on R&D (Appel et al 2015), although according to a different study the presence of long-term indexers reduces R&D expenditures (Harford et al 2015).

¹¹³ Appel et al (2015:___)

place. Facing the threat of hedge funds teaming up with institutional investors, managers have to be more careful about misusing fee cash or being unresponsive to the competitive environment. In the absence of such ‘recuperation mechanism,’ as Hirschman put it, excessive consumption of perquisites, pet projects, if not empire building could dissipate enormous value until the company is bankrupt or is acquired. Hedge funds activism can stop this well before the decline becomes irrecoverable. Moreover, because entrepreneurial activism is a credible threat in all countries where declining companies can be engaged, even controlling shareholders may have to refrain from self-dealing for fear of engagement by hedge funds. When hedge funds base their campaign on outright misbehaviour by managers or controlling shareholders, they seldom fail to achieve outcomes.¹¹⁴

The commitment towards outside investors, supported by hedge funds activism and the threat thereof, risks becoming excessive when the reason for activists’ targeting a company is disagreement about the company’s strategy. In such a situation, the strategy proposed by hedge funds in opposition to the incumbent management is particularly difficult to evaluate. Moreover, the judgement of ‘vocal’ investors such as indexed funds cannot be relied upon because the question is not simply whether existing resources are being managed efficiently, but rather how resources should be directed towards an uncertain future. This is an entrepreneurship question that indexed funds, with their typically small stakes in a particular company, do not have the expertise and the incentives to answer. In this respect, indexed funds crucially differ from venture capitalists, which specialize in dealing with entrepreneurship questions.¹¹⁵

As professor Mayer recently put it, there is a trade-off between commitment and control in corporate governance and we should let individual companies decide which mix suits their circumstances best.¹¹⁶ In his framework, control can be understood as commitment to one particular constituency, namely commitment to the shareholders’ voice. Therefore, another way to put the trade-off is whether the company should commit to the market feedback engineered by entrepreneurial activists or to something else, for instance insiders’ entrepreneurship.¹¹⁷ In general, the company may benefit from

¹¹⁴ Need a reference here.

¹¹⁵ Cite to venture capital/PE literature emphasizing the contribution of entrepreneurs to the screening of projects.

¹¹⁶ Mayer (2013: 234-236).

¹¹⁷ In the past, I have framed this as a trade-off between (entrepreneurial) discretion and (market) accountability. See Paces (2012).

commitment to stakeholders other than the shareholders, including among others employees, creditors, and entrepreneurs.¹¹⁸

I will argue that the dilemma about activism is only whether a company should commit to inside or outside entrepreneurship. In the corporate governance literature, the typical argument against the inclusion of stakeholders in the company's objective function is twofold.¹¹⁹ First, differently from shareholders, stakeholders can protect themselves through contracts. Second, the externalities of a business on stakeholders do not depend on corporate governance and therefore should not be addressed by corporate governance regulation. As I have argued elsewhere, none of these arguments applies to entrepreneurship.¹²⁰ Entrepreneurs cannot effectively protect their investment by contract. Moreover, lack of entrepreneurship in listed companies is a direct consequence (negative externality) of corporate governance. On this basis, in the next section, I am going to discuss how corporate law can support entrepreneurship by allowing companies to choose the desired degree to exposure to activism and to alter it over time.

4. Evaluating the Policy Options

The policy debate on shareholder activism is not informed by Hirschman's framework. Although Hirschman explicitly recognized the possibility of negative returns to voice,¹²¹ he could not imagine that corporate governance could ever suffer from this given the preponderance of dispersed individual owners who had no rational alternative to exit. With the reconcentration of ownership in the hands of institutional investors, this situation has changed. Stimulated by entrepreneurial activism, voice has become an important mechanism for recuperation of listed companies from temporary inefficiency. Loyal shareholders, notably including quasi-indexers, can and do screen for value-increasing activism. However, there is no guarantee that their choice will maximize the company's value. Regardless of their loyalty, institutional investors are not well positioned to decide between conflicting entrepreneurships. Because actual and potential hedge funds activism still calls upon institutional investors' voice in such situations, their voice may be

¹¹⁸ Mayer (2013: 152-153).

¹¹⁹ Retrieve references from Paces (2012).

¹²⁰ Paces (2012: ____).

¹²¹ Hirschman (1970: 31).

excessive and curb, instead of stimulating, entrepreneurship. Hirschman's argument that some exit/voice mixes do not suit certain organizations applies here in full force.

The worries about shareholder activism are framed differently. Prompted by the standard narrative about the global financial crisis, policymakers hold hedge funds responsible for short termism in corporate governance.¹²² Ideally, policymakers would like to replace their influence with the engagement of more 'loyal' shareholders. Academics sympathetic to the short-termism argument are more cautious.¹²³ While they argue that companies under the influence, or threat, of hedge funds activism cater to the short termism of the stock market, they recognize that a great deal of companies benefit from short-term market pressure. However, other companies suffer from it and they should be able to effectively opt out of hedge funds influence. Other academics disagree with this point, claiming that short termism is not a problem for anyone but the incumbent managers who seek insulation from activism – as they've done with takeovers – in order to escape accountability to the shareholders.¹²⁴ Having argued that the short-termism debate cannot shed light on the limitations of shareholder activism, I will analyse the main policy proposals to curb activists' powers from the perspective of conflict of entrepreneurship.

The first set of proposals concern the disclosure of activists' ownership.¹²⁵ In the U.S., activists have to disclose their intentions along with the ownership,¹²⁶ but this is not the crucial point. The key policy variables are: a) the threshold above which ownership needs be disclosed; b) the time window available to activists since the crossing of the threshold; c) the regulatory treatment of groups of activists. Activists' business model relies on the purchase of substantial undervalued stock – a so-called 'toehold' – before the campaign becomes public, so the obvious way to undermine activism and its influence is to reduce the size of the toehold through the above three variables.¹²⁷ In the extreme, if a block larger than, say, 0.5 percent had to be disclosed within an hour of crossing the threshold by any group of shareholders intending to vote against the management, hedge fund activism would likely disappear. Proposals along these lines, albeit less extreme, have

¹²² See most recently "Amendments adopted by the European Parliament on 8 July 2015 on the proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement." European Parliament 2014-2019, P8_TA-PROV(2015)0257.

¹²³ See Bolton & Samama (2013); Mayer (2013).

¹²⁴ See most vigorously Bebchuk et al (2015).

¹²⁵ See supra note 13.

¹²⁶ Note on Schedule 13D.

¹²⁷ See Enriques, Gargantini, Novembre (2010) for a similar argument applied to takeovers.

been aired in the American debate but, partly due to wide opposition by authoritative academics, the SEC is no longer considering changing the status quo.¹²⁸ A 5 percent threshold, a 10-day window do disclose it, and the irrelevance of conscious parallelism in voting still make the U.S. legal environment one of the most favourable to shareholder activism worldwide. The restrictions are much more demanding in the UK (3 percent threshold and 2-day window), and still quite so in the most important jurisdictions of Continental Europe (5 percent threshold and 4-5-day window).¹²⁹ In Europe, however, the discussion about tightening ownership disclosure is still ongoing, with a proposal recently made within the European Parliament to mandate disclosure above 0.5 percent.¹³⁰

If we look at shareholder activism through the lens of conflict of entrepreneurship, obviously this conflict cannot be resolved by curbing one of the opposing entrepreneurial activity, namely hedge funds activism. This approach would be economically justified only if hedge funds activism was on average detrimental of shareholder value, whether because of short termism or otherwise. As shown in Section 2, this claim is not borne out by the empirical evidence, which actually suggests the opposite. Still, activists' power might be excessive as a threat if they were very unlikely to lose. This argument, based on the very high success rate of wolf packs, could justify curbing activism particularly when it is performed 'in concert.' As put by professor Coffee, wolf packs are a nearly riskless strategy, which leads to over-engagement of target companies and an excessive threat of activism.¹³¹ Albeit impossible to falsify empirically, this claim seems overstated.¹³² Wolf packs remain a risky strategy that does not lead to short termism, at least in the only sense in which short termism can be rejected empirically. Moreover, from a conflict of entrepreneurship perspective, mandatory rules to curb the power of wolf packs, such as the inclusion of the group members in the leading activist's disclosure, are unwarranted. Companies that want to discourage activism, whether individual or in concert, have plenty of ways to do so. Countermeasures range from low-trigger poison pills (in the U.S.),¹³³ to functionally equivalent dilutive techniques in those jurisdictions where they are allowed (e.g. the Netherlands),¹³⁴ to dual-class shares, which in a way or another can be engineered

¹²⁸ See Coffee & Palia (2014).

¹²⁹ Add legal details on Italy, Germany, etc. Cite to Gilson & Gordon (2013).

¹³⁰ See Cofferati Report (2015), but proposal not included in European Parliament 2014-2019, P8_TA-PROV(2015)0257.

¹³¹ Coffee & Palia (2014).

¹³² See *supra*.

¹³³ Explain based on Sotheby's case.

¹³⁴ Elaborate on Dutch preference shares.

nearly everywhere.¹³⁵ Importantly, activism is observed also in the presence of these countermeasures.¹³⁶

This leads me to the key part of the argument. Hedge funds activism should be evaluated in the specific context in which it operates. From this perspective, a second set of proposals to deal with activism is more interesting, namely rewarding shareholders who have been invested in the company for some time with a higher voting power.¹³⁷ Perhaps the best-known implementation of this idea are the so-called ‘loyalty shares.’¹³⁸ Although the popularity of loyalty shares is accidental – and so is their assonance with Hirschman’s framework – what makes them interesting for this article is that, by choosing whether to have them, companies can optimize exposure to activism. This is much in the spirit of Hirschman’s argument that voice can be excessive for a particular organization. As it turns out, the requirement of loyalty is the least important part of this mechanism to curb activism’s influence, although it has undoubtedly contributed to make it politically palatable.

Loyalty shares are a French invention. While prohibiting multiple voting shares, French law allowed companies to grant one additional vote to shareholders that had held shares continuously for two years. This was optional for every French company until, in 2014, the *Loi Florange* made loyalty shares the default regime for listed company. This move has virtually imposed loyalty shares on existing listed companies. Companies that did not have loyalty shares in place automatically got them, unless they opted out of the default rule. However, opting out of loyalty shares requires an amendment of the articles of association, which in France is governed by a two-third majority and hence can be vetoed by only one-third of the votes. Therefore, dominant shareholders could push loyalty shares despite the opposition of institutional investors, as the French government did recently in the Renault case.¹³⁹ Curiously, it was the reincorporation of another automotive company, Fiat-Chrysler Automobiles (FCA), to increase the popularity of loyalty shares in Europe.¹⁴⁰ FCA used the flexibility of Dutch law to engineer loyalty shares immediately doubling the votes of existing shareholders while giving all the others an extra vote

¹³⁵ Explain corporate mobility story (FCA case, but flag new restrictions in the UK listing rules).

¹³⁶ Note on activism in concentrated ownership structures, both U.S. and Europe.

¹³⁷ Or some other sort of benefits – qualify variants.

¹³⁸ See Delvoie & Clottens (2015).

¹³⁹ Cite to news.

¹⁴⁰ Mention CNH 2013 preceding FCA 2014.

conditional on a three-year holding period.¹⁴¹ With the apparent goal to respond to the departure of Italy's largest family-owned corporation,¹⁴² Italian law was amended and now allows listed companies to opt into French-style loyalty shares with a two-third majority. However, Italy allowed companies to amend their articles with a simple majority for a transition period, whose prolongation was stopped by the opposition of institutional investors and several academics, including the author of this article.¹⁴³

Loyalty shares are appealing because apparently, they empower all shareholders equally on a dimension other than the *size* of their investment, namely the *time* of their investment. From this perspective, loyalty shares rebalance shareholder powers from activists to long-term investors, who are supposed to care more about companies in the long run. On the assumption that short-termism is always detrimental for a company, policymakers such as the European Parliament have been fighting for the introduction of loyalty shares across the European Union.¹⁴⁴ Similarly, academics have argued that allowing companies to opt into loyalty shares or other time-varying voting system would cope with short termism precisely when it is detrimental. Surprisingly, however, institutional investors – including owners that would qualify for the loyalty benefits – almost invariably oppose the introduction of loyalty shares.

Loyalty shares are not as good as they look and they look different from what they are. To start from their flaws, loyalty shares do not really commit to anything, let alone to long-term strategies. Having held shares for two years says nothing about for how much longer investors will hold them, although this is crucial for their voting strategy. To cope with this problem, professor Mayer proposed to allow companies to give voting rights proportional to a residual holding period to which investors commit.¹⁴⁵ This proposal, however, is legally complicated to implement and would still have the following shortcomings. The second problem of loyalty share is that they restrict takeovers by conferring a voting advantage upon the loyalists who do not tender their shares. Professors Bolton and Samama have suggested making any loyalty benefits expire in the event of an acquisition, which would cope with the problem, but make loyalty shares much less

¹⁴¹ Note on the engineering (doubling the shares, not the votes). Flag the variety of techniques mushrooming in the NL right now.

¹⁴² Note the interest of the Italian Ministry of Finance to keep the majority of voting rights in state-controlled public companies.

¹⁴³ Add references to this paragraph.

¹⁴⁴ Hopt (2015).

¹⁴⁵ Mayer (2013).

attractive.¹⁴⁶ Thirdly, the link between voting rights and holding periods, whether past or future, can be circumvented.¹⁴⁷ An intermediary company could qualify for the loyalty benefits by locking in ownership, but defer to its beneficial owners for how to vote the loyalty shares – and these owners could be transient investors. Such arbitrage can be so profitable,¹⁴⁸ particularly in times of stock market bubbles, that it is difficult to imagine low-cost solutions that could cope with it.

Loyalty shares look different from dual-class shares because formally, they allocate superior voting rights to any investor that fulfils the holding period requirements attached to them. Hence, they look like a remedy against short-termism, not an entrenchment device for managers or controlling shareholders.¹⁴⁹ But this is illusory. In reality, loyalty shares are attractive precisely when they operate as dual-class shares. Institutional investors who are entitled to the loyalty benefit will give it up whenever exit is more convenient; and they would not accept committing to loyalty if that cost them the exit option. On the contrary, the management or the dominant shareholder can use loyalty shares to fend off hostile takeovers and have more bargaining power vis a vis the activists. This makes sense from a perspective of conflict of entrepreneurship. Companies that want to commit to the incumbents' as opposed to the activists' entrepreneurship will go for loyalty shares. Because this strategy undermines the impact of institutional investors' voice, as activated by hedge funds, it is no longer surprising that also long-term investors oppose loyalty shares. What is unclear at this point is why the incumbent management should go for loyalty shares instead of classic dual-class shares structures.

The short answer is that managers and controlling shareholders who want to reduce the impact of activists have nowadays no better option than loyalty shares. A founder concerned with the adverse impact of activism on certain styles of innovation could simply go public with dual-class shares, which companies increasingly do.¹⁵⁰ The matter is much more complicated in the midstream. An already listed company may likewise need to engage in explorative, non-linear innovations to meet the challenges of the product market. However, there is no way such a listed company can introduce dual-class shares to that purpose. Dual-class recapitalizations that exchange existing shares for two classes of

¹⁴⁶ Bolton & Samama (2013).

¹⁴⁷ Elaborate on disclosure of beneficial ownership and its enforcement (Luca).

¹⁴⁸ Discuss why Mayer's argument (2013:266-267) does not work.

¹⁴⁹ Dallas & Barry (2015) – arguing that loyalty shares are intermediate between dual class shares and 1S1V

¹⁵⁰ Retrieve data from Enriques Gilson Paces (2014). And, outside the US, companies can choose to incorporate in a jurisdiction that allows them.

shares, one with higher voting rights for the controlling group and one with lower voting rights for the investors, are not allowed either in Europe or in the U.S.¹⁵¹ However, at least in some European countries, loyalty shares are a way out of this bind. Because formally they do not discriminate among shareholders, companies can issue them in the midstream. Noticeably, the few examples of loyalty shares that are observed in the U.S. were introduced exactly with the same purpose, in the short period of time when it was unclear whether dual class recapitalizations were allowed.¹⁵²

Because, as revealed by the French experience, loyalty shares used for recapitalization purposes have often unintended consequences, it would be better to allow such recapitalizations explicitly and regulate them in such a way as to avoid misuse by incumbent managers and controlling shareholders. The potential for misuse is significantly reduced if investors have veto power on the transaction. In the past, commentators were concerned that investors could be coerced into voting for recapitalizations because of their inability to coordinate.¹⁵³ The reconcentration of ownership has made such worries much less compelling. Therefore, dual-class recaps could be allowed subject to a majority-of-minority (MOM) vote. This solution would screen for the situations in which dual-class shares are the efficient response to shareholder activism from the perspective of conflict of entrepreneurship. Managers and controlling shareholders are naturally inclined to curb shareholder powers particularly in the midstream, when investors cannot collectively withdraw equity. However, subjecting dual class recapitalization to a MOM vote would require the proponent to signal that the restriction is valueincreasing and, in particular, is not aimed at empire building or otherwise taking advantage of minority shareholders.

The one-share-one-vote regime (1S1V) should then become a ‘sticky default,’ as professor Ayres has put it.¹⁵⁴ A sticky default is defined by the rules governing its alteration. By design, such default is expensive to alter for the average person or company. The purpose of such quasi-mandatory rules is to enable opt-out *only* by those parties for which the default rule would be inefficient, for not opting out of it leaves, so to say, money on the table. The controllers of existing companies who want to commit to an entrepreneurial project that could take too long for the market to appreciate – and could be

¹⁵¹ Cite to US and to EU (Ferrarini 2006).

¹⁵² Dallas & Barry (2015: ____). Explain that today, in the US, also loyalty shares cannot be issued in the midstream.

¹⁵³ See Gilson (1987) for a critical discussion of the argument.

¹⁵⁴ Ayres (2013: 2032, 2084-88) on “Impeding altering rules”

struck down by activists meanwhile – will benefit from persuading institutional investors to enter into a dual-class recapitalization. Because institutional investors will typically have a policy against dual-class shares, a (prospective) controlling shareholder will have to offer some credible commitment to have it the control enhancement passed. A right often valued by minority shareholders, especially in concentrated ownership systems, is board representation. This is not a price that controllers who merely aim at expropriating investors will be willing to pay, because investors’ representatives can effectively stop self-dealing and, particularly if activists take over the board seats, make empire-building hard to pursue. Conversely, minority board representation is a credible signal for controllers who want to commit to a specific entrepreneurial project while reassuring non-controlling shareholders that they will not be taken advantage of. On the other hand, investors’ commitment to insiders’ entrepreneurship could be time-bound. Dual class shares could be set to expire in a time horizon agreed upon, in which the goals of the project are realized or clearly become unattainable.¹⁵⁵

In this perspective, the combination of a 1S1V default with a MOM rule for altering it would achieve one feature that loyalty shares have only in theory: The temporary character of control enhancement.¹⁵⁶ Because the loyalty premium depends on a given holding period, eventually there should be no disproportionality between ownership and voting rights among loyal shareholders. In practice, this never leads to the elimination of control enhancement because, as explained, institutional investors cannot commit to the same loyalty as controlling shareholders. However, having to negotiate with institutional investors the conditions for introducing disproportional voting rights, controlling shareholders may have to commit to sunseting such disproportionality. As the recent U.S. experience with regard to the poison pill suggests, institutional investors can be talked into accepting control enhancements, but only for a limited period.¹⁵⁷ If, within that period, the entrepreneurial project had succeeded, both controlling and non-controlling shareholders would have made their profits and the dual-class structure could be collapsed. If, instead, the project had failed, the expiration of the dual-class structure would make it easier to reallocate control of the company’s assets, with or without the intervention of entrepreneurial activists. The likely need for controllers to offer investors a sunset

¹⁵⁵ On the theoretical advantages of such sunset clauses, see Bebchuk (2003). For an application to the takeover context, see Enriques Gilson Paces (2014: 126).

¹⁵⁶ Noted by Dallas & Barry (2015: ____).

¹⁵⁷ Gilson and Gordon (2013) on Interco pill.

arrangement to enable a dual-class recap overcomes one major disadvantage of dual-class shares (and entrenched control structures in general): Once they are in place, it is difficult to remove them when they become inefficient. Therefore, the sticky default approach proposed here supports not only the selection of voice restrictions by the companies for which this is efficient ex-ante, but also the removal of the restrictions when they become inefficient ex-post.

5. Conclusion

In this essay, I have discussed the policy responses to hedge funds activism in corporate governance. The analysis has been based on Hirschman's classic, *Exit, Voice and Loyalty*. Although Hirschman wrote before the reconcentration of ownership in the hands of institutional investors, which nurtured entrepreneurial activism by hedge funds, his framework can be adapted to the new situation. In particular, contrary to the received wisdom, hedge funds do not pose problems of loyalty because the arbiters of their activism are typically quasi-indexers, which cannot exit strategically. What we can still learn from Hirschman, though, is that voice can be excessive for a particular company.

From this perspective, I have discussed hedge funds activism both empirically and in theory. This analysis reveals that, while the claim that the gains from hedge funds activism are short lived is not borne out by the empirical evidence, the latter can tell us neither whether the existence of hedge funds activism leads to short-termism in corporate governance nor whether this is efficient across the board. The real issue with activism is a conflict of entrepreneurship, namely between two views about what the target company should become in the future – the view of the activist as opposed to the view of the incumbent management. Leaving the choice between these views to institutional investors is not efficient for every company at every point in time.

In order to cope with this problem, this article has argued that regulation should refrain from curbing the power of activists. Rather, regulation should enable individual companies to limit the impact of activism when this is efficient for them. Reviewing the recent European experience with loyalty shares, this article contends that they operate as dual-class shares in disguise, sometimes allowing their midstream introduction without the approval by institutional investors. It is preferable for efficiency to allow dual-class recapitalizations explicitly, subject to a majority of minority vote conferring an effective

veto power upon institutional investors. This ‘sticky default’ solution would screen the companies for which limiting the influence of activists is efficient, and induce these companies to negotiate time-bound restrictions with institutional investors.

References

- Aghion, Philippe, John Van Reenen, and Luigi Zingales (2013). "Innovation and Institutional Ownership." *The American Economic Review* 103, no. 1, 277-304.
- Angrist, Joshua D., and Jörn-Steffen Pischke (2008). *Mostly harmless econometrics: An empiricist's companion*. Princeton University Press.
- Appel, Ian and Gormley, Todd A. and Keim, Donald B. (2015). "Passive Investors, Not Passive Owners." (September 30, 2015). Available at SSRN: <http://ssrn.com/abstract=2475150>.
- Arlen, Jennifer, and Eric Talley (2003). "Unregulable defenses and the perils of shareholder choice." *University of Pennsylvania Law Review* __, no. __: 577-666.
- Atanasov, Vladimir A., and Bernard S. Black (2014). "Shock-based causal inference in corporate finance research." *ECGI-Finance Working Paper No 448*. Available at SSRN: <http://ssrn.com/abstract=1718555>.
- Ayres, Ian (2011) "Regulating Opt-Out: An Economic Theory of Altering Rules." *Yale Law Journal* 121: 2032-2116.
- Bebchuk, Lucian A. (2003). "Why Firms Adopt Antitakeover Arrangements." *University of Pennsylvania Law Review* __, no. __: 713-753.
- Bebchuk, Lucian A. (2013). "The Myth that Insulating Boards Serves Long-Term Value." *Columbia Law Review* 113, no. 6: 1637-1694.
- Bebchuk, Lucian A., Alon Brav, and Wei Jiang (2015). "The long-term effects of hedge fund activism." *Columbia Law Review* 115, no. 5: 1085-1156.
- Bebchuk, Lucian A., and Lars A. Stole (1993). "Do Short-Term Objectives Lead to Under- or Overinvestment in Long-Term Projects?" *Journal of Finance* 48, no. 2: 719-729.
- Becht, Marco and Julian R. Franks, Jeremy Grant, and Hannes F. Wagner (2015). "The Returns to Hedge Fund Activism: An International Study" (March 2, 2015). *European Corporate Governance Institute (ECGI) - Finance Working Paper No. 402/2014*. Available at SSRN: <http://ssrn.com/abstract=2376271>
- Becht, Marco, Julian Franks, and Jeremy Grant (2015). "Hedge fund activism in Europe: does privacy matter?" in Jennifer G. Hill and Randall S. Thomas (eds.), *Research Handbook on Shareholder Power*. Cheltenham: Edward Elgar: 116-127.
- Becht, Marco, Julian Franks, Colin Mayer, and Stefano Rossi (2010). "Returns to shareholder activism: Evidence from a clinical study of the Hermes UK Focus Fund." *Review of Financial Studies* 23, no. 3: 3093-3129.

- Becht, Marco, Patrick Bolton, and Ailsa Röell (2007). "Corporate law and governance." in A. Mitchell Polinsky and Steven Shavell (eds.), *Handbook of law and economics 2*. Amsterdam: Elsevier: 829-943.
- Belcredi, Massimo, and Luca Enriques (2015). "Institutional investor activism in a context of concentrated ownership and high private benefits of control: the case of Italy." In Jennifer G. Hill and Randall S. Thomas (eds.), *Research Handbook on Shareholder Power*. Cheltenham: Edward Elgar: 383-403.
- Belenzon, Sharon, Patrick Bolton and Ulya Tsolmon (2013). "The Organization of Innovation Across Countries and Industries." *Unpublished Working Paper, Duke University*.
- Bessler, Wolfgang, Wolfgang Drobetz, and Julian Holler (2015). "The returns to hedge fund activism in Germany." *European Financial Management* 21, no. 1: 106-147.
- Bolton, Patrick, and Frédéric Samama (2013). "Loyalty-Shares: Rewarding Long-term Investors." *Journal of Applied Corporate Finance* 25, no. 3: 86-97.
- Bolton, Patrick, Jose Scheinkman, and Wei Xiong (2006). "Executive compensation and short-termist behaviour in speculative markets." *The Review of Economic Studies* 73, no. 3: 577-610.
- Brav, Alon, Wei Jiang, and Xuan Tian (2014). "Shareholder power and corporate innovation: Evidence from hedge fund activism." *Kelley School of Business Research Paper* 2014-05. Available at SSRN: <http://ssrn.com/abstract=2409404>
- Brav, Alon, Wei Jiang, Frank Partnoy, and Randall S. Thomas (2008). "Hedge fund activism, corporate governance, and firm performance." *Journal of Finance* 63, no. 4: 1729-1775.
- Buchanan, Bonnie G., Jeffry M. Netter, Annette B. Poulsen, and Tina Yang (2012). "Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom." *American Business Law Journal* 49, no. 4: 739-803.
- Bushee, Brian J. (1998). "The influence of institutional investors on myopic R&D investment behavior." *Accounting review* ____, no. ____ : 305-333.
- Bushee, Brian J. (2001). "Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?" *Contemporary Accounting Research* 18, no. 2: 207-246.
- Bushee, Brian J. (2004). "Identifying and attracting the "right" investors: Evidence on the behavior of institutional investors." *Journal of Applied Corporate Finance* 16, no. 4: 28-35.
- Choi, Stephen J., Jill E. Fisch, and Marcel Kahan (2010). "The Power of Proxy Advisors: Myth or Reality?" *Emory Law Journal* 59: 869-918.
- Choi, Stephen, Jill Fisch, and Marcel Kahan (2013). "Who Calls the Shots: How Mutual Funds Vote on Director Elections." *Harvard Business Law Review* 3, no. ____: 35-81.
- Clifford, Christopher P (2008). "Value creation or destruction? Hedge funds as shareholder activists." *Journal of Corporate Finance* 14, no. 4: 323-336.
- Coates IV, John C. (2015). "Thirty years of evolution in the roles of institutional investors in corporate governance." In Jennifer G. Hill and Randall S. Thomas (eds.), *Research Handbook on Shareholder Power*. Cheltenham: Edward Elgar: 79-96.

- Coffee, John C. and Palia, Darius (2014), "The Impact of Hedge Fund Activism: Evidence and Implications" (September 15, 2014). *European Corporate Governance Institute (ECGI) - Law Working Paper No. 266/2014*. Available at SSRN: <http://ssrn.com/abstract=2496518>.
- Daines, Robert M., Ian D. Gow, and David F. Larcker (2010). "Rating the ratings: How good are commercial governance ratings?" *Journal of Financial Economics* 98, no. 3: 439-461.
- Dallas, Lynne, and Jordan M. Barry (2015). "Long-Term Shareholders and Time-Phased Voting." Forthcoming *Delaware Journal of Corporate Law (DJCL)*.
- De Jong, Abe, Ailsa Röell, and Gerarda Westerhuis (2010). "Changing national business systems: corporate governance and financing in the Netherlands, 1945–2005." *Business History Review* 84, no. 04: 773-798.
- De Jong, Abe, Gerard Mertens, and Peter Roosenboom (2006). "Shareholders' voting at general meetings: Evidence from the Netherlands." *Journal of Management & Governance* 10, no. 4: 353-380.
- Delvoie, Jeroen, and Carl Clottens (2015). "Accountability and short-termism: some notes on loyalty shares." *Law and Financial Markets Review* 9, no. 1: 19-28.
- Edmans, Alex, and Gustavo Manso (2011). "Governance through trading and intervention: A theory of multiple blockholders." *Review of Financial Studies* 24, no. 7: 2395-2428.
- Edmans, Alex. "Blockholders and Corporate Governance (2014)." *Annual Review of Financial Economics* 6, no. 1: 23-50.
- Emmerich, Adam O., Theodore N. Mirvis, Eric S. Robinson, and William Savitt (2013). "Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power." *Harvard Business Law Review* 3, no. ____: 135-156.
- Enriques, Luca, Matteo Gargantini, and Valerio Novembre (2010). "Mandatory and contract-based shareholding disclosure." *Uniform Law Review* 15: 713-742.
- Enriques, Luca, Ronald J. Gilson, and Alessio M. Paces (2014). "The Case for an Unbiased Takeover Law (with an Application to the European Union)." *Harvard Business Law Review* 4, no. 1, 85-127.
- Ferrarini, Guido (2006). "One Share–One Vote: A European Rule?." *European Company and Financial Law Review* 3, no. 2: 147-177.
- Fox, Justin, and Jay W. Lorsch (2012). "What Good Are Shareholders?" *Harvard Business Review* 90, no. 7/8: 48-57.
- Fried, Jesse M (2014). "The Uneasy Case for Favoring Long-Term Shareholders." *Yale Law Journal*: 1554-1627.
- Fuster, Andreas, Benjamin Hebert, and David Laibson (2011). "Natural expectations, macroeconomic dynamics, and asset pricing." *National Bureau of Economic Research Working Paper No. w17301*.
- Gilson, Ronald J. (1987). "Evaluating dual class common stock: The relevance of substitutes." *Virginia Law Review*: 807-844.

- Gilson, Ronald J., and Jeffrey N. Gordon (2013). "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights." *Columbia Law Review* ___, no. __: 863-927.
- Gilson, Ronald J., and Reinier H. Kraakman (1984). "The mechanisms of market efficiency." *Virginia Law Review* ___, no. __: 549-644.
- Grossman, Sanford J., and Joseph E. Stiglitz (1980). "On the impossibility of informationally efficient markets." *The American economic review* ___, no. __: 393-408.
- Grossman, Sanford J., and Oliver D. Hart (1980). "Takeover bids, the free-rider problem, and the theory of the corporation." *The Bell Journal of Economics* ___, no. __: 42-64.
- Harford, Jarrad and Kecskes, Ambrus and Mansi, Sattar (2015). "Do Long-Term Investors Improve Corporate Decision Making?" (April 18, 2015). *Finance Down Under 2015 Building on the Best from the Cellars of Finance Paper*. Available at SSRN: <http://ssrn.com/abstract=2505261>.
- Hirschman, Albert O. (1970). *Exit, Loyalty, and Voice: Responses to Decline in Firms, Organizations, and States*. Harvard University Press.
- Hopt, Klaus J. (2015). "Corporate Governance in Europe: A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance." *European Corporate Governance Institute (ECGI)-Law Working Paper No. 296*.
- Iliev, Peter, and Michelle Lowry (2015). "Are Mutual Funds Active Voters?." *Review of Financial Studies* 28, no. 2: 446-485.
- Isaksson, Mats, and Serdar Çelik (2013). "Who Cares? Corporate Governance in Today's Equity Markets." *OECD Corporate Governance Working Papers* 8.
- Kahan, Marcel, and Edward B. Rock (2007). "Hedge funds in corporate governance and corporate control." *University of Pennsylvania Law Review* 155, no. 5: 1021-1093.
- Kastiel, Kobi (2015). "Against All Odds: Shareholder Activism in Controlled Companies." Available at SSRN: <http://ssrn.com/abstract=2628987>.
- Keynes, John Maynard (1936). *General theory of employment, interest and money*, Reprint 2008, Milton Keynes (UK): BN Publishing.
- Klein, April, and Emanuel Zur (2009). "Entrepreneurial shareholder activism: Hedge funds and other private investors." *Journal of Finance* 64, no. 1: 187-229.
- Knight, Frank H. (1921). *Risk, uncertainty and profit*. Boston (MA): Houghton Mifflin.
- Lekvall, Per (ed.). *The Nordic Corporate Governance Model*. Stockholm: SNS Forlag (2015).
- Macey, Jonathan R. (2010). *Corporate governance: Promises kept, promises broken*. Princeton University Press.
- Manne, Henry G. (1965). "Mergers and the market for corporate control." *The Journal of Political Economy* ___, no. __: 110-120.
- Mayer, Colin (2013). *Firm Commitment: Why the corporation is failing us and how to restore trust in it*. Oxford University Press.

- McCahery, Joseph, Zacharias Sautner, and Laura Starks (2015). "Behind the Scenes: The Corporate Governance Preferences of Institutional Investors." *Journal of Finance*, Forthcoming.
- Pacces, Alessio M. (2012). *Rethinking Corporate Governance: The Law and Economics of Control Powers*. Oxford: Routledge.
- Partnoy, Frank (2015). "U.S. hedge fund activism." In Jennifer G. Hill and Randall S. Thomas (eds.), *Research Handbook on Shareholder Power*. Cheltenham: Edward Elgar: 99-115.
- Poulsen, Thomas, Therese Strand, and Steen Thomsen (2010). "Voting power and shareholder activism: A study of Swedish shareholder meetings." *Corporate Governance: An International Review* 18, no. 4: 329-343.
- Rock, Edward B. (2015). "Institutional Investors in Corporate Governance" (July 21, 2015). In Oxford Handbook on Corporate Law and Governance, Forthcoming; *U of Penn, Inst for Law & Econ Research Paper* No. 14-37. Available at SSRN: <http://ssrn.com/abstract=2512303>.
- Roe, Mark J. (2013). "Corporate Short-Termism – In the Boardroom and in the Courtroom." *Business Lawyer* 68: 977-1006.
- Shleifer, Andrei, and Robert W. Vishny (1997). "The limits of arbitrage." *The Journal of Finance* 52, no. 1: 35-55.
- Smith, Adam (1776), *The Wealth of Nations*, Cannan edn, New York: The Modern Library.
- Yermack, David (2010). "Shareholder Voting and Corporate Governance." *Annual Review of Financial Economics* 2, no. 1: 103-125.