Director Notes

The Separation of Ownership from Ownership

Concerns Arising from Institutional Investors as Intermediaries

by Arthur H. Kohn and Julie L. Yip-Williams

The increase in institutional ownership of corporate stock has led to questions about the role of financial intermediaries in the corporate governance process. This report focuses on the issues associated with the so-called "separation of ownership from ownership," arising from the growth of three types of institutional investors, pensions, mutual funds, and hedge funds.[1]

To a great extent, individuals no longer buy and hold shares directly in a corporation. Instead, they invest, or become invested, in any variety of institutions, and those institutions, whether directly or through the services of one or more investment advisers, then invest in the shares of America's corporations. This lengthening of the investment chain, or "intermediation" between individual investor and the corporation, translates into additional agency costs for the individual investor and the system, as control over investment decisions becomes increasingly distanced from those who bear the economic benefits and risks of owners as principals. The rapid growth in intermediated investments has led to concerns about the consequences of intermediation and the role of institutional investors and other financial intermediaries in the corporate governance process. These concerns are particularly relevant against a background of increasing demands for shareholder engagement and involvement in the governance of America's corporations.

The Rise of the Intermediaries

Business ownership before the Industrial Revolution was marked by the simplicity of sole proprietorships and businesses owned and managed by a handful of individuals. These simple forms gave way to the more complicated corporate form that called for investments by an ever-growing number of individuals into a single corporate pool to be managed by corporate managers chosen by those individuals. The success of the corporate form in terms of its ability to generate lucrative return on investment and to efficiently deliver goods and services sought by its customers resulted in the demand by corporations for, and a willingness by individuals to provide, more capital. This brought even more complexity to evolving investment practices, as it invited professional investment managers to oversee the deployment of large amounts of capital. The actual suppliers of capital were

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Table 1

Institutional holdings of outstanding equity

Year	Total outstanding equity ($ billions)	Total institutional equity ($ billions)	Percent of total outstanding equity
1950	$142.7	$8.7	6.1%
2009	20,227.6	10,238.7	50.6[a]

[a] This percentage represented a small decrease off a peak of 53.3 percent in 2005.

Source: The Conference Board, 2010. Values of total outstanding equity from the Board of Governors, Federal Reserve System.

willing or, in some cases, required to abdicate their right to decide in which corporations they would invest, and, in turn, relinquish all of the related decisions associated with that right to trusted and experienced third parties. These third parties would pool the capital and deploy it in any number of funds characterized by different investment time horizons, objectives, and strategies. In return, the fund manager generally would receive a fee for these management services from the suppliers of capital.

The last 60 years have seen a remarkable increase in the use of these intermediaries to invest the savings of Americans (Table 1).[2]

Notably, the concentration of institutional ownership in the top 1,000 companies in the United States was significantly higher than the 50.6 percent cited in Table 1. As of the end of 2009, institutions owned 73 percent of such companies.[3]

It is important to note that these figures take into account the holdings of private and public pension funds, mutual funds, insurance companies, savings institutions (e.g., savings and loan institutions, mutual savings banks, etc.) and foundations. They do not take into account the holdings of a major category of institutional investor: hedge funds.[4] Hedge funds manage capital invested in domestic equities that amounts to only a few hundreds of billions of dollars (that is, a few percentage points out of the outstanding equity).[5] Yet they have become well-known for their shareholder activism, frequently advocating for significant changes to a corporation's strategic direction. As shown in Table 2, among institutional investors holding U.S. equities, pension and mutual funds own the most significant amounts by a substantial margin.[6]

Table 2

Institutional equity holdings as a share of total institutional assets and of total outstanding equity (by type of institution)

	2009 ($ billions)			
Type of institution	Total assets	Equity holdings	% Total equity	% Total
Pension funds	$10,123.7	$4,185.1	20.7%	41.3%
Private trusteed	5,396.8	1,807.9	8.9	33.5
Private insured	2,053.6	850.9	4.2	41.4
State and local	2,673.3	1,526.3	7.5	57.1
Investment companies	7,195.5	4,228.6	20.9	58.8
Open-end mutual funds	6,961.6	4,136.2	20.4	59.4
Closed-end	233.9	92.4	0.5	39.5
Insurance companies	6,194.8	1,476.1	7.3	23.8
Life insurance	4,825.5	1,256.3	6.2	26.0
Property and casualty	1,369.3	219.8	1.1	16.1
Savings institutions	1,253.7	22.2	0.1	1.8
Foundations	583.4	326.7	1.6	56.0
All institutions	**$25,351.1**	**$10,238.7**	**50.6%**	**40.4%**

Note: "Savings institutions" includes savings and loan associations, mutual savings banks, and federal savings banks. As of 2008, the Federal Reserve System discontinued reporting data on bank trusts and estates, which were previously computed under this category of institutional investors.

Source: The Conference Board, 2010. Calculated from data provided by: the Board of Governors, Federal Reserve System; the Employee Benefit Research Institute (EBRI); and the Foundation Center.

The Conference Board Governance Center®
Task Force on Corporate/Investor Engagement

From accounting scandals to the global financial crisis, events of the past decade have damaged the reputation of business, contributing to a public distrust of business in general. In February 2013, The Conference Board Governance Center® formed a Task Force on Corporate/ Investor Engagement to bring together directors of public companies and investors to find solutions to help create a stronger corporate governance system through effective engagement.

The task force is examining the facts, the issues, and the policy implications of the current state of U.S. corporate governance, with the objective of addressing the following questions:

1. What is the optimal balance in the relative roles of management, directors, and investors in the governance of public corporations?
2. What are the gaps between the optimally balanced system and the current system?
3. How should boards and investors engage with one another to lead to an optimally balanced system?

The task force will issue its report in January of 2014. For more information about the task force, its mission, and its members, visit www.conference-board.org/taskforce or email task.force@conference-board.org.

For this reason, in addressing concerns surrounding the lengthening of the investment chain, the attention of this report is focused on pension and mutual funds—also known as "traditional" institutional investors—and hedge funds because of their activist tendencies and reputation.

The proliferation of institutional investors is undoubtedly attributable in large part to the widespread acceptance of modern portfolio theory, which promotes diversification as the optimal investment strategy, where returns are maximized in a manner consistent with overall market performance and economic conditions, all at relatively low risk and low cost to the individual investor. Institutional investors are able to diversify to an extent that the individual investor is not, as a practical matter, able to do. They also offer a more attractive investment alternative for individual investors, since their returns are certainly higher than the negligible amounts that the investor would receive in a bank savings account.[7]

Legal Safeguards against Agency Concerns

The insertion of intermediaries introduces additional agency relationships into the investment chain. As is the case with the establishment of any agency relationship, there are always concerns about whether the agent is acting in the best interests of the principal. The following briefly describes the legal framework governing certain institutional asset managers, which, to a significant extent, address and thereby serve to identify and highlight agency concerns.

Mutual funds Mutual funds, formed as corporations or, sometimes, business trusts, are a type of investment company regulated by the Investment Company Act of 1940. In certain respects, they very much resemble the conventional corporation—they are formed by a sponsor, managed by a board of directors, who are subject to the same fiduciary duties of loyalty and care under state law as a director of any other corporation, and have shareholders whose liability is limited to their equity investment. Mutual fund directors are also charged with oversight responsibilities, principally overseeing the fund's performance. Like publicly traded corporations, mutual fund directors are required to engage in certain practices to promote good governance, including conducting annual self-evaluations and quarterly executive session meetings. Under the Investment Company Act, at least 40 percent of a board's members must be independent (although, in practice, most mutual funds have boards that are 75 percent independent), which generally means that those directors do not have any material relationships with the investment adviser retained by the fund.[8] Mutual funds, as incorporated entities, must afford their shareholders the same general rights as shareholders of conventional corporations (e.g., election of directors (although only two-thirds of directors need to be elected by shareholders), attendance at shareholder meetings (although such meetings are much less common), and binding votes on certain fundamental transactions). Because mutual funds are registered under the Securities Act of 1933, current and prospective fund shareholders benefit from extensive information rights under federal securities laws. Regularly updated prospectuses disclose a fund's investment policies and objectives, potential risks, fees and expenses, historic performance, and information about the fund's directors, investment adviser, and other third-party service providers (although there are no disclosure obligations as to their or their investment advisers' voting policies or other information as to their positions on corporate governance matters).

However, a mutual fund is entirely distinct in its operations and structure from a conventional corporation in that it does not have employees or other staff to manage its pool of contributed capital. Rather, all operations are outsourced to investment advisers, distributors, custodians, transfer agents, and other third parties who are frequently considered for purposes of the Investment Company Act as "affiliated" with the mutual fund and its sponsor. Because of the potential for conflicts of interest inherent in such relationships, one of the primary responsibilities of the board of directors is to evaluate and approve those arrangements on a periodic basis.

The investment adviser is the most critical of the mutual fund's service providers, empowered with the authority to manage the mutual fund's capital and make all day-to-day investment decisions. Therefore, the investment adviser is a vital player within the intermediation process, representing the existence of another principal–agent relationship within the investment chain. Legal safeguards exist to protect the principal (i.e., in this instance, the mutual fund). It is the mutual fund's prerogative to terminate an existing relationship with an investment adviser by either terminating or declining to renew the advisory agreement. However, this rarely happens, largely because the investment advisers are affiliated with the mutual funds and their sponsor. Unless there are extreme circumstances, such as fraud, a change of advisers would also be costly, disruptive, and potentially contrary to shareholders' express intention to invest with a particular mutual fund. Instead, to effect change, directors typically would urge action by the investment adviser, such as a change in portfolio management, increased investment research capability, or retaining a sub-adviser.

As a legal matter, an investment adviser owes fiduciary duties to its client, the mutual fund, including duties of care (e.g., by exercising prudence and reasonableness in making investment decisions), loyalty (e.g., by placing the client's interests first, acting in the client's best interests and avoiding conflicts of interests) and good faith (e.g., by being truthful and accurate in all communications and disclosures). These fiduciary duties are rooted in a combination of common law (principally, in the laws of agency and trust) and federal statutory law (principally, the Investment Company Act[9] and the Investment Advisers Act of 1940 (the Advisers Act)).[10]

Most notably in the context of investor engagement with public companies, the proper exercise of an investment adviser's fiduciary duties today includes diligently exercising its right to vote on behalf of its institutional clients.[11]

In the more distant past, advisers often did not vote on behalf of their clients, believing that the task was too costly and time-consuming and that their clients' small holdings were unlikely to make a difference in the outcome. However, at the beginning of this century and coinciding with an era of greater shareholder activism, advisers and their institutional clients were increasingly criticized for not voting, given their enormous collective voting power and ability, in some cases, to affect the outcome of the shareholder votes and influence corporate governance. In 2003, the U.S. Securities and Exchange Commission (SEC) promulgated Rule 206(4)-6 under the Advisers Act, which made it fraudulent for an adviser to exercise proxy voting authority without having procedures reasonably designed to ensure that the adviser votes in the best interest of its clients. In the rule's adopting release, the SEC confirmed that an adviser owes fiduciary duties of care and loyalty to its clients with respect to all services undertaken on its client's behalf, including proxy voting. The adopting release further stated, "The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests for its own."[12]

Pension funds The governance of retirement savings vehicles—that is, the processes by which their investment decisions are made—as a threshold matter, depends on the type of pension arrangement concerned. Generally, pension vehicles are classified into one of three categories for this purpose.[13]

1. **Private-sector defined benefit pension plans** are subject to the federal Employee Retirement Income Security Act of 1974 (ERISA). ERISA requires employers to set aside assets to satisfy their future pension payment obligations and imposes a governance structure pursuant to which those assets are invested. Generally, each plan must designate a "named fiduciary," which has ultimate investment control. The named fiduciary of corporate pension plans is typically a committee of senior executives of the corporate plan sponsor.[14] While some named fiduciaries directly make individual investment decisions (that is, decisions about investing in particular stock or other assets), most only keep responsibility for asset allocation and management selection decisions, with individual investment decisions being made by investment advisers hired for this purpose. The investment advisers may manage plan assets either through separate accounts or through collective investment vehicles they maintain.[15]

2 **Public-sector defined benefit plans** are not governed by federal pension law, but rather are subject to distinct state or local laws. Generally, ultimate investment authority for those plans rests with a board or investment committee that is composed of state or local politicians or their appointees. Generally, those committees may either make individual investment decisions or delegate such decisions to investment advisers hired for that purpose.

3 **401(k) and other similar defined contribution plans** are subject to the governance structure mandated by ERISA, if they are sponsored by private-sector companies, or by state or local law, if they are government-sponsored plans. What these plans have in common, however, is that they generally pass investment decisions to individual plan participants, whose ultimate retirement savings under the plans depend on their investment choices. The large majority of such assets are invested among a limited menu of mutual funds or other commingled investment vehicles that each plan's named fiduciaries designate as available under the plan. While many such plans also permit participants to make individual investment decisions through so-called "open brokerage windows," only a very small portion of the aggregate assets of such plans are so invested.

Persons who make decisions related to the investment of ERISA plan assets are subject to strict fiduciary duties, as are, generally, persons who have discretion over the investment of governmental plan assets.[16] Under ERISA, the duties of plan fiduciaries include a duty of care, skill, diligence and prudence (under a so-called "reasonable expert standard"), diversification, and exclusive attention to the interests of plan participants and their beneficiaries. In addition, ERISA fiduciaries are subject to a strict and complex framework of detailed conflict-of-interest rules. Fiduciaries of public-sector plans are typically subject to similar conflict-of-interest rules, which have been expanded recently to include, in some jurisdictions, so-called "pay-to-play" rules that were enacted in response to concerns about inappropriate influence on investment decisions of public-sector plans by pension investment consultants. The disclosure requirements ERISA imposes for the benefit of plan participants with respect to individual investment decisions made with plan assets are relatively limited.

Interestingly, the ERISA conflict-of-interest rules have been applied to impose limits on the types of incentive fee arrangements that may be implemented for investment advisers who manage ERISA plan assets, based on a concern that such fees may incentivize advisers to make investment decisions with their own interests in mind (i.e., earning an incentive fee) and take inappropriate risks with plan assets.[17]

As with mutual funds, as discussed above, regulators were required to step in to encourage managers of ERISA plan assets to actually vote the shares in which they have invested. In 1988, the U.S. Department of Labor issued an advisory opinion, concluding that the right to vote shares was a "plan asset" to which the fiduciary rules referred to above apply.[18]

Hedge funds Hedge funds are yet another type of pooled investment vehicle. Their organizational structure enables them to avoid certain legal and regulatory requirements that apply to other investment companies. Hedge funds domiciled in the United States are generally formed as limited partnerships or other limited liability entities and are managed by the partnership's general partner (or equivalent entity), who may also serve as the hedge fund's investment adviser.[19] Investors contribute capital to the partnership (or other equivalent entity), which executes a partnership or other operating agreement that frequently entitles them to certain rights that are generally limited to information and reports and redemption of all or a portion their interest at specified periods. There is often limited visibility into the general partner's investment practices and other activities. Because U.S.-domiciled hedge funds are not formed and operated as corporations, there is no board of directors; therefore, director independence requirements and the extensive body of law governing a director's duties to a corporation's investors do not apply. Investors also do not have a right to attend shareholder meetings or otherwise vote in certain fundamental decisions (i.e., sales and mergers). Furthermore, the private nature of hedge fund offerings (their interests are not sold through registered public offerings) and the limits on the number and types of investors admitted into their partnerships, ensure that their interests are exempt from the registration requirements of the Securities Act of 1933 and the fund itself is exempt from being classified as an investment company under the Investment Company Act. As a "private fund" exempt from the registration requirements of the Investment Company Act, hedge funds are not bound by the disclosure and other requirements and investment limitations that it sets. For example, registered investment companies, including mutual funds, are prohibited from trading on margin or engaging in short sales and must secure shareholder approval to take on significant debt or invest in certain types of assets, such as real estate or commodities. These types of transactions are often core elements of hedge fund trading strategies. Hedge funds trade in all sorts of assets, from traditional stocks, bonds, and currencies to more exotic financial derivatives and even nonfinancial assets, and often use leverage to increase their returns.

As a result of recent regulatory changes, most investment advisers of hedge funds are now required to register as such under the Advisers Act, thereby making them subject to its requirements.[20] These requirements include disclosure obligations about gross and net asset values, investor concentration, borrowing and liquidity, performance, investment strategies, credit risk and trading, and clearing practices. Large advisers must also disclose information regarding exposures to asset class, geographical concentration and the monthly value of portfolio turnover by asset class. Investment advisers are also now required to have written policies reasonably designed to prevent violations of the Advisers Act, regular review of those policies, and a chief compliance officer, who is responsible for administering those policies. As with investment advisers to traditional institutional investors, hedge fund investment advisers are also subject to fiduciary duties (both at common law and based on the antifraud provisions of Section 206 of the Advisers Act) that obligate them, among other things, to allocate their fees and expenses fairly between themselves and their clients, disclose conflicts of interest, and properly oversee the management of risk.[21]

The Downside of Intermediation

Some advocates for stewardship place the blame for events at Enron, WorldCom, and other corporate scandals of the last decade, as well as the financial crisis, in part on intermediation and, more specifically, on the many intermediaries who stand between the ultimate beneficial owners and the corporation. Intermediation creates multiple layers of agency costs that cannot be entirely mitigated by legal safeguards. According to this line of thought, the potential for misaligned interests is exacerbated by the growing divide between ownership and control, where institutional investors and their advisers lack any real incentive to actually "own" the companies in which they invest but seek merely to manage their portfolios to maximize their own returns. In other words, institutional investors deserve blame because they failed to act as owners or "stewards" to adequately monitor and hold accountable corporate managers, and in so doing, failed in protecting the interests of their investors, the ultimate beneficial owners. The idea of stewardship is most popular in the United Kingdom and the European Union.

Because institutional investors own large blocks of stock, they have the unique ability to play a far more active role in corporate governance than dispersed individual investors traditionally have. Stewardship advocates assert that short-termism by corporate managers is partly attributable to the institutional investors' singular focus on short-term returns, which are an inevitable result of their focus on extreme diversification and their compensation and incentive structures.

Diversification is the principal means by which institutional investors manage risk—not merely through investing in multiple companies and other classes of assets, but also through a manager diversification, in which management of a pool of capital is divided among separate investment advisers who employ different investment strategies. This contributes to extreme diversification, with one institutional investor holding fragmented positions sometimes in hundreds or even thousands of companies. Extreme diversification is also fostered by modern portfolio theory, which shifts the focus away from the specifics of a particular company to "mathematical insights into the relative performance of shares and investment funds in relation to selected benchmarks or indices."[22] Investment decisions are made on the basis of mathematical calculations where an investor must ensure that its portfolio is an adequate reflection of the market or otherwise increase risk to the portfolio. Selling and buying of shares is therefore based on their weight in an index.[23]

Compensation for investment advisers of traditional institutional investors is almost always determined based on assets under management and not upon investment return (except in the case of hedge fund advisers, who are compensated based on a combination of both factors). Therefore, there is incentive for investment advisers to attract as much investment as possible. Additionally, the security of an investment adviser's continued position, particularly those who manage pension funds, is also based on its performance, typically with a short-term focus measured quarterly, semiannually, or annually, but too often not in terms of the multiyear time horizons that companies often need to see a return on implementing new strategies. Competition among those advisers and sub-advisers to attract more clients also places an emphasis on short-term performance and meeting short-term investment returns.

Pressures to maintain adequate levels of diversification and deliver results with respect to performance have led to increasingly short holding periods. While the information differs slightly, depending on the type of investor being surveyed and the locus of the trading, commentators generally report that holding periods, which were in the five-year range 30 years ago, have shrunk to between five and nine months today.[24] The concern is that institutional investors who invest in companies for short periods of time have relatively little interest in the long-term performance of those companies. Furthermore, high rates of portfolio turnover, many argue, is said to increase risk and decrease investment return.[25]

What Downside?

The view that traditional institutional investors are culpable in contributing to market failures is by no means a universally accepted one. Those on the other side of the debate see no merit in institutional investors acting as stewards or otherwise compelling them to do so, pointing to the fact that institutional investors have consistently failed to play any stewardship role, despite the urging of academics and regulators.[26] Opponents of stewardship offer the following arguments against it:

- Given business models driven by diversification, relatively short holding periods, and, in many cases, passivity in tracking a market index, institutional investors are rationally apathetic to corporate governance decisions;
- There is little to no correlation between shareholder activism by traditional institutional investors or improved corporate governance practices and the maximization of shareholder value;[27] and
- A fundamental assumption of stewardship advocates—the notion of the very existence of short-termism and long-termism—is flawed. Opponents of stewardship believe in the efficient market hypothesis, which holds that a company's share price incorporates all information relevant to its value and reflects the best estimate of the stock's future risk and return. Long term and short term run together because the company's share price is the only accurate way to measure future risks and returns. Under this theory, short-term behavior by corporate managers is punished by the market through a lowering of share price. Rejecting the notion of long-termism or short-termism, critics maintain there is no basis for much of the criticism lodged by stewardship advocates against institutional investors.

Inconsistent views and disagreements on all of these issues among the institutional investor community is evidenced by the varying levels of interest in and capacity for engagement exhibited by institutional investors (although, interest and capacity also seem to have a practical correlation with the size of an institutional investor; larger institutional investors appear more inclined to engage and, therefore, more likely to act as stewards).[28]

Ronald J. Gilson and Jeffrey N. Gordon propose what may be viewed as an attractive middle ground in the debate over whether institutional investors should act as stewards. They argue that mutual funds and pension funds are and should be encouraged to serve as governance intermediaries; while they can generally be expected to be passive and not initiate any important proposals, they can be called upon to consider proposals made by shareholder activists (i.e., hedge funds). Gilson and Gordon say that the effect would be "to potentiate institutional investor voice, to increase the value of the vote, and thereby to reduce the agency costs" associated with the intermediation process.[29]

Possible Solutions to Problems Associated with Intermediation

For stewardship advocates, the solution to the problems associated with intermediation, particularly as it relates to the promotion of short-termism, is to find ways for institutional investors to act more like owners and, therefore, better represent the interests of those whose capital they invest.[30] In certain cases, this means requiring institutional investors to revamp their business practices. Stewardship advocates recommend measures encouraging institutional investors to:

- invest in fewer companies so that scarce resources can be better allocated to understanding more deeply the business strategies and objectives of the companies in which the institutional investor is invested;
- devote more resources to corporate governance and engagement issues;
- retain more investment responsibilities rather than outsourcing them to investment advisers;
- develop policies on corporate governance and engagement;
- change the performance evaluation procedures for investment advisers so that they are evaluated on a five- to 10-year cycle;
- revamp compensation practices—for example, by including a performance fee that is paid over several years, adding an equity component to promote long-term behavior, and offering additional compensation for corporate governance-related activities; and
- limit the amount of portfolio turnover.

These recommendations would necessitate a fundamental shift in the business model of institutional investors and their advisers, which makes them unlikely to be implemented.

Suggested Alternatives to Stewardship

As an alternative to mandating fundamental changes to the business model of institutional investors, other proposals and initiatives have been advanced that are aimed at more closely aligning the interests of the ultimate beneficial owner and intermediary. They include:

Enhanced disclosure requirements This includes enhancing disclosure requirements around fees and expenses, especially as to the costs associated with a fund's high turnover rate. Some have also called for greater disclosure around complex investment strategies relating to structured and derivative arrangements that would appear to promote short-term gains at the expense of long-term value creation (e.g., an activist who becomes a formal shareholder with voting power while simultaneously shorting the same corporation's stock, or an investor who owns shares of one company and uses that position to increase the value of its holdings in another company instead).[31] Increased and enhanced disclosure would theoretically provide individual investors with the information needed to evaluate an institutional investor's short-term approaches.

Changes to the taxation of transactions by institutional investors The Aspen Institute has recommended revising capital gains tax provisions or implementing an excise tax in ways that would discourage excessive portfolio turnover and encourage longer-term share ownership. The capital gains tax rate might be set on a descending scale, based on the number of years a security is held. The Aspen Institute also recommended the elimination of limitations on capital-loss deductibility for very long-term holdings, now capped at $3,000 per year for losses related to holdings of any duration.[32]

Clarifying fiduciary duties This proposal includes urging fiduciaries to reevaluate, and courts and other governmental bodies to clarify or alter as necessary, the generally accepted understanding of the nature and extent of fiduciary duties owed by various intermediaries. Some argue that the understanding of fiduciary duties has evolved into a purely economic analysis that considers quantitative factors only, and that it has devolved into a practice of simply comparing fund performance and fees, without regard to qualitative factors. For example, when a fund manager is deciding whether it would be consistent with its fiduciary duties to recall a stock on loan to vote it, fund managers are obligated to compare the value of voting against the stock-lending revenues that would be sacrificed for the vote. Given the difficulty of valuing a vote quantitatively, some fund managers routinely assign it a zero value and, hence, conclude that shareholder interest is better served by not recalling the stock, even when contentious issues are to be voted. In the takeover context, the decision of whether to accept a bid is guided principally by stock price, which is highly influenced by short-term considerations, rather than a thorough assessment of a company's long-term prospects.[33] Reform in this area would focus on clarifying fiduciaries' duties to include taking long-term and short-term considerations, as well as other qualitative considerations, into account. Aside from any new regulations requiring greater disclosure as described above, the Aspen Institute has also suggested that fiduciary duties should include an obligation for investment advisers to take into account, and clearly inform investors of, tax and other factors that have implications for long-term investing.[34]

Adopting a stewardship code In 2010, the Financial Reporting Council (FRC) released the UK Stewardship Code, which aims to enhance the quality of engagement between institutional investors and companies and describes governance practices to which institutional investors should aspire.[35] The Stewardship Code sets out good practice on engagement with companies to which the FRC believes institutional investors should aspire and operates on a "comply or explain" basis. UK-authorized asset managers must report on whether or not they apply the Stewardship Code. The principles embrace the notion of institutional investors as stewards of the public corporation (i.e., active monitoring and engagement) and call on them to:[36]

- publicly disclose their policy on how they will discharge their stewardship responsibilities;
- have and publicly disclose a robust policy on managing conflicts of interest in relation to stewardship;
- monitor their investee companies;
- establish clear guidelines on when and how they will escalate their stewardship activities;
- be willing to act collectively with other investors, where appropriate;
- have a clear policy on voting and disclosure of voting activity; and
- report periodically on their stewarding and voting activities.

In conclusion, evidence of substantial change in the structures of corporate ownership seems clear. Changes in governance processes to reflect and counterbalance the changes in ownership structures could help to optimize corporate performance. However, changes to entrenched practices can lead to unintended consequences, and it's unclear whether such changes would develop organically through the operation of the markets. Under the circumstances, incremental approaches to test the impact of adjustments in governance processes, such as the one suggested by Gilson and Gordon, seem attractive.

Endnotes

1 "The separation of ownership from ownership" is described in Leo E. Strine, Jr., "Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance," Harvard Law and Economics Discussion Paper No. 585, May 2007.

2 Matteo Tonello and Stephan Rabimov, *The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition,* The Conference Board, Research Report 1468, November 2010, p. 22.

3 Tonello and Rabomiv, *The 2010 Institutional Investment Report,* p. 27.

4 Definitive figures with respect to the amount of capital invested in U.S. equities by hedge funds are difficult, if not impossible, to obtain. While investment managers (which includes hedge fund advisers, as well as advisers to other institutional investors and individuals) with assets under management above a threshold amount are required to file quarterly statements on Schedule 13F disclosing their equity holdings, this requirement only applies to designated "13F securities" and is not applicable to all hedge funds and their advisers. Other institutional investors have other regulatory requirements that call for extensive disclosure as to their holdings in U.S. equities.

5 Of the roughly 6,000 hedge funds in the United States, the top 10 largest hedge funds have $282 billion of assets under management. Ben W. Heineman, Jr. and Stephen Davis, "Are Institutional Investors Part of the Problem or Part of the Solution?" The Committee for Economic Development and the Millstein Center at the Yale School of Management, October 3, 2011, p. 34.

6 Tonello and Rabimov, *The 2010 Institutional Investment Report*, p. 26.

7 Gilson and Gordon also attribute the proliferation to the decision in this country to rely primarily on privately funded pensions (as opposed to reliance on government-sponsored social security) for retirement financing and the shift in employer-provided pension plans from defined benefit to defined contribution plans. See Ronald J. Gilson and Jeffrey N. Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights," *Columbia Law Review*, forthcoming 2013.

8 "Frequently Asked Questions about Mutual Fund Directors," Investment Company Institute (www.ici.org/pubs/faqs/faq_fund_gov_idc).

9 Section 36(b) of the Investment Company Act imposes a fiduciary duty on the investment adviser of an investment company with respect to the receipt of compensation from the investment company and grants an express private right of shareholders to enforce this fiduciary duty. Many courts have interpreted this fiduciary duty to be limited to matters involving excessive fee payment. Donald C. Langevoort, "Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty," *Washington University Law Quarterly,* 83,No. 4, 2005, pp. 1017, 1023. Under Section 36(a) of the Investment Company Act, an adviser can be held liable for breach of fiduciary duty involving personal misconduct in respect of any investment company for which it serves as adviser. The scope of fiduciary duties imposed by this provision is broader than that established by Section 36(b) and was designed to protect shareholders from many subtle abuses that are not separately prohibited by the Investment Company Act. See Lorna A. Schnase, "An Investment Adviser's Fiduciary Duty," August 1, 2010, p. 4 (www.40actlawyer.com/Articles/Link3-Adviser-Fiduciary-Duty-Paper.pdf). By and large, courts have found most claims of breach of fiduciary duty under the Investment Company Act to be ones where the harm is to the fund rather than shareholders and, hence, must be brought derivatively.

10 Section 206 of the Adviser's Act, an anti-fraud provision that generally prohibits an adviser from engaging in any practice that is fraudulent, deceptive, or manipulative, has been interpreted as standing for the proposition that advisers owe a fiduciary duty to their clients, including an affirmative duty to act with utmost good faith, to make full and fair disclosure of all material facts, and to employ all reasonable care to avoid misleading clients. See *SEC v. Cap. Gains Research Bureau Inc.,* 375 U.S. 180 (1963). The Advisers Act is viewed as setting a federal fiduciary standard for advisers. Because there is generally no private right of action under the Advisers Act, the contours of that duty are shaped largely by federal courts interpreting the Advisers Act, as well as by SEC interpretation of Section 206 and rules promulgated under that section.

11 "Proxy Voting by Investment Advisers," SEC Final Rule adopted January 31, 2003, effective April 14, 2003 (www.sec.gov/rules/final/ia-2106.htm).

12 "Proxy Voting by Investment Advisers," SEC Final Rule. However, the SEC rule notes that failure to vote would not mean breach of fiduciary duties. It stated, "We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may not, however ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies."

13 For purposes of this report, we do not treat individual retirement accounts, a type of retirement savings vehicle that in the aggregate hold $4.9 trillion of U.S. equity capital (as of the end of 2011), as a separate type of pension plan vehicle. Approximately 45 percent of such assets are invested, at the direction of their individual owners, in mutual funds or other similar pooled investment vehicles. *2012 Investment Company Fact Book,* 52nd Edition, Investment Company Institute, May 2012 (www.ici.org/pdf/2012_factbook.pdf).

14 Private-sector defined benefit pension plans maintained jointly with unions (so-called multi-employer or Taft–Hartley plans) have a governance structure that differs from other private-sector defined benefit plans, as described in the text above, insofar as investment advisers are selected by a union–management board. The influence of union representatives in these arrangements on investment decisions may introduce additional, unique agency costs. See, for example, the U.S. Department of Labor, (DOL) "Interpretive Bulletin Relating to Investing in Economically Targeted Investments," in which the DOL made an effort to limit the potential impact of those costs. 29 C.F.R. § 2509.08-1, RIN 1210-AB29, *Federal Register*, 73, no. 202, October 17, 2008, p. 61731.

Endnotes (continued)

15 Some of those collective investment vehicles are so-called “funds of funds,” in which one collective investment vehicle invests in other collective investment vehicles.

16 Courts have described the fiduciary obligations imposed by ERISA as “the highest known to the law.” See *Donovan v. Bierwirth,* 680 F.2d 263, 272 n.8 (2d Cir. 1982), cert. denied, 459 U.S. 1069 (1982).

17 The DOL has issued a series of advisory opinions blessing incentive fee arrangements that satisfy certain criteria that are intended to address that perceived conflict. See DOL Advisory Opinion 86-21A (Batterymarch Financial Management), August 29, 1986; Advisory Opinion 86-20A (BDN Advisers, Inc.), August 29, 1986; Advisory Opinion 89-31 (Alliance Capital Management L.P.) October 11, 1989; and Advisory Opinion 99-16 (Mount Lucas Management Corp.) December 9, 1999. These opinions authorize the use of performance fees in the following circumstances: (a) the fees are structured to comply with applicable securities laws; (b) the fees are based on both realized and unrealized gains and losses during a pre-established performance period; (c) the investments would mostly be in securities with readily determinable market values and, for those securities which could not be readily valued, an independent valuation would be obtained; and (d) the only plans for whom the service would be available would be those with assets in excess of $50 million. The DOL has granted prohibited transaction exemptions permitting certain performance fee arrangements for certain real-estate investment managers. See, e.g., DOL Prohibited Transaction Exemptions 88-73, *Federal Register,* 53, July 29, 1988, p. 28730, and 89-13, *Federal Register*, 54, March 15, 1989, p. 10743.

18 Letter from Alan D. Lebowitz, Deputy Assistant Secretary, U.S. Department of Labor, to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc., February 23, 1988, reprinted in *Pension and Benefits Reporter,* Bureau of National Affairs, 15, no. 9, February 29, 1988, p. 391.

19 For various tax and other reasons, hedge funds are also often domiciled offshore, in which case, they are formed as corporations, limited liability companies, or trusts.

20 “Rules Implementing Amendments to the Investment Advisers Act of 1940,” SEC Final Rule, adopted June 22, 2011 (www.sec.gov/rules/final/2011/ia-3221.pdf).

21 For a description of the recent regulatory changes as applicable to investment advisers of hedge funds, see Norm Champ, “What SEC Registration Means for Hedge Fund Advisers,” speech to New York City Bar, May 11, 2012 (www.sec.gov/news/speech/2012/spch051112nc.htm).

22 Jaap Winter, “Shareholder Engagement and Stewardship: The Realities and Illusions of Institutional Share Ownership,” Working Paper, June 2011, pp. 4–5 (http://ssrn.com/abstract=1867564).

23 Winter, “Shareholder Engagement and Stewardship.” pp. 4–5.

24 The average holding period in 1980 was five years, whereas it is less than five months today. Simon C.Y. Wong, “Why Stewardship Is Proving Elusive for Institutional Investors,” *Butterworths Journal of International Banking and Financial Law*, July/August 2010, pp. 406, 409. Heineman and Davis found that average holding period in the 1970s on the New York Stock Exchange was about seven years and is now about seven to nine months. Heineman and Davis, “Are Institutional Investors Part of the Problem,” p. 9.

25 David Blanchett, “The Pre-Tax Costs Of Portfolio Turnover,” Indexuniverse.com, April 30, 2007 (www.indexuniverse.com/publications/journalofindexes/joi-articles/2623.html).

26 Gilson and Gordon, “The Agency Costs of Agency Capitalism,” p. 19.

27 There is extensive literature, including numerous empirical studies, on the question of whether shareholder activism with a view toward improving corporate governance practices improves firm value, with conflicting results (in part due to the varied objectives of shareholder activism, the definition and timing of improvements in firm value, as well as the general complexities of the corporation). For a good summary of the studies and the debate, see Jay W. Einsenhofer and Gregg S. Levin, “Does Corporate Governance Matter to Investment Returns?” *Corporate Accountability Report*, 3, no. 37, September 23, 2005, and Jonathan M. Karpoff, “The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings,” Working Paper, August 2001 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=885365).

28 See, for example, Robyn Bew and Richard Fields, “Voting Decisions at U.S. Mutual Funds: How Investors Really Use Proxy Advisers,” commissioned by the IRRC Institute, written by Tapestry Networks, Inc., June 2012, p. 15 (www.irrcinstitute.org/pdf/Voting_Decisions_at%20US_Mutual_Funds.pdf).

29 See, generally, Gilson and Gordon, “The Agency Costs of Agency Capitalism.”

30 This obviously assumes that the ultimate beneficial owner would want to act as an engaged owner if he were to own the shares of the corporation directly, and to promote long-termism. While there seems to be little empirical evidence to support this assumption, at least in the context of pension investment, which typically involves investing assets to meet very long-term needs of pension plan participants, the assumption seems reasonable.

31 “Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management,” The Aspen Institute, September 9, 2009 (www.aspeninstitute.org/publications/overcoming-short-termism-call-more-responsible-approach-investment-business-management).

32 Ibid.

33 Wong, “Why Stewardship Is Proving Elusive,” p. 408.

34 “Overcoming Short-Termism,” The Aspen Institute.

35 The FRC is the United Kingdom’s independent regulatory body responsible for promoting high-quality corporate governance and reporting to foster investment. It sets the framework of codes and standards for the accounting, auditing, actuarial, and investor communities and oversees the conduct of the professionals involved.

36 Although the European Commission has also embraced a general call for greater engagement and involvement in corporate governance by institutional investors and asset managers, its Action Plan (released in December 2012), in terms of new obligations on institutional investors, only addresses specifically its intention to pass an initiative to require disclosure of voting and engagement policies, as well as voting records by institutional investors. See “Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan: European Company Law and Corporate Governance—A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies,” December 12, 2012 (http://ec.europa.eu/internal_market/company/docs/modern/121212_company-law-corporate-governance-action-plan_en.pdf).

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