2007

What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight

Robert C. Illig
rillig@uoregon.edu

Follow this and additional works at: http://digitalcommons.wcl.american.edu/aulr

Part of the Corporation and Enterprise Law Commons

Recommended Citation
What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight

Abstract
Hedge funds and other private equity funds are aggressive monitors of corporate America. Their investment strategies are designed to squeeze agency costs and other inefficiencies out of underperforming companies. Mutual funds and public pension funds, by contrast, have remained relentlessly passive despite their many resources. Rather than seek to improve the performance of their portfolio companies, they generally prefer to exit any investments that turn sour. Why the difference? In this Article, I compare the business environments and regulatory regimes affecting different types of institutional investors. I conclude that the primary reason that most institutional investors do not better discipline corporate wrongdoing is that their individual fund managers have little incentive to do so. Were they permitted to adopt the incentive compensation structure of a hedge fund, however, mutual funds and public pension funds would compete to provide the oversight necessary to make corporate managers more accountable. The result would be a deeper market for good corporate governance.

Keywords
Hedge funds, Private Equity Funds, Corporation, Investor Monitoring, Public Funds, Private Funds

This article is available in American University Law Review: http://digitalcommons.wcl.american.edu/aulr/vol57/iss2/1
ARTICLES

WHAT HEDGE FUNDS CAN TEACH CORPORATE AMERICA: A ROADMAP FOR ACHIEVING INSTITUTIONAL INVESTOR OVERSIGHT

ROBERT C. ILLIG

Hedge funds and other private equity funds are aggressive monitors of corporate America. Their investment strategies are designed to squeeze agency costs and other inefficiencies out of underperforming companies. Mutual funds and public pension funds, by contrast, have remained relentlessly passive despite their many resources. Rather than seek to improve the performance of their portfolio companies, they generally prefer to exit any investments that turn sour. Why the difference? In this Article, Professor Illig compares the business environments and regulatory regimes affecting different types of institutional investors. He concludes that the primary reason that most institutional investors do not better discipline corporate wrongdoing is that their individual fund managers have little incentive to do so. Were they permitted to adopt the incentive compensation structure of a hedge fund, however, mutual funds and public pension funds would compete to provide the oversight necessary to make corporate managers more accountable. The result would be a deeper market for good corporate governance.

* Assistant Professor, University of Oregon School of Law. B.A. 1991, Williams College J.D. 1996, Vanderbilt University. E-mail: rillig@uoregon.edu. Support for this project was provided by the University of Oregon’s Dean’s Advisory Council Endowment Fund. I am grateful to Royce Barondes, Bernie Black, Tamar Frankel, Don Langevoort, Brian McGall, and Harwell Wells, as well as to my many wonderful colleagues at Oregon, for their helpful thoughts and comments. I also benefited from the insights of my fund manager friends, most notably Jamie Hague of Millburn Corp., and from faculty workshops at Willamette University and the University of Oregon.
TABLE OF CONTENTS

Introduction................................................................................................. 227
I. Institutional Investor Monitoring ........................................................... 234
   A. Background .................................................................................. 235
   B. The “Discovery” of Public Equity Funds ....................................... 243
   C. Passivity Explained ...................................................................... 248
   D. Efforts at Reform ........................................................................ 253
   E. The Persistence of Passivity .......................................................... 258
      1. Shareholder apathy ................................................................. 259
      2. Fewer monitors ....................................................................... 264
      3. Index funds ............................................................................. 266
II. Private Equity Funds ........................................................................... 268
   A. Overview and History .................................................................... 268
   B. Regulatory Environment .............................................................. 275
   C. Structure and Organization .......................................................... 278
   D. Alignment of Interests .................................................................. 282
III. Public and Private Equity Funds Compared—Internal Characteristics ........................................................................... 287
    A. Size and Resources ...................................................................... 288
    B. Use of Leverage .......................................................................... 292
    C. Need for Liquidity ....................................................................... 293
    D. Investment Culture ...................................................................... 297
IV. Public and Private Equity Funds Compared—External Regulatory Environment ........................................................... 299
    A. Rules Limiting Voice ................................................................... 300
    B. Rules Limiting Control .................................................................. 306
       1. ERISA .................................................................................. 306
       2. The 1940 Acts ......................................................................... 312
    C. Governance Rules ........................................................................ 315
       1. Disclosure rules ....................................................................... 315
       2. Eligible investor rules ............................................................... 316
       3. Limits on incentive compensation .......................................... 318
V. Implications for Governance Reform .................................................... 322
    A. Existing Incentives for Fund Managers ....................................... 323
       1. Profit growth ........................................................................... 325
       2. Growth through advertising .................................................... 327
       3. Incentives to cut costs ............................................................... 330
    B. The Promise of Public Equity Fund Oversight ................................. 332
Conclusion ................................................................................................. 336
INTRODUCTION

Corporate America needs better monitoring. Even in the post-Sarbanes-Oxley era, managers of public companies remain largely insulated from outside influence. They are protected by a combination of takeover defenses and the business judgment rule and have little to fear from either hostile raiders or their own shareholders. The pendulum remains stuck in favor of managerial discretion. It will swing back toward greater accountability to shareholder interests only if managers are subject to more effective oversight.

In the early 1990s, a group of corporate governance scholars led initially by Mark Roe and Bernard Black believed they had at last identified corporate law’s white knight. So-called institutional investors—large pools of capital invested by professional fund managers—appeared to have amassed the resources necessary to act as a check against corporate wrongdoing. Remove the barriers that make shareholder activism so expensive, they argued, and institutional investors would happily provide the oversight that seemed to be missing from corporate America.

Among institutional investors, mutual funds and public pension funds displayed the greatest potential as monitors. They therefore received the bulk of the scholarly attention and took on increased importance in America’s overall system of corporate governance. 


2. See Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 523 (1990) (arguing that “institutional shareholders are hobbled by a complex web of legal rules that make it difficult, expensive, and legally risky to own large percentage stakes”); John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1336 (1991) (arguing that public pension funds are closer than any other market player to the ideal corporate monitor); Rock, supra note 1, at 449 (arguing that “the institutional investor would seem to have both the incentive and the abilities to constrain management”); Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10, 11, 31–53 (1991) (arguing that “American law and politics deliberately diminished the power of financial institutions to hold the large equity blocks that would foster serious oversight of managers”). The first modern support for institutional investor monitoring appears to have come from Alfred Conard. See Alfred F. Conard, Beyond Managerialism: Investor Capitalism?, 22 U. Mich. J.L. Reform 117, 175–76 (1988) (arguing that “institutional investors . . . offer the best hope of restoring to private enterprise the vigor that is inherent in the design of capitalism”).

3. See Coffee, supra note 2, at 1292–93 (arguing that public pension funds and, to a lesser degree, mutual funds are the most likely institutional investors to engage in criticism and opposition of corporate management); Rock, supra note 1, at 450
Moreover, like public companies, they aggregate the capital of retail investors and are the subject of extensive federal regulation. I therefore refer to mutual funds and public pension funds collectively as "public equity funds."

Despite their obvious promise, however, most institutional investors have remained stubbornly passive. As explained in Part I of this Article, banks and insurance companies suffer from too many conflicts of interest to oppose management prerogatives. The same is true for private pension funds, those that are sponsored by corporate employers. Meanwhile, despite being free from most obvious conflicts, public equity funds generally prefer to follow the Wall Street Rule—sell when performance begins to lag—rather than expend resources to influence corporate policy.4

Not all institutional investors are passive, however. As demonstrated in Part II, venture capital, leveraged buyout ("LBO") and certain hedge funds5—known collectively as private equity funds—are the antithesis of passive investors. Denoted the "kings of capitalism" by The Economist, they generally seek to acquire control over a limited number of target companies in order to actively direct corporate policy.6 In other words, they compete based on their relative ability to squeeze agency costs out of inefficient companies.7

("The heads of public employee pension funds have become high profile players in the corporate governance process.").

4. See K.A.D. Camara, Classifying Institutional Investors, 30 J. CORP. L. 219, 230 (2005) (observing that mutual funds have no preference between improving the value of a portfolio company and selling to invest elsewhere).

5. In recent years, hedge funds have increasingly invested in leveraged buyouts and other traditional private equity transactions. See SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 33 (2003), available at http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter SEC HEDGE FUND REPORT] (noting that a number of hedge funds "adopt traditional, long-only strategies similar to those used by most registered investment companies"); see also Alan Murray, Hedge Funds Are New Sheriffs of Boardroom, WALL ST. J., Dec. 14, 2005, at A2 ("Any risk-averse company that wants to sit on a big pile of cash waiting for a rainy day is likely to find itself under quick attack from [hedge funds] that will come in, buy up stock, and agitate for change."); Emily Thornton & Susan Zegel, Hedge Funds: The New Raiders, BUSINESSWEEK, Feb. 28, 2005, at 32 ("Flush with hundreds of billions of dollars in cash from investors and hard-pressed to maintain the double-digit returns they promise as competition stiffens, many hedge funds are reinventing themselves as private investment firms..... [T]hey’re seizing control of companies."). Thus, to the extent a hedge fund invests in corporate equities with a view to acquiring control, it may properly be categorized as a private equity fund. See infra notes 203–207 and accompanying text. Notable examples of this trend include the acquisitions in 2004 and 2005 of American icons Sears and Kmart by ESL Investments. See infra note 207.


7. Industry insiders generally articulate this concept by noting that private equity funds compete based upon four factors: their access to deals, their access to leverage, their ability to manage costs, and their ability to pick deals. Considered from the light of corporate governance, however, it seems clear that at least the first
In doing so, they have effectively resolved corporate law’s fundamental agency problem by reuniting ownership and control. The result has been annual returns that can be as high as twenty to forty percent or more.

and last of these factors, and probably the third as well, are really just aspects of the broader competition to minimize agency costs. In other words, the term “deal” in this formulation must really be interpreted as meaning “deal that presents the opportunity to identify and minimize agency costs.” Thus, competition in actuality revolves around the fund managers’ ability to access and select (and manage) investment opportunities that present excess agency costs.

For examples of research supporting the industry’s success at minimizing agency costs, see George P. Baker & Karen H. Wruck, Organizational Changes and Value Creation in Leveraged Buyouts: The Case of the O.M. Scott & Sons Company, 25 J. FIN. ECON. 163, 189 (1989) (arguing that the pressure created by a high debt load and the incentives created by management equity ownership following an LBO lead to improved firm performance); Michael Jensen, Eclipse of the Public Corporation, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 65 (arguing that post-LBO companies have an incentive structure that is superior to that of public corporations); Krishna G. Palepu, Consequences of Leveraged Buyouts, 27 J. FIN. ECON. 247, 248–56 (1990) (summarizing the existing evidence and finding that leveraged buyouts create value through significant operating performance improvements); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, Hedge Fund Activism, Corporate Governance, and Firm Performance 31–32 (European Corporate Governance Inst., Finance Working Paper No. 139/2006, 2006), available at http://ssrn.com/abstract_id=948907 (finding that activist hedge funds create value for target company shareholders). See also JOSH LERNER, FELDA HARDYMON & ANN LEAMON, VENTURE CAPITAL & PRIVATE EQUITY: A CASEBOOK 1 (3d ed. 2005) (explaining that private equity funds “protect the value of their equity stakes by undertaking careful due diligence before making the investments and retaining powerful oversight rights afterwards”); Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. PA. L. REV. 1021, 1062–69 (2007) (discussing the nature of hedge fund monitoring); Walter Kiechel III, Private Equity’s Long View, HARV. BUS. REV., July–Aug. 2007, at 18, 19 (arguing that private equity managers, “in their treatment of the businesses they acquire, are merely putting to use many of the best ideas and analytic techniques that have been developed in the corporate strategy revolution”).

8. For background on the agency problem that lies at the heart of America’s separation of ownership and control, see infra Part IA.

9. See GEORGE P. BAKER & GEORGE DAVID SMITH, THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE 207–09 (1998) (reporting returns of twenty-five to forty percent on a portfolio of LBO investments); KEY TERMS AND CONDITIONS FOR PRIVATE EQUITY INVESTING 74 (William M. Mercer, Inc. ed. 1996) [hereinafter MERCER REPORT] (finding that “annual returns range from 0% to more than 30%, with an average of 10% to 20%, far surpassing that 9% to 10% average returns historically realized by common stock investors”); Michael Jensen, Active Investors, LBOs, and The Privatization of Bankruptcy, 2 J. APPLIED CORP. FIN. 35, 39 (1989) (testifying to Congress that returns on successful LBOs ranged from forty percent to fifty-six percent); Greg Ip & Henny Sender, Cash Machine: In Today’s Buyouts, Payday for Firms is Never Far Away, WALL. ST. J., July 25, 2006, at A1 (reporting that buyout funds had average annual returns of twenty-four percent in 2004 and 2005, triple the return of the S&P 500). In 2006, the nation’s highest paid hedge fund manager posted a forty-four percent return, net of fees, while the second and third posted returns of around thirty percent and twenty-four and one-half percent, respectively. Stephen Taub, Top 25 Moneymakers: The New Tycoons, ALPHA, Apr. 2007, at 39, 42–43.
Surprisingly, however, most corporate governance scholars have thus far ignored the important role played by private equity funds.\textsuperscript{10} In fact, some have gone so far as to warn against attempts to imagine a counterfactual world with different legal rules that encourage institutional investor monitoring.\textsuperscript{11} Yet public and private equity funds are closely related in that both are simply pools of money that professional fund managers use to purchase securities on behalf of their investors. As a result, their different approaches to corporate governance create a sort of natural experiment that is unburdened by differences in culture or time.\textsuperscript{12} By contrasting the various characteristics and regulatory regimes impacting public and private


\textsuperscript{11} See Bernard S. Black, \textit{Agents Watching Agents: The Promise of Institutional Investor Voice}, 39 \textit{UCLA L. Rev.} 811, 830–31 (1992) (“We can’t today answer the counterfactual questions: How much monitoring would the institutions do if legal rules were different? How valuable is institutional oversight?”); see also Donald G. Langevood, \textit{Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty}, 83 \textit{Wash. U. L.Q.} 1017, 1019, 1031–32 (2005) (arguing that the unique features of mutual fund governance suggests that “judges and policymakers should not even try to reason by analogy to governance in other kinds of corporations”).

\textsuperscript{12} This term was used by Coffee to describe a comparison between U.S. capital markets and those of Great Britain, the foreign economy most closely resembling that of the United States. John C. Coffee, Jr., \textit{The SEC and the Institutional Investor: A Half-Time Report}, 15 \textit{Cardozo L. Rev.} 837, 844 (1994). However, the dichotomy between public and private equity funds is superior and presents a cleaner comparison than either a historical or cross-cultural analysis. While such comparisons are undoubtedly helpful and provide valuable insights, they suffer obvious impediments resulting from differences in culture, history and language. See Roberta Romano, \textit{A Cautionary Note on Drawing Lessons from Comparative Corporate Law}, 102 \textit{Yale L.J.} 2021, 2036 (1993) (noting that it is difficult to judge which country’s system produces the best economic performance); see also Edward B. Rock, \textit{America’s Shifting Fascination with Comparative Corporate Governance}, 74 \textit{Wash. U. L.Q.} 367, 368 (1996) (tracing the emerging interest of comparative corporate governance scholarship). For this reason, this Article does not attempt to draw any conclusions based on the distinctions between American private equity markets from those of Europe or Asia.
equity funds, I seek to uncover in Parts III and IV important insights about the continued passivity of public equity funds.

My thesis is that the key difference between public and private equity funds lies in the types of compensation that fund managers are permitted to charge. Private equity fund managers charge a fee based on performance, typically retaining for themselves twenty percent of any profits they produce through effective corporate oversight. By contrast, the individuals who administer mutual funds and public pension funds are generally limited to charging a flat percentage fee based on the assets they manage. Thus, whereas managers of private equity funds are entitled to share directly in any profits that accrue from efficient monitoring, public equity fund managers have at best an indirect incentive to monitor. Indeed, with mutual fund fees generally peaking at around one or two percent of assets under management, the costs of shareholder activism are almost certain to outweigh such limited benefits.

Put succinctly, private equity funds invest in active corporate monitoring because the structure of their compensation provides their managers with a direct financial incentive to do so. As I argue in Part V, it is not only the high cost of oversight that discourages monitoring, as some scholars have suggested, but the fact that monitoring is not profitable for the fund managers in light of such costs. Like their public company brethren, public equity funds are fictional legal entities that suffer from their own internal agency problems, with the interests of fund managers and their investors often differing. Permit the fund managers to share in the profits from monitoring and you give them a direct financial interest in more active oversight. The result would be to engage public equity

13. John Coffee made the same point. See Coffee, supra note 2, at 1362–63 (arguing that the compensation of public equity fund managers “does little to align incentives between the manager and the fund it serves . . . incentive compensation based on capital appreciation would work far better”). However, this Article takes Coffee’s argument one step further, by expressly comparing the fee structure of public equity funds with that of private equity funds. It also extends the argument by concluding that deregulating fund manager compensation would have the effect of fostering a system of institutional investor control, not merely voice. Cf. Paul G. Mahoney, Manager-Investor Conflicts in Mutual Funds, 18 J. ECON. PERSP. 161, 179–80 (2004) (raising the possibility of trying to “harness the monitoring efforts of institutional investors for the benefit of unsophisticated investors” by relaxing the restrictions on incentive compensation); Jesse Eisinger, Long & Short: Pay-for-Performance Bedevils Mutual Funds, WALL ST. J., Apr. 13, 2005, at C1 (arguing that more mutual funds should copy hedge funds in adopting performance fees).
14. See infra Part II.D.
15. See infra Part IV.C.3.
16. Rock, supra note 1, at 469–72 (describing the agency problem existing between public equity fund money managers and their depositors); see also infra Part V.A (examining existing incentives for public equity fund managers).
funds, with their vast store of retail dollars, in competition to impose greater discipline on corporate managers. Indeed, the continued willingness of sophisticated investors to pay the outsized fees of private equity fund managers attests to the power of their compensation model.

In addition to my primary thesis, an important theme of this Article is that a system characterized by institutional investor voice—as opposed to institutional investor control—would be too subtle to succeed. Voice is the term used by scholars to describe a system wherein shareholders are limited to small, fractional stakes but able to combine their energies so as to wield greater collective influence over management. It can be contrasted to the private equity model of acquiring direct control over individual corporations in order to dictate policy. However, the relatively minor benefits attainable through the exercise of voice may not be sufficient to justify the increased expense. Rather, the impetus to monitor requires a much greater incentive: that which comes from exercising control. Thus, it may not be possible to obtain the benefits sought by proponents of increased voice without going one step further and adopting a system of institutional investor control.

Before continuing to the substance of my argument, it is important to note that a significant debate continues with respect to the advisability of enlisting institutional investors as corporate monitors.

17. See, e.g., Black, supra note 11, at 816 (“Institutional voice means a world in which particular institutions can easily own 5–10% stakes in particular companies, but can’t easily own much more than 10%; in which institutions can readily talk to each other and select a minority of a company’s board of directors, but can’t easily exercise day-to-day control or select a majority of the board.”). Under some circumstances, the term “shareholder voice” may also include informal means of communication between shareholders and corporate managers occurring outside of the formal voting and proxy system but aimed at and supported by the corporate franchise. Black, supra note 2, at 522 n.3. It is sometimes used synonymously with the concept of “investor capitalism.”

18. Part of the explanation for the persistence of our current system of corporate governance may be attributable to a lingering discomfort among scholars and policymakers with the notion of financial institutions exercising control over major American corporations. This, of course, is exactly the point that Mark Roe made with respect to the nation as a whole. See Roe, supra note 2, at 11 (“Opinion polls show Americans mistrust large financial institutions with accumulated power and have always been wary of Wall Street controlling industry.”); see also Kahan & Rock, supra note 7, at 1042–45 (comparing the nature of hedge fund activism favorably to the more traditional types of monitoring engaged in by public equity funds).

19. To borrow John Coffee’s typically colorful prose:

One side in this debate tends to see institutional investors essentially as Gulliver tied down by a host of Lilliputian regulations. . . . Free Gulliver, they argue, and the market will work. The other side not only believes that the market today is working satisfactorily, but that it is threatened by . . . [a] nightmarish vision of the future . . . in which invisible coalitions of institutional investors can form virtually overnight . . .
A group of reform-minded scholars, among them Black, Roe and Lucian Bebchuk, believe that federal proxy regulations should be amended to lower the costs associated with institutional investor activism. For them, managers remain unaccountable and the increased discipline that would likely come with greater institutional shareholdings would be a net positive. By contrast, a great many scholars, many of them prominent in the law and economics movement, believe otherwise. There is also a related question as to whether activist monitoring strategies would impose undue risk on the retirement savings of retail investors. Finally, not everyone

Coffee, supra note 12, at 842. For an assessment of some of the risks associated with institutional investor monitoring, see id. at 871–75; Coffee, supra note 2, at 1329–36. See also Roe, supra note 2, at 53–67 (“Concentrated financial capital does not mix well with a broad-based egalitarian democracy in which interest groups can acquire great influence . . . .”).

20. Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 HARV. L. REV. 833, 835–36 (2005) (advocating proxy reform in order to encourage the exercise of institutional investor voice); Black, supra note 11, at 812–15 (arguing that institutional investor oversight of corporate wrongdoing is not only possible but desirable); see Roe, supra note 2, at 15 (noting that when General Motors faced bankruptcy due to mismanagement in the 1920s, Pierre DuPont—who owned twenty-five percent of GM—relocated to Detroit and reorganized the company without a proxy fight or hostile takeover (citing ALFRED D. CHANDLER, JR. & STEPHEN SALISBURY, PIERRE S. DU PONT AND THE MAKING OF THE MODERN CORPORATION 457–560 (1971))); see also Melvin Aron Eisenberg, Access to the Corporate Proxy Machinery, 83 HARV. L. REV. 1489, 1502–17 (1970) (arguing at an early date that five-percent shareholders should be entitled to use management’s proxy materials); Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863, 883–92 (1991) (recommending a program of increased institutional investor activism).


22. See Thomas A. Smith, Institutions and Entrepreneurs in American Corporate Finance, 85 CAL. L. REV. 1, 5 (1997) (arguing that the primary purpose of institutional investors is to shield their customers from undue risk). But see Gregory S. Alexander, Pensions and Passivity, 56 LAW & CONTEMP. PROBS. 111, 112 (1993) (arguing that the regulation of retirement plans combines passivity with paternalism in a manner that “denies pension participants the political and moral virtues that historically have been associated with the two great models of ownership that have competed since the nineteenth century: liberalism and socialism”).
believes that private equity funds have a positive impact on either the companies in which they invest or society as a whole. 23

I do not attempt to answer such questions in this Article, nor do I attempt to make any type of cross-cultural analysis of foreign regulatory systems. Rather, the purpose of this Article is to provide a roadmap for those who would enlist public equity funds as monitors of corporate America, thereby bringing retail investment dollars into the market for good corporate governance. Existing research on public equity funds provides an inadequate explanation for their continued passivity. Thus, my goal is to advance the scholarly thinking on the subject by offering a new methodology of comparison and a new exemplar of corporate discipline.

Private equity funds engage in the kind of aggressive monitoring that is absent from the investment strategies of most public equity funds. By building on their example, regulators can fundamentally alter the relationship between corporate managers and their shareholders. In particular, they can help promote a competitive marketplace for good corporate governance.

I. INSTITUTIONAL INVESTOR MONITORING

Part I of this Article explores the puzzle presented by public equity funds: given their size and resources, why have they remained such passive investors? After presenting some general background on corporate governance in Part I.A, Parts I.B and I.C review the existing scholarship regarding institutional investor monitoring. Part I.D then considers various efforts that have been undertaken to reform the federal proxy system in order to encourage public equity funds to engage more actively in oversight activities. Finally, Part I.E examines the current landscape and concludes that, even after substantial legal reform and scholarly attention, public equity funds remain as stubbornly passive today as when they were first “discovered” by scholars in the early 1990s.

23. As an example, a number of legal scholars have been critical of the structure of leveraged buyouts undertaken by LBO funds. See Patricia L. Bryan, Leveraged Buyouts and Tax Policy, 65 N.C. L. REV. 1039, 1041–42 (1987) (summarizing arguments against LBOs); see also Victor Bradley & Marvin A. Chirelstein, A Restatement of Corporate Freezeouts, 87 YALE L.J. 1354, 1366 (1978) (arguing that LBOs offer little more than an opportunity for management to benefit at the expense of stockholders); Dale Arthur Oesterle & Jon R. Norberg, Management Buyouts: Creating or Appropriating Shareholder Wealth?, 41 VAND. L. REV. 207, 218–23 (1988) (summarizing potential abuses of the use of leverage).
A. Background

It is by now an old and familiar story that America’s system of corporate governance is characterized by a separation of ownership and control. As we have known since the 1930s, shareholders, despite being the corporation’s residual claimants, possess little to no direct power over the officers and directors who control its day-to-day affairs.\(^{24}\) The cause is atomization: unlike their counterparts in Europe and Japan, American shareholders tend to own small, fractional stakes in any given corporation, preferring instead to diversify their investments across a wide number of stocks.\(^{25}\)

The result of our system of dispersed share ownership is a collective action problem that leads inexorably to rational shareholder apathy.\(^{26}\) For any one shareholder, the cost of monitoring corporate management almost certainly outweighs the potential benefits.\(^{27}\) This

\(^{24}\) Adolph A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932) (offering the first complete description of the separation of ownership and control); see also Bainbridge, Politics, supra note 21, at 674–78 (arguing that “shareholders of a public corporation have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation’s agents”). This separation has been embedded in the corporate statutes of all fifty states in the statutory delegation of power to the board of directors. See, e.g., Del. Code Ann., tit. 8, § 141(a) (2001) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .”); Model Bus. Corp. Act § 8.01(b) (2005) (“All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors . . . .”).

\(^{25}\) See Roe, supra note 2, at 12–16 (recounting the traditional Berle-Means story). The American system is often contrasted with those of Germany and Japan. In Germany in 1985, for example, banks effectively exercised control over thirty-four percent of the voting power of the top one hundred companies, and over fifty percent of the voting power of the top ten. Coffee, supra note 2, at 1303. Japanese financial institutions have similarly dominated industrial firms through the keiretsu system. Id. at 1294–1302. See generally John C. Coffee, Jr., The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications, 95 NW. U. L. Rev. 641, 641 (1999) (noting that “contemporary empirical evidence finds that, even at the level of the largest firms, dispersed share ownership is . . . largely limited to the United States and Great Britain”).

\(^{26}\) For a superb explication of corporate law’s agency problem and collective action problem from the law and economics tradition, see Rock, supra note 1, at 453–63 (summarizing the work of Mancur Olson, Russell Hardin, Albert Hirschman and others). See also Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organizations, 62 Am. Econ. Rev. 777, 788 (1972) (arguing that it is neither desirable nor feasible for individual shareholders to participate in each decision in a corporation); Black, supra note 2, at 526 n.10 (cataloguing law and economics scholarship that views passivity as inevitable and therefore opposes legislative efforts to reform the proxy system).

\(^{27}\) Roe gives the example of the shareholder who owns $10 million of the stock of a $10 billion company. Such investor should rationally decline to invest $100,000 in monitoring activities even if such amount would create $100 million in additional value for the company. Roe, supra note 2, at 14.
is because those benefits must be shared pro rata with one's fellow shareholders. Thus, when an investment turns sour, American shareholders rationally prefer to sell their shares rather than attempt to influence management to improve its performance.\(^{28}\)

The fundamental problem of corporate law is that this separation of ownership and control causes the interests of shareholders and managers to diverge, thereby producing agency costs.\(^{29}\) For example, shareholders would generally prefer that managers work diligently, competently, honestly and efficiently. Managers, on the other hand, often use their discretion over a corporation’s affairs to benefit themselves, either through lawful mechanisms such as high salaries and lavish benefits, or occasionally through unlawful means such as occurred most recently and spectacularly at the likes of Enron and WorldCom.\(^{30}\) The result is a loss of value for shareholders and a disincentive for the optimal level of investment.\(^{31}\)

Admittedly, the traditional image of countless small investors each owning a few isolated shares is outdated.\(^{32}\) Today, over sixty percent of all securities in the United States are held by large and

28. See generally Black, supra note 2, at 526-29 (describing what he terms “The Passivity Story”).

29. ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 1 (1970) (“Under any economic, social, or political system, individuals, business firms, and organizations in general are subject to lapses from efficient, rational, law-abiding, virtuous, or otherwise functional behavior. No matter how well a society’s basic institutions are devised, failures of some actors to live up to the behavior which is expected of them are bound to occur. . . .”); Stephen M. Bainbridge, Shareholder Activism and Institutional Investors 7 (UCLA School of Law, Law-Econ Research Paper No. 05-20, 2005), available at http://ssrn.com/abstract=796227 (arguing that “agency costs are the inescapable result of placing ultimate decision-making authority in the hands of someone other than the residual claimant”).


32. See Black, supra note 2, at 523 (“The passivity story also assumes a company with thousands of anonymous shareholders, each owning a tiny fraction of the company’s voting stock. That assumption, never wholly true, is increasingly obsolete. Institutional investors have grown large enough so that a limited number of institutions own a sizeable percentage of the shares of most public companies.”).
sophisticated institutional investors. However, so long as institutional investors continue to pursue passive investment strategies, the fact of their higher ownership percentages will remain largely irrelevant for corporate governance purposes. Their function is to provide retail investors with the benefits of a diversified portfolio, not to act on their own behalf as independent players in the financial markets. For most companies, then, ultimate beneficial ownership remains widely dispersed.

Moreover, the underlying agency problem has been exacerbated because management has used its power over the corporate purse to protect itself from outside discipline. Not only is management’s discretion increasingly shielded by the business judgment rule, for


34. See Allan F. Conwill, Blight or Blessing? The Wharton School Study of Mutual Funds, 18 BUS. LAW. 663, 667 (1963) (“[A]n investor of moderate means cannot achieve the diversification provided by most funds by individual investment in selected stocks. Unless he has substantial funds available, he cannot buy each of the one hundred or more securities which are in the portfolio of the typical mutual fund. Thus, the mutual fund provides the modest investor with an easy and convenient vehicle for achieving diversification.”); Mahoney, supra note 13, at 180 (“Mutual funds give investors the benefit of diversification and, if the fund is actively managed, professional money management.”); Smith, supra note 22, at 5 (arguing that the primary purpose of institutional investors is to shield their customers from undue risk via diversification).

35. The business judgment rule is a presumption that managers, when making a business decision, do so “on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company.” Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). It is generally understood as protecting managerial discretion by barring courts and shareholders from second-guessing board decisions unless certain exceptions apply. See ROBERT CHARLES CLARK, CORPORATE LAW 123 (1986) (noting that “the mere mention of the business judgment rule brings smiles of relief to corporate directors”). The adoption by the Delaware legislature of section 102(b)(7), which authorizes corporations to limit or eliminate the personal liability of directors for breaches of their fiduciary duty of care, as well as recent caselaw regarding the duty of good faith, appear part of a trend to minimize the impact of those exceptions. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); Stone v. Ritter, 911 A.2d 362, 372–73 (Del. 2006) (holding that defendant directors could not be found liable for failing to prevent employee actions that led to $50 million in fines because the directors had exercised their oversight responsibility in good faith by implementing what the court considered a reasonable reporting system, despite the fact that the system had ultimately proven to be ineffective); In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006) (holding that the business judgment rule protected the actions of directors of The Walt Disney Company in agreeing to terminate then-president Michael Ovitz on a no-fault basis, thereby allowing him to
example, but managers have shown themselves to be adept at manipulating politics and the press, as well as at co-opting their leave the company with a lucrative severance package); Brehm v. Eisner, 746 A.2d 244, 267 (Del. 2000) (holding that the business judgment rule protected the actions of directors of The Walt Disney Company in approving what plaintiffs characterized as an extravagant and wasteful employment agreement for Michael Ovitz as the company’s president).

For an interesting take on how existing law regarding the duty of care could be interpreted expansively, see Judd F. Sneirson, Doing Well by Doing Good: Leveraging Due Care for Better, More Socially Responsible Corporate Decisionmaking, 3 CORP. GOV. L. REV. 438, 468–69 (2007) (arguing that, in order to satisfy the duty of care, a manager must inform herself as to the environmental and social impacts of corporate decisions).

36. Management’s successful lobbying of state politicians during the “takeover wars” of the 1980s is well known and resulted in a wide variety of anti-takeover legislation. See, e.g., BNS, Inc. v. Koppers Co., 683 F. Supp. 458, 463 (D. Del. 1988) (summarizing the operation and effect of various anti-takeover statutes). Many of these statutes were written and adopted in haste at the request of a local firm that was facing the threat of a hostile takeover. According to Dale Oesterle:

When rumors circulated about a takeover of Boeing Corporation, for example, the Washington legislature met in emergency session and approved a bill, signed immediately by the governor, that had been drafted by Boeing counsel. Arizona state officials, at the request of Greyhound Corporation, introduced, adopted, and signed into law the Arizona Control Share Act in three days. It took Illinois only two days and Minnesota only one to pass their statutes. The governor of Massachusetts signed the Massachusetts statute in the offices of Gillette, a takeover target at the time. D ALE A. OESTERLE, THE LAW OF MERGERS AND ACQUISITIONS 615 (3rd ed. 2005). More recently, management has scored notable successes by quashing a proposal to significantly overhaul the proxy process and convincing the SEC to water down new rules on reporting executive compensation. With respect to the SEC’s proposed overhaul of the proxy system, see infra Part I.D. With respect to the rules on executive compensation, see Gretchen Morgenson, Weird and Weirder Numbers on Pay Reports, N.Y. TIMES, Mar. 11, 2007, (Sunday Business) at 1; John Schwartz, Transparency, Lost in the Fog, N.Y. TIMES, Apr. 8, 2007, at C1.

There has also been a great deal of lobbying aimed at lessening the impact of Sarbanes-Oxley on small businesses. See, e.g., Stephen Labaton, Investors’ Suits Face Higher Bar, Justices Decide, N.Y. TIMES, June 22, 2007, at A1 (reporting that, with the end of the Bush Administration looming, “industry groups and allies in academia have urged the Administration, Congress and regulators to make it harder for investors and consumers to sue companies [and] have also sought to relax some of the provisions in the Sarbanes-Oxley Act of 2002”). In fact, until the failure of WorldCom, it appeared that management might be successful in staving off any effort at reform proposed in the wake of Enron’s collapse. Ironically, one event that may have helped to change the then-dimming prospects for reform was a speech by President Bush that was intended to reassure markets but that instead coincided with a sharp fall on Wall Street. See David E. Sanger, How a Clear Strategy Got Muddy Results, N.Y. TIMES, July 12, 2002, at C1 (noting that the Dow Jones industrial average dropped 473 points, or five percent, in the three days following the President’s speech); see also Floyd Norris, Real Reform: What Bush Might Have Said, N.Y. TIMES, July 12, 2002, at C1 (suggesting that a speech proposing stronger corporate reforms would have gotten a better market reception); David E. Sanger & David E. Rosenbaum, White House Moves to Limit Corporate Scandals’ Fallout, N.Y. TIMES, July 25, 2002, at A1 (describing political maneuvering by the Bush Administration aimed at containing fallout from the accounting scandals and the volatile stock market). The Senate approved its version of Sarbanes-Oxley 97–0 only hours after a second speech by President Bush, this one in Birmingham, Alabama, in which he again attempted to reassure investors even as the Dow Jones industrial average plunged another 440
supposed gatekeepers. In the judicial arena, corporate managers continue to score impressive victories against class action lawsuits, including the recent Supreme Court decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* They have apparently “won” the takeover wars, effectively insulating themselves from all but the most costly of proxy points. David E. Sanger & Richard A. Oppel, Jr., *Senate Approves a Broad Overhaul of Business Laws,* N.Y. TIMES, July 16, 2002, at A1.

37. Corporate public relations efforts currently appear aimed at laying the groundwork for a further rollback of Sarbanes-Oxley. They are spreading the notion that America’s share of the worldwide initial public offering (“IPO”) market is being diminished by its draconian recordkeeping and certification requirements. See, e.g., Stephen Labaton, *Is the S.E.C. Changing Course?* N.Y. TIMES, Mar. 1, 2007, at C1 (reporting on a speech by SEC Chairman Christopher Cox in which Cox blames Sarbanes-Oxley for America’s perceived loss of IPO market share). In fact, America’s share of global stock-market activity has increased, rather than fallen, over the past decade, with the U.S. market for equities growing at almost twice the pace of many foreign exchanges. See James Surowiecki, *The Financial Page: Over There,* NEW YORKER, Feb. 5, 2007, at 29; see also Greg Ip, *Maybe U.S. Markets Are Still Supreme,* WALL ST. J., Apr. 27, 2007, at C1 (reporting on a study conducted by investment management scholars Andrew Karolyi, Rene Stulz, and Craig Doidge, which concluded that there is no evidence that Sarbanes-Oxley has led to foreign companies listing their shares in London instead of New York). For an almost farcical example of management’s manipulation of the media, see *Stewart’s Prison Life: Martha Popular with Lunch Crowd,* NEWSDAY, Nov. 29, 2004, at A12 (painting a domestic picture of prison life for “the famous homemaker” by highlighting the fact that she was serving time—and having lunch—with an anti-war Catholic nun).

38. See, e.g., JOHN C. COFFEE, JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* 55–56 (2006) (summarizing several theories explaining the failure of gatekeepers—auditors, attorneys, etc.—to avoid the scandals at Enron and WorldCom, including the theory that corporate managers pressured or seduced their advisers into abetting their wrongdoing). Post-Sarbanes-Oxley examples of apparently legal manipulation by management include using record-breaking corporate profits to redeem shares—and hence push up the value of management stock options—rather than make capital or other long-term investments, and deliberately underestimating corporate profits so as to minimize the risk of liability for a subsequent restatement of financial reports. See, e.g., Buttonwood: *Companies Are Buying Back Their Own Shares at a Record Rate,* ECONOMIST, Apr. 28, 2007, at 87 (noting that “businesses are buying back shares, rather than investing in new plant and equipment”); Paul Krugman, Editorial, *Another Economic Disconnect,* N.Y. TIMES, Apr. 30, 2007, at A21 (“Instead of investing in physical capital, many companies are using profits to buy back their own stock. And cynics suggest that the purpose of these buybacks is to produce a temporary rise in stock prices that increases the value of executives’ stock options, even if it’s against the long-term interests of investors.”); Floyd Norris, *Why Won’t Companies Invest More?* N.Y. TIMES, Apr. 27, 2007, at C1 (quoting public remarks by Robert W. Parenteau, the chief U.S. economist and strategist for a subsidiary of Allianz, the German bank and insurance company, to the effect that American companies are using historically high corporate profits to buy back shares, thereby pushing up the value of management stock options).

39. 127 S. Ct. 2499 (2007) (ruling 8–1 that shareholders must show “cogent and compelling evidence” of intent to defraud in order to sustain a securities class action lawsuit); see also Linda Greenhouse, *In Steps Big and Small, Supreme Court Moved Right,* N.Y. TIMES, July 1, 2007, at A1 (quoting an executive at the National Chamber Litigation Center, which represents the U.S. Chamber of Commerce in the Supreme Court, as stating that the 2006–2007 Roberts Court was “our best Supreme Court term ever”); Stephen Labaton, *Investors’ Suits Face Higher Bar, Justices Decide,* N.Y. TIMES, June 22, 2007, at A1 (discussing *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*).
contests and generally reducing even successful shareholder proposals to a merely advisory role. 40 Even the adoption of the Sarbanes-Oxley Act in 2002 has had only marginal impact on the level of managerial accountability. 41

As Mark Roe has demonstrated, however, the American system is most likely the product of a political choice, rather than an inevitable result of market or other historical forces. 42 Americans appear to have long distrusted large accumulations of capital, fearing the power of wealth more than they feared the power of industrial capacity. 43 As a result, over the years, American corporate law has slowly accumulated a series of rules that discourage shareholders from acquiring more than five (or sometimes ten) percent of any given corporation. 44 The separation of ownership and control has thus

40. See Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 STAN. L. REV. 857, 858 (1993) (announcing famously: “The takeover wars are over. Management won.”). For a recent example of the ability of a corporate board to thwart a takeover attempt that is popular with its shareholders, see Gretchen Morgenson, A Board That Knows Two Words: NoSale, N.Y. TIMES, July 8, 2007, (Sunday Business) at 1 (reporting on a $400 million offer for Midwest Air Group: “While Midwest’s stockholders are jumping up and down for the deal, its directors have staunchly rejected it. As a result, some Midwest shareholders wonder whether the board is performing its duty to the company’s owners or acting instead to benefit a management with whom it has long been associated.”).

41. See, e.g., George W. Dent, Jr., Corporate Governance: Still Broke, No Fix in Sight, 31 J. CORP. L. 59, 60 (2005) (arguing that Sarbanes-Oxley set modest goals—deterring and catching illegal acts—and is still unlikely to meet them); Robert W. Hamilton, The Crisis in Corporate Governance: 2002 Style, 40 HOU. L. REV. 1, 49-52 (2003) (describing the mostly unfavorable reactions of commentators following enactment of the Sarbanes-Oxley Act). For a more critical view of the Act, see Robert Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 YALE L.J. 1521, 1602 (2005) (“An extensive empirical literature suggests that the mandates [imposed by the Sarbanes-Oxley Act] were seriously misconceived, because they are not likely to improve audit quality or otherwise enhance firm performance and thereby benefit investors as Congress intended.”).

42. Roe, supra note 2, at 10. Roe has also extended his analysis of the political roots of corporate governance and applied it to the international stage. E.g., Mark J. Roe, Political Determinants of Corporate Governance: Political Context, Corporate Impact (2003); Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994).

43. See Roe, supra note 2, at 31–55 (arguing that restraints on the power of institutional investors arose from a combination of populist distrust of financial institutions, interest group politics, and the federalist structure of the American constitution); see also Joseph A. Grundfest, Subordination of American Capital, 27 J. FIN. ECON. 89, 89–90 (1990) (stating that the theme behind state and federal government efforts to limit investors’ influence over the governance of publicly traded corporations is that “society cannot trust stockholders and bondholders to promote the ‘public interest’”). But see Coffee, supra note 2, at 1280 (arguing that “the populist image of a domineering J.P. Morgan seems to have been forever erased from the public’s mind” and that bank weakness, not bank strength, is the greater concern).

44. See Roe, supra note 2, at 11 (arguing that “American law and politics deliberately diminished the power of financial institutions to hold the large equity blocks that would foster serious oversight of managers”); see also Bainbridge, supra
become deeply embedded in the fundamental workings of our legal system.

And yet, despite Roe’s admonition, much of the history of corporate governance reform has been directed at empowering some intermediary body to serve as a check against excessive managerial discretion.\textsuperscript{45} Thus, scholars and policymakers have, at various times and often at the same time, sought to enlist independent directors,\textsuperscript{46}

---

\textsuperscript{45} See, e.g., Black, supra note 11, at 817 (explaining that “institutional voice means asking one set of agents (money managers) to watch another set of agents (corporate managers)”). It is worth noting that this search for an effective monitor has not been linear, nor has it focused exclusively on one agent. Rather, it has jumped from agent to agent, occasionally re-discovered a previously discarded agent, and often taken a shotgun approach, seeking to enlist the power of several monitors at once. See, e.g., Coffee, supra note 38, at 1–5 (attempting to enlist as monitors, simultaneously, auditors, attorneys, securities analysts, credit rating agencies, and investment bankers, among others).

At the same time, it should also be recognized that there has been a countervailing push to expand managerial discretion and thus insulate managers from what is sometimes viewed as too much oversight. See, e.g., Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547, 550–74 (2003) (presenting a theory of corporate governance, director primacy, which is based on the notion that “the board of directors is not a mere agent of the shareholders, but rather is a \textit{sui generis} body—a sort of Platonic guardian”). This trend can be seen, for example, in the expansion of the business judgment rule and the more recent rollback of the fiduciary duties of care and good faith. See supra note 35 (discussing Delaware caselaw that expanded protections for corporate directors). In a more practical application of the trend, the founders of Google, Larry Page and Sergey Brin, took an unconventional approach to broad managerial discretion when they inserted in their IPO registration statement a letter to investors stating that its corporate structure “is likely to leave [the management team] with significant control over the company’s decisions and fate . . . . New investors will fully share in Google’s long term growth but will have less influence over its strategic decisions than they would at most public companies.” Letter is Manifesto of Founders, WALL ST. J., Apr. 30, 2004, at A10; see also Holman W. Jenkins, Jr., Google Baloney, WALL ST. J., May 5, 2004, at A15 (critiquing Google’s efforts to “entrench insiders in control of the company” when it went public in 2004); Richard Waters, Google in Plan for $2.7 Bn Flotation, FIN. TIMES, Apr. 30, 2004, at A1 (describing Google’s unusual stock offering).

\textsuperscript{46} See, e.g., Jay W. Lorsch with Elizabeth MacIver, Pawns or Potentates: The Reality of America’s Corporate Boards 173–75 (1989) (recommending a reduced role for the CEO in selecting directors as a way to increase director independence and thereby improve corporate governance); Gilson & Kraakman, supra note 20, at 883–92 (proposing that institutional investors take an active role in electing independent, professional directors). But see, e.g., Victor Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597, 658 (1982) (analyzing past performance of independent directors and concluding that it is unrealistic to suggest that the independent director can be successful in fostering social responsibility). For a more nuanced view, see Donald Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 Geo. L.J. 797, 810–14 (2001) (arguing that the small group
hostile raiders, debtholders, institutional investors, and, most recently, gatekeepers as substitute corporate monitors. The idea has been that, if it is impossible to completely align the interests of shareholders and managers, it may be possible to better align the interests of shareholders and these various market players, thus minimizing overall agency costs. In effect, by seeking to interpose a

dynamics of the board could be disrupted by too great a concentration of independent directors).

47. See Grundfest, supra note 40, at 869–73 (discussing the power of takeovers as a disciplinary mechanism); see also Roberta Romano, A Guide to Takeovers: Theory, Evidence and Regulation, 9 YALE J. ON REG. 119, 122–33 (1992) (analyzing two value-maximizing efficiency explanations of takeovers: realizing synergy gains and reducing agency costs); Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. POL. ECON. 110 (1965) (arguing that takeovers protect the interests of non-controlling shareholders by providing some assurance of efficiency among corporate managers).

48. See Baker & Wruck, supra note 7, at 163, 169 (arguing that the pressure of servicing a high debt load following an LBO leads to improved firm performance); Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323, 324 (1986) (arguing that a high debt load forces managers to become more disciplined in order to make periodic debt payments and meet quarterly financial goals); see also George G. Triantis & Ronald J. Daniels, The Role of Debt in Interactive Corporate Governance, 83 CAL. L. REV. 1073, 1080 (1995) (proposing a theory of interactive corporate governance that is not centered on equity). But see Roe, supra note 2, at 29 (noting that creditors tend to avoid exercises control because of the increased risk of liability).

49. See, e.g., Black, supra note 11, at 812–17 (arguing that legal reforms should be undertaken to facilitate oversight by institutional investors); Coffee, supra note 2, at 1336 (stating that the benefits of institutional monitoring would outweigh the costs).

50. See Coffee, supra note 38, at 6–8 ("Effective corporate governance requires a chain of actors: directors, managers, and gatekeepers.").

51. It is important to note, however, that an alternative thread of corporate law reform has been aimed at reducing agency costs by effectively reuniting ownership and control. See, e.g., Jensen & Meckling, supra note 31, at 309 (stating that "the issues associated with the 'separation of ownership and control'... are intimately associated with the general problem of agency"). For example, a number of scholars have argued that business executives should be compensated primarily through grants of stock options that would serve to better align the interests of managers and shareholders. See Michael C. Jensen & Kevin J. Murphy, CEO Incentives—It's Not How Much You Pay, But How, HARV. BUS. REV., May–June 1990, at 138–39 (arguing that basing CEO salaries on a pay for performance structure would lead to a substantial increase in corporate performance). Charles Elson has extended this argument to directors, and it was picked up by Bill Clinton as far back as his initial bid for the presidency. Charles M. Elson, Director Compensation and the Management-Captured Board: The History of a Symptom and a Cure, 50 SMU L. REV. 127, 164–73 (1996). It has since been incorporated into the federal tax code. See I.R.C. § 162(m) (2007) (imposing an excise tax on compensation paid to certain "covered employees" to the extent it exceeds $1 million, other than "remuneration payable solely on account of the attainment of one or more performance goals" including stock options).

More recently, options have come under attack as creating perverse incentives for managers. See, e.g., Roger L. Martin, Taking Stock, HARV. BUS. REV., Jan. 2003, at 19 ("Motivating managers with company stock can do damage on a grand scale, encouraging them to pursue strategies that fatten their wallets at shareholders' expense."); M. P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, The Economic Impact of Backdating of Executive Stock Options, 105 MICH. L. REV. 1597, 1605–07 (2007) (noting that when a manager participates in backdating, "shareholders may be
monitor between shareholders and managers, each of these reform efforts has sought to convert our two-tiered system of corporate governance into something more closely approximating a three-tiered system. Rather than merely involve managers and shareholders, such a system would involve managers, shareholders and monitors. Each such effort, however, has disappointed, been the object of easy manipulation, or been defeated politically. Corporate managers therefore remain largely free of any significant oversight and the goal of enlisting an outside corporate monitor has remained both elusive and ongoing. Thus, because shareholders are unable to discipline errant managers on their own, a new monitor is required to engage in discipline and oversight on their behalf.

B. The “Discovery” of Public Equity Funds

Near the end of the 1980s, observers had begun to realize that the much-heralded market for corporate control would fail as a mechanism for causing managers to adhere more closely to
shareholder interests. By then, corporate managers had begun to successfully fight back against most unfriendly takeover attempts. Thenceforth, they would be protected by a combination of poison pills, staggered boards, and the wide discretion granted them by the business judgment rule. If management discretion was to be checked, a different monitor was clearly needed.

Enter the institutional investor. By the early 1990s, a series of forces had conspired to generate the incredible vastness that now epitomizes banks, insurance companies, mutual funds and pension

54. See, e.g., Black, Empirical Evidence, supra note 10, at 896 (noting that “hostile takeovers are nearly dead, killed by a combination of lender retrenchment and political hostility. And hostile bids were no panacea: our corporate landscape is still littered with the carcasses of the overpriced deals of the late 1980s”); Grundfest, supra note 40, at 858 (“Although hostile tender offers remain technically possible, the legal and financial barriers in their path are far higher today than they were a few short years ago. As a result, it will be difficult for hostile bidders to prevail in takeover battles, even if shareholders support the insurgents’ efforts.”); see also Coffee, supra note 2, at 1278 (noting the changes in academic thinking that were arising even “[a]s the takeover wave of the 1980s ebbs”). A mere four percent of deals struck in 2000 were either hostile or unsolicited, although that number has climbed back up to twenty percent in 2007. The Global Merger Boom: The Beat Goes On, ECONOMIST, May 12, 2007, at 77. Interestingly, the decline in takeover activity may also have encouraged academics to consider the question of the role that politics—as opposed to markets—play in shaping corporate governance. Coffee, supra note 2, at 1278.


56. In order to combat the efficacy of the poison pill, bidders began in the late 1980s to combine tender offers with proxy fights. The idea was that, after a successful proxy fight, the new directors could redeem the pill, thereby permitting the tender offer to move forward. This was the strategy at issue in Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988). In order to thwart this strategy, companies began having staggered boards, so that it would take two successive proxy contests to take control of the board. This combination, together with the protection of the business judgment rule, has proved almost unbeatable. See Bebchuk, Coates & Subramanian, supra note 52, at 889–91 (discussing how the combination of staggered boards and poison pills drastically reduced the success of hostile takeovers). Nonetheless, unsolicited bids still do occasionally work, provided the suitor offers a high enough premium (known as a “bear hug”) to convert an unfriendly deal into a friendly one. See, e.g., David Carr, Once Again, Murdoch’s Siren Song, N.Y. TIMES, May 7, 2007, at C1 (correctly predicting at the outset that Rupert Murdoch’s hostile bid to acquire the Dow Jones Corporation “will be [completed] at some point, regardless of what the [controlling shareholders] said last week. Brute-force capital, like flood waters, always finds a way to break through”).
funds. The Baby Boom generation had begun saving for retirement, and stocks seemed to be the best place to put their money.\(^{57}\) Then, in what became something of a virtuous cycle, the more public invested, the more dollars were available for advertising, which in turn attracted more capital.\(^{58}\) At the same time, Congress accelerated the flow of funds into institutional investor coffers by creating certain tax advantages for fund investments, most notably the 401(k) savings account and the individual retirement account.\(^{59}\)

The results amounted to nothing less than an explosion in the size of American capital markets. According to numbers that were in use at the time, institutional ownership of U.S. stocks surged from about eight percent in 1950 to over forty-five percent in 1989.\(^{60}\) In terms of dollars, the total value of institutional investor holdings grew from around $673 billion in 1970 to over $11 trillion in 1996—a sixteen-

---

\(^{57}\) See Hamilton, supra note 1, at 353; see also Michael J. McDermott, *Boom Time with the Boomers*, FIN. PLANNING, Oct. 1996, at 38 (“From now into the next century, one American will turn 50 years old every 8 seconds. That makes the country’s 76 million baby boomers the mother lode of financial planning.”).


\(^{59}\) Hamilton, supra note 1, at 353. The moniker 401(k) refers to a section of the tax code adopted by the Internal Revenue Act of 1978. IRA’s were created in 1974 by the Employee Retirement Income Security Act and expanded under President Reagan by the Economic Recovery Tax Act of 1981. Both sections establish tax advantages for retirement savings and were subsequently expanded and/or enhanced by rule and by statutes, including the Economic Growth and Tax Relief Reconciliation Act of 2001.

As an interesting side note, section 401(k) was originally intended to expand profit-sharing opportunities, rather than retirement savings. It was only when Theodore Benna, an employee benefit consultant in Newtown, Pennsylvania, realized that the provision could be used by employers to create savings plans that its true impact began to be understood. See Robert Metz, *Market Place; Little-Noticed Tax Shelter*, N.Y. TIMES, Oct. 22, 1981, at D8 (explaining contemporaneously the benefits of this heretofore unknown tax shelter); Fred Williams, *R. Theodore Benna: Founder, the 401(k) Association, Jersey Shore, Pa.*, PENSIONS AND INVESTMENTS, Oct. 27, 2003, at 16 (noting that “Ted Benna didn’t set out to revolutionize the world of retirement saving . . . . Still, he wound up being credited with creating the first 401(k) plan”). At the end of 2006, U.S. investors maintained approximately $2.7 trillion in 401(k) accounts, up from $385 billion in 1990, and $4.2 trillion in IRAs, up from $637 billion in 1990. *Investment Company Fact Book*, supra note 33, at 73, 77.

\(^{60}\) Rock, supra note 1, at 447 (citing the *New York Stock Exchange Institutional Investor Fact Book 4* (1990)). Because of the difficulty associated with compiling accurate data regarding fund activities, and because definitions sometimes vary, estimates as to size also frequently vary. According to another contemporary source, for example, institutional investor holdings represented thirty-eight percent of all U.S. markets in 1981 and approximately fifty-three percent in 1990. Black, supra note 11, at 827 (citing Carolyn Kay Brancato & Patrick A. Gaughan, *The Growth of Institutional Investors in U.S. Capital Markets tbl.10* (1991 update)).
fold increase in under a generation. Today, various estimates suggest that institutional investors hold as much as $24 trillion in U.S. stocks, or over sixty percent of the market capitalization of all U.S. companies. Moreover, the trend continues to accelerate. In 2006, $474 billion of new capital flowed into mutual funds, a rate that is up from the pace of the prior four years. All told, approximately half of all U.S. households now own shares in one or more investment funds.

It was in this context—the failure of hostile takeovers and the rise of the institutional investor—that a group of scholars began to think seriously about the potential for institutional investors to act as corporate monitors. Mark Roe, Bernard Black and John Coffee, each then teaching at Columbia, along with Ed Rock of the University of Pennsylvania, together produced a voluminous literature in the early 1990s regarding the potential for institutional investors to be enlisted in the quest for better corporate governance. Other scholars concurred in their support or argued closely related points.

62. Institutional Investors Snap Up U.S. Stocks, supra note 33 (summarizing 2005 data collected by the Conference Board). Because of variations regarding how to define the various categories, different sources suggest different numbers. The Reuters figures, for example, included “U.S. pension funds, money managers, insurance companies and foundations.” Id. Thus, bank holdings were omitted from these figures, as were the holdings of private equity funds.
63. INVESTMENT COMPANY FACT BOOK, supra note 33, at 17.
64. Id. at 57.
65. See, e.g., Rock, supra note 1, at 448 (noting that “dramatic developments” regarding institutional investors “hold the promise of enormous changes in the nature of corporate law”). Coffee described the new attention being devoted to institutional investor monitoring as amounting to a “paradigm shift.” Coffee, supra note 2, at 1278–79. Interestingly, at the time of the discovery of the size and power of institutional investors, contemporaries estimated their combined holdings at $7.5 trillion, or less than one-third of today’s estimates. See Roe, supra note 2, at 16 (noting—with some degree of awe—that commercial banks, mutual funds, insurance companies and pension funds held, respectively, assets worth $3.2 trillion, $548 billion, $1.8 trillion, and $1.9 trillion).
67. See, e.g., Jayne W. Barnard, Institutional Investors and the New Corporate Governance, 69 N.C. L. Rev. 1135, 1138 (1991) (assessing the advantages of increasing institutional investor participation in corporate governance and recommending strategies for such participation); Bebchuk, supra note 20, at 836 (arguing
The hope was that institutional investors—and in particular, public equity funds—had the size, sophistication and, potentially, the incentive to serve as ideal corporate monitors.\textsuperscript{68}

It is important to note that the model of governance that these scholars contemplated was one of institutional investor voice.\textsuperscript{69} For the most part, they were comfortable with the common practice by institutional (and other) investors of owning a small fraction of the stock of any given company. What they proposed was not for institutional investors to seek to acquire control over individual companies, but rather for them to work together to become more active in voting campaigns and more effective in informal communications with management.\textsuperscript{70} Thus, to this group of scholars, enlisting institutional investors as corporate monitors would only be an incremental change. The fundamentals of the system would not be altered. Rather, individual companies would continue to be owned by a large number of shareholders, but those shareholders would pool their resources to provide better oversight.\textsuperscript{71}

Put differently, the hope was to obtain some of the benefits of a three-tiered approach to corporate governance while retaining as much as possible of our two-tiered system.

Black in particular, along with Ronald Gilson and Reinier Kraakman, also imagined that institutional investor voice would focus not on company-specific performance but on issues of corporate governance that affected the entire marketplace.\textsuperscript{72} This was because a

shareholders should be able to initiate and vote to adopt changes on a company’s basic corporate governance); Ronald J. Gilson, Lilli A. Gordon & John Pound, \textit{How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors}, 17 J. CORP. L. 29, 32–33 (1991) (arguing that appropriate barriers should be lowered to encourage institutional investors to nominate a minority of a company’s directors to serve as professional monitors); Gilson & Kraakman, supra note 20, at 883–92 (proposing actions that institutional investors could take, without the need for legal reform, in order to exercise greater influence over portfolio companies).

68. See, e.g., Black, supra note 11, at 815–16 (discussing the arguments in favor of institutional monitoring); Coffee, supra note 2, at 1336, 1367–70 (arguing that pension funds are “the optimal corporate monitor”). \textit{But see} Gilson & Kraakman, supra note 20, at 864 (noting that many corporate and money managers viewed institutional investors as poor candidates for monitors); Kahan & Rock, supra note 7, at 1048–62 (discussing the pluses and minuses of public equity fund monitoring).

69. See supra note 17 (discussing and defining “institutional investor voice”).

70. See Black, supra note 11, at 815 (“I believe that there is a strong case for measured reform that will facilitate joint shareholder action \textit{not directed at control}, and reduce obstacles to particular institutions owning stakes \textit{not large enough to confer working control}.”).

71. E.g., id. at 816–17; Rock, supra note 1, at 448–49.

72. Black, supra note 11, at 834–35 (“Institutional shareholders can’t and shouldn’t watch every step a manager takes . . . . In contrast, shareholders have stronger incentives to take an active interest on issues for which scale economies will
campaign to encourage all companies to, for example, eliminate confidential voting would create economies of scale.\textsuperscript{73} Thus, if barriers to shareholder voice were lowered, the first areas to succumb to shareholder activism would be those that yielded most readily to the reduced costs associated with repeated, and sometimes parallel, proxy campaigns. To Black, these were “process and structural issues” and included topics such as those related to board structure and composition as well as antitakeover defenses.\textsuperscript{74} Coffee concurred insofar as he believed that institutional investor oversight could best be expressed through the formation of monitoring coalitions, led by public pension funds but joined by other institutional investors.\textsuperscript{75}

C. Passivity Explained

Institutional investor voice had a flaw, however. By the early 1990s, institutional investors—despite their great size and obvious potential—had not yet shown themselves to be active investors.\textsuperscript{76} If they truly were the ideal corporate monitor that some had suggested, they should already have begun to be more assertive. Admittedly, there were anecdotal stories of activist shareholders, as well as additional reasons to hope that shareholder self-confidence would increase.\textsuperscript{77} However, given that the institutional investors had already partly offset the incentives for passivity created by fractional ownership.\textsuperscript{78}); Gilson & Kraakman, supra note 20, at 866–67 (arguing that institutional investors hoping to increase the value of their entire portfolio must focus on “improving the corporate governance system rather than by attempting to improve the management of particular companies”).

\textsuperscript{73} See Black, supra note 2, at 580–84, 589–91 (factoring economies of scale into his equations as to the costs and benefits of shareholder activism). Black believed that economies of scale would be the largest for process and structural issues, such as issues relating to board structure and composition, confidential voting, asking managers to seek shareholder approval before taking various actions, rescinding or weakening poison pills, antitakeover amendments, and reincorporating in states with more desirable antitakeover statutes. Black, supra note 11, at 836. \textit{But see} Rock, supra note 1, at 489–90 (arguing that fund managers do not care about confidential voting because the widespread adoption of confidential voting would benefit their portfolios equally and so provide them no selective benefits).

\textsuperscript{74} Black, supra note 2, at 836.

\textsuperscript{75} See Coffee, supra note 12, at 850–51, 856–57 (assessing the feasibility of forming institutional investor coalitions to monitor management and arguing that, “because institutional investors cannot hold large blocks and because they value liquidity, they can influence control only to the extent they can form broad-based coalitions”).

\textsuperscript{76} See, \textit{e.g.}, Rock, supra note 1, at 451 (acknowledging that “the actual manifestations of institutional shareholder activism have been puzzling and do not unambiguously support an optimistic scenario”). Indeed, despite the hopes of scholars such as Rock, institutional investor passivity has remained the norm to this day. \textit{See infra} Part I.E.

\textsuperscript{77} See Black, supra note 2, at 570–75 (discussing the apparent rise in shareholder activism in the 1980s); Black, supra note 11, at 828–29, 840–42 (same); Rock, supra
grown to well beyond critical size before attracting the attention of
legal scholars, the results were far less than had been predicted. An
explanation for their general passivity was needed.

With respect to banks and insurance companies, there appears to
be a general consensus that their passivity results from their close ties
to management. Taking a position against a particular corporation
might mean the loss of a potential customer for lucrative consulting,
risk-management or other services. More significantly, however, it
might also give the impression that the bank or insurance company
was generally anti-management in its outlook, thereby jeopardizing
its relationship not merely with the company in question but with all
companies. The same is true for private pension funds, which are
almost universally controlled by their corporate sponsors. Thus,
significant conflicts of interest make banks, insurance companies and
private pension funds poor candidates as corporate monitors.

Mutual funds and public pension funds have been viewed as having
the greatest potential as monitors. For example, because they
typically market themselves directly to individual investors, public
equity funds probably suffer from fewer conflicts of interest. As a
result, the search for an explanation for the continued passivity of
institutional investors generally has focused on public equity funds.

For Black and Roe, the passivity of public equity funds results from
in the mesh of legal rules that make the exercise of shareholder voice

---

[78] See Black, supra note 2, at 600 (noting that banks often vote with management
because they usually own stock in companies with which they do business).

[79] See, e.g., Bainbridge, Politics, supra note 21, at 725 (noting that “corporate
managers are well-positioned to buy off most institutional investors that attempt to
act as monitors”); Black, supra note 2, at 600–01 (noting, for example, that “banks
have been relentlessly passive”); Coffee, supra note 12, at 857 (“By general consensus,
banks and insurance companies have not been active investors and rarely oppose
management.”); see also Roe, supra note 2, at 17–18, 22–23 (discussing regulatory
impediments to activism on the part of banks and insurance companies).

[80] See Black, supra note 2, at 600–01 (noting that a bank will not “want to
develop a reputation for casting antimanager votes, lest it lose current or prospective
banking clients”).

[81] See Roe, Private Pensions, supra note 66, at 77 (“Few managers want their
pension more active in the corporate governance of other companies than they
would want their own stockholders to be active in their firm.”); see also Coffee, supra
note 12, at 857–62 (comparing the corporate governance potential of public and
private pension funds).

[82] See Coffee, supra note 12, at 858 (“As a class, public pension funds are
pressure resistant, because they have few (if any) conflicts of interest.”). But see
Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93
COLUM. L. REV. 795, 796 (1993) (arguing that “public pension funds face distinctive
investment conflicts that limit the benefits of their activism”).
costly, burdensome, and sometimes risky. For example, increased reporting requirements, insider trading liability and other burdens all apply to shareholders who hold more than five (or sometimes ten) percent of a public company’s stock. Thus, although such rules were probably designed in good faith to address other unrelated abuses, they add significant costs and legal risks to anyone who chooses to exceed the five percent threshold. No one rule specifically prohibits monitoring, but their cumulative effect is sufficient to deter most shareholder activists. Moreover, even if a particular rule would not necessarily lead to liability, the culture of money management is such that the mere risk that a rule could lead to liability is often enough to deter the conduct in question.

83. See Black, supra note 2, at 523 (“In fact, institutional shareholders are hobbled by a complex web of legal rules that make it difficult, expensive, and legally risky to own large percentage stakes or undertake joint efforts.”); Roe, supra note 2, at 11 (arguing that “American law and politics deliberately diminished the power of financial institutions to hold the large equity blocks that would foster serious oversight of managers”). Black also blamed management’s ability to control the agenda and conflicts of interest within institutional investor groups. Black, supra note 2, at 591–607. However, the main thrust of his argument was that legal rules were the most significant barrier to shareholder voice. See id. at 566 (“Shareholder passivity may be partly a function of legal rules. Institutional shareholders who want to become active face costs, legal limits, and legal risks wherever they turn.”). But see Randall S. Thomas, Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information, 38 ARIZ. L. REV. 331, 332 (1996) (analyzing shareholders’ use of state corporate law inspection statutes as a means for obtaining the information necessary for active monitoring).

84. For example, under sections 13(d) and 13(g) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(d), 78m(g) (2000), any person or group that acquires more than five percent of a public company must file, and periodically update, a schedule 13D or schedule 13G. Rule 13d-1, 17 C.F.R. § 240.13d-1 (2007). Other impediments generally apply once the investor has reached the ten-percent level. For example, section 16(b) of the Securities Exchange Act of 1934 prohibits beneficial owners of ten percent of a public company’s stock to forfeit any “short-swing” trading profits that accrue from buying and selling, or selling and buying, shares of that company in a six-month period. 15 U.S.C. § 78p(b) (2000). The impact of this rule is to significantly reduce the ability of ten-percent holders to exit their position if the company’s performance begins to sour. In other words, short-term liquidity is sacrificed for additional control. See generally Black, supra note 2, at 530–66 (surveying the rules governing shareholder voting and discussing the obstacles to shareholder action they create); Roe, supra note 2, at 16–31 (discussing the various regulatory impediments to activism on the part of institutional investors).

85. See, e.g., Black, supra note 2, at 565 (“Through much of the period from 1934 to the present [1990], SEC Stafford genuinely believed that the Proxy Rules helped shareholders by ensuring complete and accurate information as a basis for voting. The costs of disclosure rarely were part of the equation.”); Roe, supra note 2, at 11 (“Many legal restraints had public-spirited backers; some rules would be those that wise regulators, unburdened by politics, would reach.”).

86. See Black, supra note 2, at 533, 542–45 (“The obstacles faced by shareholders who would be active are many. No single rule is a show stopper, but their cumulative impact is large.”).

87. See id. at 532 (“Cultural factors reinforce the legal obstacles to shareholder action. Money managers . . . expect to take market risk, but legal risk is beyond the
finally, to make matters worse, Congress and the Securities and Exchange Commission (“SEC”) crafted the various rules broadly so as not to be easily circumvented by joint action. As a result, they not only create disincentives for shareholders to accumulate large stakes in a given corporation, but they also make it more difficult for fractional shareholders to communicate and work together. Thus, for Black and Roe, institutional investors remain passive largely because a host of overlapping legal rules make monitoring too costly.

Coffee told a somewhat different, though related, story. He compared the American system of corporate governance with those of Japan and various European countries and concluded, among other things, that American institutional investors are not subject to a significantly greater level of regulation than are their more active foreign counterparts. Instead, the concentration of share ownership is significantly higher, even in economies as similar to the United States as Great Britain, Canada, and Australia. As a result, without rejecting the significant role that legal rules play in causing institutional investor passivity, he argued that extra-legal factors also discourage active monitoring. In particular, he believed that there is an inherent tradeoff between exit and voice, such that an increase in influence (voice) would generally be coupled with a decrease in liquidity (exit). He therefore proposed a series of deregulatory
reforms—aimed primarily at public pension funds—intended to make the exercise of voice more attractive, while at the same time making exit somewhat more difficult.\(^94\) He also proposed positive incentives for monitoring, including incentive compensation.\(^95\) For Coffee, however, the separation of ownership and control is unlikely to disappear even if legal constraints on shareholder activism are removed.\(^96\) Thus, he argued, "to create a truly activist institutional investor, it may be necessary to invent a new one."\(^97\)

Although Rock also saw great promise in the rise of the institutional investor, he recognized that institutional investors themselves suffer from their own agency costs and so doubted whether they could be sufficiently incentivized to overcome the regulatory hurdles facing activist shareholders.\(^98\) Contrary to some of the others, he believed that individual fund managers have little incentive to engage in oversight activities that would improve the overall economy.\(^99\) This is because public equity fund managers are generally evaluated in comparison to other managers (or to market indices).\(^100\) Any efforts to improve overall corporate performance would therefore be of little benefit to the fund managers as they would not impact their relative performance.\(^101\)

Although Black, Roe, Coffee, and Rock differed in the details of their explanations for the persistence of institutional investor passivity, they shared much common ground. In particular, they all believed that public equity funds had great potential as corporate monitors. For them, the problem was simply how to tweak the cost-benefit equation until it could be tipped in favor of shareholder voice.\(^102\) In their view, then, public equity funds \textit{wanted} to exercise

---

95. Coffee, \textit{supra} note 12, at 845, 903–05.
96. \textit{Id.} at 845.
97. \textit{Id.} at 905.
98. Rock, \textit{supra} note 1, at 452, 464 (summarizing his argument that "the collective action analysis indicates that as the concentration of shareholding increases, discipline by [institutional] shareholders becomes more rational").
99. \textit{Id.} at 473.
100. \textit{Id.}
101. \textit{See id.} ("To the extent that money managers are evaluated in comparison to other managers and to market indices, such money managers will have no selective incentives to engage in actions that improve the performance of widely diversified funds across the board.") (citations omitted).
102. \textit{See, e.g.,} Coffee, \textit{supra} note 12, at 905 (noting that "the issue is how to lure into the money management market new entrepreneurs who will offer monitoring services in return for incentive compensation").
voice, they simply could not justify the expense given the rather
meager rewards then available to them.

There can be little doubt that this body of scholarship was correct
in its essential message—there are significant legal and other barriers
that make shareholder activism unnecessarily burdensome and
expensive. I in no way dispute this basic insight. In fact, I seek to
identify several additional legal reforms that are necessary to permit
public equity funds to engage in active oversight through control
acquisitions.

However, a comparison between public and private equity funds
suggests that many of the legal rules that make activism so expensive
for public equity funds apply equally to private equity funds. What
remains to distinguish them, therefore, are primarily the rules that
limit the ability of public equity fund managers to share personally in
the rewards that accrue from active corporate monitoring. Permit
such managers to charge incentive fees similar to those charged by
private equity funds, and one creates direct financial incentives that
can be expected to result in aggressive oversight. Passivity, therefore,
may be explained not solely or even primarily by the combination of
rules that make activism so expensive. Rather, passivity may be
explained by the fact that it is not currently profitable for public
equity fund managers to compete based on their ability to discipline
underperforming corporations.

D. Efforts at Reform

In the decade or so that followed publication of the first important
articles on institutional investor monitoring, the SEC made no fewer
than four major proposals to expand the power of shareholder voice

103. As Black alluded to, however, their different analyses of shareholder passivity
were based entirely on theory. After all, one could not create a real-world
experiment to test their various hypotheses. See Black, supra note 11, at 815 (“Pure
theory can’t tell us whether we’d be better off if imperfectly watched money
managers did more watching of corporate managers.”). However, this Article, while
not an empirical study, seeks to use the activist investment strategies of private equity
funds as a sort of naturally occurring experiment. Unlike comparisons to foreign
systems of corporate governance which, though helpful, suffer from the obvious
defects of culture and history, the comparison between public and private equity
funds is extremely direct. Understanding the different incentives and regulatory
regimes facing these two groups of investment funds should therefore shed light on
the underlying question of institutional investor passivity. See discussion supra note
12 (noting that this Article does not attempt to draw conclusions based on
distinctions between American private equity markets from those of Europe or Asia).

104. See infra Parts IV.B and IV.C (discussing two categories of legal rules that
differentiate the monitoring by public and private equity funds).

105. See generally infra Part IV (discussing three categories of legal rules that
explain the different investment strategies of public and private equity funds).
by amending the federal proxy rules.\textsuperscript{106} In all four instances, the proposals borrowed directly from this body of scholarship—as well as from work by Lucien Bebchuk—by attempting to eliminate or reduce barriers to the exercise of shareholder voice.\textsuperscript{107} Although only three were eventually adopted, proxy reform remains an open issue.\textsuperscript{108}

The first proposed amendment came in 1991, when the SEC recommended rule changes aimed at reducing the costs associated with shareholder-initiated proxy proposals and opening informal channels of communication among shareholders.\textsuperscript{109} In response to strong opposition by pro-management groups such as the Business Roundtable, the SEC was forced to revise the proposal to eliminate its most controversial aspects.\textsuperscript{110}

\begin{itemize}
\item See, e.g., Bebchuk, supra note 20, at 833; Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675, 676 (2007) (offering proposals for reforming corporate elections) [hereinafter Bebchuk, Shareholder Franchise]; Lucian A. Bebchuk, Letting Shareholders Set the Rules, 119 Harv. L. Rev. 1784, 1784–85 (2005) (discussing proposals to increase shareholder oversight of corporate governance). But see Coffee, supra note 12, at 876 (arguing that the SEC’s attitude towards proxy reform is “equivocal, that it is torn between the standard impulse of a bureaucratic agency to expand its jurisdiction and defend its existing turf and the recognition that a regulatory system must have some relevant end purpose if it is to survive”); Jill E. Fisch, From Legitimacy to Logic: Reconstructing Proxy Regulation, 46 Vand. L. Rev. 1129, 1132 (1993) (arguing that the SEC’s efforts at proxy reform were subject to significant political forces).
\item Regulation of Securityholder Communications, Exchange Act Release No. 29,315, Investment Company Act Release No. 18,201, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,811, at 81,845 (June 17, 1991). The proposal sought to eliminate the pre-clearance requirement for most solicitation materials, eliminate the filing requirements for parties that provide proxy information but are otherwise disinterested, permit the use of solicitation materials even if they are not accompanied by a proxy card, and permit shareholders to obtain a full shareholder list. See id.; see also Black, supra note 11, at 829–30 (discussing the 1991 proxy reform proposals). For a contemporary critique of the proposal, see Coffee, supra note 2, at 1351–52 (arguing that the proposal “would largely remove the chill on shareholder communications that the current proxy rules create” but that they would do little to address the underlying problem of rational shareholder apathy).
\end{itemize}
adopted in October 1992, significantly eased shareholder communications by allowing shareholders to publicly announce how and why they intended to cast their votes without the requirement of filing a formal proxy statement. It was therefore an important early victory for proponents of shareholder voice.

The second major amendment came in 1997 in response to the SEC’s infamous “Cracker Barrel” no-action letter. The ruling in Cracker Barrel had been viewed as a setback by most proponents of increased shareholder activism because it permitted management to exclude certain shareholder proposals from its proxy statement. The amendment sought to reverse this decision and at the same time remove some of the existing impediments to shareholder proposals.
By attempting to be even-handed, however, it attracted criticism from both advocates and opponents of shareholder democracy. In the end, the amendment passed, handing shareholder activists their second significant victory in a little under six years.

The most recent and by far the most ambitious effort at reforming the proxy process to encourage institutional investor monitoring was initiated by the SEC in a pair of related releases in the fall of 2003. The first was fairly modest and generated little controversy, requiring only that existing disclosures regarding the practices of the issuer's nominating committee be expanded and clarified. It was adopted with minor changes in November of 2003 and thus served as a third, albeit minor, victory for proponents of institutional investor voice.

Additional disclosure regarding a corporation's procedures regarding whether to include or exclude shareholder proposals.

115. See, e.g., Brett D. Fromson, SEC Criticized for Plan on Shareholder Voting: Companies, Social Activists Dislike Rule Changes, WASH. POST, Oct. 28, 1997, at C3 (noting that neither management nor shareholder activists were pleased with the SEC's new rules); Michael Schroeder, SEC Expected to Adopt Compromise On Votes For Shareholder Resolutions, WALL ST. J., May 20, 1998, at C19 (discussing the SEC's efforts to develop a compromise on when management can exclude certain shareholder proposals).


118. Specifically, the proposed amendments required management to include in its proxy statement a statement as to whether the company's board of directors had a nominating committee (and if not, an explanation for why not), the names of the directors serving on such committee, an explanation of the nominating process, and instructions for how and where shareholders could submit nominations. Disclosure Regarding Nominating Committee Functions and Communication Between Security Holders and Board of Directors, Exchange Act Release No. 48,301, Investment Company Act Release No. 26,145, [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,954, at 88,047 (Aug. 8, 2003).

The second proposal of 2003 was nothing short of an attempt to completely overhaul the role of institutional investors in the proxy process.\footnote{120} Building on the work of Bebchuk, the idea was to create a mechanism whereby shareholders could use management’s proxy to make substantive proposals, including the nomination of directors opposed by management, if certain triggering events had occurred.\footnote{121} The SEC, however, did not want the proposal to distort the business function of the proxy process by converting the proxy into a vehicle for every disgruntled shareholder to give voice to her own personal politics.\footnote{122} Thus, the proposed amendments applied only to shareholders (or shareholder groups) who had continuously held five percent of the company’s shares for at least two years.\footnote{123} Effectively, this aspect of the proposal disqualified all but large institutional investors. Had they been adopted, the amendments would therefore have constituted a near-direct application of the scholarship on institutional investor voice, as well as a major victory for proponents of shareholder activism.\footnote{124}

The proxy access release attracted the opposition of both the Bush Administration and business groups, and even generated a party-line split within the SEC.\footnote{125} It was ultimately defeated politically.\footnote{126}

\begin{quote}
\footnote{120} See Bebchuk, supra note 20, at 835–36; see also Eisenberg, supra note 20, at 1502–17 (arguing that five-percent shareholders should be entitled to use management’s proxy materials). For opponents of increased shareholder access to the proxy statement, see supra note 21. See also Strine, supra note 21, at 1759 (presenting a critique of Bebchuk’s proposed reforms to increase shareholder power).

\footnote{121} Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, [2003–2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,101, at 88,408 (Oct. 14, 2003). The triggering events included (1) the receipt by a director of “withhold” votes from at least thirty-five percent of the shareholders at an annual meeting, or (2) a shareholder proposal that rule 14a–11 should apply be adopted by fifty percent of the shareholders at an annual meeting. \textit{Id.}


\footnote{124} Interestingly, however, the proposal was opposed by some institutional investor activists on the grounds that it did not go far enough in providing them access to management’s proxy. Patrick McGeehan, \textit{It’s Voting Time Again, But No Isn’t an Option}, N.Y. TIMES, Apr. 10, 2005, (Sunday Business) at 4.

\footnote{125} See Herb Allison, Editorial, \textit{Giving Investors a Say}, WASH. POST, Aug. 19, 2004, at A25 (advocating a proposed SEC rule which would give shareholders more say in board elections and oversight); Carrie Johnson, \textit{Commissioner Condemns SEC Inaction},
Interestingly, however, the SEC appears at the time of this Article to be once again revisiting the subject. In an unusual move that drew immediate criticism from the U.S. Chamber of Commerce, the SEC in July 2007 issued two contradictory releases for public comment—one granting access to the proxy to five-percent shareholders (i.e., public equity funds) and the other denying such access. Given the highly fluid political environment, it is an open question whether further reform in favor of institutional investor voice is in the offing.

E. The Persistence of Passivity

Despite the rule changes described above, and notwithstanding the occasional burst of well-publicized shareholder revolt, institutional investor activism remains today the exception, not the rule. The number of shareholder-initiated resolutions and proxy contests has increased only slightly since 1990, and such efforts achieve success only in rare instances. Huge amounts of money have shifted away from actively managed funds and into indexed investments, removing such resources from potential monitors. Finally, well-known shareholder activist groups that had been hailed in the early 1990s as potential change agents have instead merged or closed their doors. All told, shareholder activism has had only a marginal impact on
corporate governance and has never experienced growth to match its potential.

1. Shareholder apathy

As predicted by economic theory, the American system of corporate governance is presently characterized by shareholder apathy. Shareholders in general continue to shun active monitoring. Georgeson, a leading proxy solicitation firm, summarized the current mood in its most recent review of the annual proxy season:

Once again the intensity of shareholder activism and demands for improved corporate governance boiled below the surface of the 2006 annual meeting season. No records were set for shareholder-sponsored governance resolutions and there was only a modest increase in proxy contest activity . . . .

Admittedly, there are positive signs that shareholder activism is working. In the first place, proxy contests and shareholder resolutions are prevalent enough during annual proxy seasons to have taken on an almost ritualistic air. For example, according to an annual review of the S&P 1500 by Georgeson, 2006 saw 385 shareholder proposals at 189 companies. For the first half of 2007, Institutional Shareholder Services (“ISS”) reported an increase in support for “say on pay” resolutions that seek an annual shareholder vote on executive compensation. ISS also reported that major shareholder insurgencies occurred in 2007 at KB Home,

129. For an explanation of the theory behind shareholder apathy, see Rock, supra note 1, at 453–63. For an argument that the “old” narrative of shareholder apathy is no longer accurate, see Black, supra note 2, at 523.


131. According to Georgeson’s annual survey, 385 corporate governance proposals were voted on during 2006. GEORGESON, supra note 130, at 9. Of these, fifty-five percent were related to board composition and structure, while another twenty-four percent addressed executive compensation. Id.

132. Id.

International Paper, Mead/Westvaco, McGraw-Hill, Honeywell, Convergys, Blockbuster, and Goodyear Tire & Rubber.\(^{134}\)

Various well-known contests also provide anecdotal evidence of shareholder interest in corporate governance.\(^{135}\) Perhaps the best known modern example was the attempt by Walter Hewlett to derail the proposed merger of Hewlett-Packard and Compaq in 2002.\(^{136}\) Another was the successful ouster of embattled Walt Disney CEO Michael Eisner in 2004, where the opposition of Fidelity, T. Rowe Price, and other institutional investors proved decisive.\(^{137}\) Both also gave rise to substantial shareholder litigation.\(^{138}\)

Finally, it is possible that many proposals are not made—or not voted on—because management chooses to accede to shareholder demands and so avoid a costly and embarrassing fight. For example, fully forty-four percent of corporate governance proposals in 2006 were withdrawn or omitted before the date of the annual meeting, suggesting that many may have been mooted by management

---

134. See Walton, supra note 133 (listing notable votes on shareholder proposals at major corporations).

135. For two recent, if otherwise unremarkable, examples, see Erin White, Stage-Managing the Annual Meeting, WALL ST. J., Apr. 16, 2007, at B1 (citing instances of shareholder activism and alleged intimidation of shareholders by corporate agents at the board meetings of Home Depot and Brinker International, among others), and White & Patrick, supra note 133, at B1 (indicating that shareholder activism resulted in changes in corporate pay at GlaxoSmithKline).

136. See generally Steve Lohr, Clash Over Legacy Fuels Computer Merger Battle, N.Y. TIMES, Nov. 18, 2001, (Sunday Business), at 28 (discussing the opposition of the merger between Hewlett-Packard and Compaq by the Hewlett and Packard families); Andrew Ross Sorkin, Hewlett Vow to Oppose Hewlett-Packard Merger with Compaq, N.Y. TIMES, Nov. 7, 2001, at C1 (discussing opposition to the merger by the Hewlett family).

137. See Laura M. Holson, For Disney’s Embattled Chief, a Double Rebuke from Fidelity, N.Y. TIMES, Mar. 15, 2004, at C7 (noting that Fidelity showed its opposition to Eisner’s continued tenure twice: once by withholding the votes on the shares it owned, and once by withholding the votes on the shares it controlled as administrator of Disney’s 401(k) plan). Much of the opposition by institutional investors arose because proxy advisor ISS recommended that its members withhold their votes for Eisner. See Frank Ahrens, Disney’s New Drama: Dissension, WASH. POST, Mar. 1, 2004, at A1 (noting that up to thirty-five percent of Disney’s investors would likely not support Eisner’s reelection). In all, forty-three percent of shareholders withheld their votes for Eisner. David A. Vise, Some Stockholders Think Disney Stopped Short, WASH. POST, Mar. 5, 2004, at E1. Although the no-confidence vote was only symbolic, Eisner was finally forced to resign a year early on September 30, 2004. See Richard Verrier & Claudia Eller, Disney Names One of Its Own as New Chief, L.A. TIMES, Mar. 14, 2005, at A1 (discussing Eisner’s departure from Disney and indicating that Eisner was criticized for his authoritarian management style, poor relations with other partners and companies, and sub-par corporate performance).

acquiescence.\footnote{139} Similarly, of the forty-six companies that held a vote on shareholder proposals to eliminate staggered boards, forty-five of them actually supported the change.\footnote{140}

Unfortunately, however, there is no way to know how often shareholders made informal requests or how effective these informal communications may be. Also, many shareholder proposals may be omitted not because of their merit but because of their lack of merit.\footnote{141}

Despite these apparent bright spots, the real incidence of shareholder activism remains quite small. The fact that there were 385 shareholder proposals at 189 companies in the S&P 1500 during 2006 means that there were no shareholder proposals at the other 1311 companies.\footnote{142} In other words, more than eighty-seven percent of large U.S. companies were not subject to any level of formal shareholder activism in 2006. Moreover, those that were generally found it easy to defeat the attempted discipline.\footnote{143} Indeed, Walter Hewlett’s attempt to defeat the HP-Compaq merger ultimately failed when Deutsche Bank was persuaded to side with management.\footnote{144} At

\footnote{139. See GEORGESON, supra note 130, at 12; see also Amy Cortese, Better to Switch Than Fight?, CHIEF EXECUTIVE, July 2004, at 8 (reporting that, during the 2004 proxy season, "[a] growing number of companies took steps to cooperate with shareholder groups and head off potentially damaging situations"); Walton, supra note 133 (reporting that twelve shareholder proposals regarding executive compensation had been withdrawn in the first half of 2007, "indicating companies are more willing to engage with stockholders in drawing up performance metrics for calculating executive pay").}

\footnote{140. GEORGESON, supra note 130, at 3.}

\footnote{141. Although Exchange Act rule 14a-8 requires management to include certain shareholder proposals in its proxy statement, the rule also permits management to exclude proposals that lack merit or are otherwise not a proper subject for shareholder action. See 17 C.F.R. § 240.14a-8 (2007) (addressing when a company must include a shareholder’s proposal in its proxy statement and indicating when it is proper to exclude a shareholder’s proposal). See generally supra note 113 (noting that some companies routinely use § 14a-8 to exclude shareholder proposals).}

\footnote{142. See GEORGESON, supra note 130, at 1 (listing statistics of number of shareholder proposals at S&P 1500 companies); see also Bebchuk, Shareholder Franchise, supra note 107, at 682–87 (arguing that the actual number of contested proxy solicitations is quite low).}

\footnote{143. See Walton, supra note 133 (reporting that, for example, investors had filed more than sixty proposals in the first half of 2007 requesting that companies more closely link executive pay and company performance, but that the average support for such proposals was only thirty-five percent); White, supra note 135 (cataloguing strategies utilized by management to avoid or defuse potential controversies).}

\footnote{144. This decision, which Walter Hewlett alleged was the result of an illegal vote-buying scheme on the part of Hewlett Packard CEO Carly Fiorina, was ultimately upheld by the Delaware Chancery Court. Hewlett v. Hewlett-Packard Co., No. 19513-NC, 2002 Del. Ch. LEXIS 35 (Apr. 30, 2002). As a result of subsequent investigations by the SEC and the U.S. Attorney’s Office for the Southern District of New York, however, Deutsche Asset Management later agreed to pay a $750,000 settlement for failing to disclose its conflict of interest. See Deutsche Bank Settles Proxy-Votes Case, N.Y. TIMES, Aug. 20, 2003, at C3 (reporting that Deutsche Asset Management agreed to...}
the same time, opponents of Michael Eisner were successful in ousting him only after ten turbulent years of sub-par performance, the end of Disney's successful partnership with Pixar Animation Studios, the announcement of an unpopular takeover bid by Comcast, and a negative public relations campaign by former board members including Walt Disney's nephew, Roy. In fact, perhaps the greatest indictment against American shareholder activism is the fact that headlines are made each time even a modest fraction of a company’s shareholders are roused to express their dissatisfaction with management.

Overall, the 2006 proxy season saw a fourteen-percent decrease from 2005 in the number of shareholder resolutions that were submitted. Similarly, although there was a slight increase in actual proxy contests between 2005 and 2006, there were fewer contests in 2006 than in 1990. In fact, the 2006 total of thirty-one proxy contests hovered only just above the long-term average of twenty-seven. Shareholder anger—at least as expressed through the proxy process—has grown increasingly muted.

Equally important as the relative number of shareholder-initiated proposals is their dismal rate of success. In 2006, for example, only twenty-nine percent of outstanding shares were voted in favor of

---

145. See Ahrens, supra note 137 (reporting on the company’s poor performance and Disney and Gold’s efforts to oust Eisner); Geraldine Fabrikant, Comcast Shareholders Have Little Difficulty Containing Enthusiasm, N.Y. TIMES, Feb. 13, 2004, at C1 (noting that Comcast’s shares tumbled twelve percent after the announcement that it was offering a nine-percent premium for Disney); Peter Grant, Comcast Will Adopt Strategy of Patience in Bid for Disney, WALL ST. J., Mar. 9, 2004, at B6 (following the ongoing takeover attempt by Comcast). Comcast’s bid was ultimately unsuccessful. See Geraldine Fabrikant, Comcast Pulls Disney Bid Off the Table, and Wall Street Breathes a Sigh of Relief, N.Y. TIMES, Apr. 29, 2004, at C1 (discussing Comcast’s pulling of its bid for Disney and highlighting that the process put the spotlight on corporate governance issues at Disney and Comcast). Instead, Disney purchased Pixar in January 2006. See Mark A. Stein, Carmaking Bites Bullet; Other Industries Dine Well, N.Y. TIMES, Jan. 28, 2006, at C2 (indicating that Pixar’s CEO would be Disney’s largest shareholder and have a seat on the Disney Board and that Disney’s CEO had made reconciliation a top priority in the merger). For the full story of Eisner’s turbulent twenty-one-year reign as CEO, see generally JAMES B. STEWART, DISNEYWAR (2005).

146. GEORGESON, supra note 130, at 1.

147. See id. at 45 (providing statistics of contested proxy solicitations for 1982 through 2006).

148. Id.

149. See Morgenson, supra note 130 (“With stock indexes near their record highs, investor anger, not surprisingly, has been muted.”).
board-related shareholder resolutions, and a mere twenty-one percent were voted in favor of hot-button executive compensation reforms.\footnote{150} Moreover, although a respectable—though still insufficient—forty-nine percent of outstanding shares were voted in favor of proposals to repeal classified boards as a takeover defense, this level of support remains almost unchanged from prior years.\footnote{151} The numbers are even worse with respect to efforts to repeal poison pills, where there has been a steady decline in support.\footnote{152} Finally, hidden in the ISS data on the 2007 proxy season is the fact that the level of support for the much-heralded “say on pay” resolutions was actually down from 2006, although the number of proposals was up.\footnote{153} In fact, ISS reports that shareholder resolutions attracted majority support at only eight of 1500 U.S. companies in the first half of 2007.\footnote{154} Thus, even where shareholders are able to successfully launch some kind of insurgency, such efforts almost never succeed.

The very nature of public equity fund activism also seems unlikely to produce significant results. According to Marcel Kahan and Ed Rock, the strategy of seeking governance changes through shareholder proposals, while perhaps inexpensive, is “unlikely to result in big changes in specific companies.”\footnote{155} Likewise, behind-the-scenes discussions with company management also seem likely to produce only modest, incremental improvements.\footnote{156}

Implicit in this picture of general shareholder apathy is a lack of activism on the part of institutional investors. If few shareholders are involved in active monitoring campaigns, it must also be true that few institutional investors are so engaged. In fact, the available data bear this out. According to the Georgeson study, for example, pension funds initiated only nineteen proxy proposals in 2006, while mutual funds, banks and insurance companies initiated none.\footnote{157} Thus, in 2006, fully ninety-nine percent of the S&P 1500 companies were

---

150. See Georgeson, supra note 130, at 15 (listing a summary of figures of selected voting results for proposals during the 2006 annual meeting season).
151. See id. at 16 (indicating that forty-six percent of outstanding shares were voted in favor of proposals to repeal classified boards in 2002, while fifty-one percent were so voted in 2004).
152. See id. (noting that support for efforts to repeal poison pills fell from forty-two percent in 2002 to thirty-six percent in 2006).
153. See Walton, supra note 133 (reporting that executive compensation reform proposals averaged thirty-five percent support during the first half of 2007, as compared to thirty-six percent in the first half of 2006).
154. Id.
155. Kahan & Rock, supra note 7, at 1044.
156. Id.
completely unconstrained by formal institutional investor oversight.\textsuperscript{158} As an added insult, this level of passivity has persisted even as proxy reforms have made institutional investor activism less expensive.\textsuperscript{159}

2. Fewer monitors

Pessimism regarding the level of monitoring would also be appropriate for those market players that Rock hoped would serve as corporate governance entrepreneurs.\textsuperscript{160} One example is the United Shareholders’ Association (“USA”), a non-profit advocacy group that was founded in 1986 with the aim of targeting firms with poor performance, excessive executive pay, and limited shareholder input. Despite its initial successes, USA closed its doors only two years after Rock’s article.\textsuperscript{161} Likewise, the Investor Responsibility Research Center (“IRRC”), a non-profit research center aimed at assisting investors with socially responsible agendas, was acquired by its rival, ISS, in 2005.\textsuperscript{162} ISS itself was sold in 2006.\textsuperscript{163}

Admittedly, whether these changes can be interpreted as an unmitigated defeat for advocates of shareholder voice is doubtful. USA only dissolved after successfully lobbying the SEC to ease rules governing shareholder communication, while IRRC continues to

\textsuperscript{158} See id. (listing the names and categories of shareholder groups who sponsored governance proposals and the number of proposals each shareholder group sponsored).

\textsuperscript{159} See, e.g., Coffee, supra note 12, at 840–41 & n.18 (citing an estimate by the United Shareholders Association that a mailing that once cost $1 million could now be completed for as little as $5,000).

\textsuperscript{160} See Rock, supra note 1, at 479–81 (discussing the activities of, and the potential for, providing oversight of corporate governance by the Investor Responsibility Research Center, the Council for Institutional Investors, and the United Shareholders Association).

\textsuperscript{161} See Deon Strickland, Kenneth W. Wiles & Marc Zenner, A Requiem for the USA: Is Small Shareholder Monitoring Effective?, 40 J. Fin. Econ. 319, 320, 336–37 (1996) (analyzing the positive contribution of USA to the process of shareholder monitoring and indicating that it discontinued operations because it had met its goal of giving shareholders the ability to influence the corporate board decision-making process).


exist (and operate) as a division of ISS. Moreover, some have argued that ISS, under its new owner, is more powerful than ever, if only because it has fewer competitors. In the minds of some proponents, in fact, “the beginnings of a new corporate social responsibility movement are under foot.”

Even so, Rock’s larger point that monitoring by entrepreneurs was, in 1991, set to take off, has been disproved by events. For example, the merger of IRRC and ISS appears to have resulted in a decrease in services for activist shareholders. Similarly, in 2006, only seventeen proposals were sponsored by institutional shareholder activists. Instead, forty-seven percent of all proposals were sponsored by individuals, suggesting that shareholder activism remains largely an avocation, pursued primarily by those without the means to make a truly credible threat against managerial discretion.

Another forty-five percent of shareholder proposals in 2006 were sponsored by labor unions and related public pension funds, suggesting as well that shareholder activism retains a significant political, as opposed to economic, dimension.

164. See Strickland, Wiles & Zenner, supra note 161, at 320–21 (indicating that USA did not disband until it had met its goal of positively influencing the relationship between shareholders and corporate boards); Starkman, supra note 162 (indicating ISS intended to operate IRRC as a subsidiary). For a discussion of the SEC’s rule change easing stockholder communication restrictions, see supra notes 108–110 and accompanying text.

165. See John Plender, ISS to Dominate, FIN. TIMES, July 25, 2005, at 20 (citing one analyst’s belief that a recommendation by ISS can sway as much as twenty percent of the vote in a proxy contest); Starkman, supra note 162 (noting the role played by ISS in the 2004 ouster of Disney CEO Michael Eisner as well as in the 2002 proxy campaign surrounding the proposed merger of Hewlett-Packard and Compaq). As of 2005, ISS and “its analysts cover[ed] 28,000 listed companies on behalf of 1,300 institutional clients.” Sundeep Tucker, ISS Buys US Research Group IRRC, FIN. TIMES, July 14, 2005, at 27.


167. For example, the combined ISS/IRRC canceled publication of Corporate Governance Highlights and The Friday Report early in 2006 and instead merged the two into Governance Weekly, thereby diminishing the number of publications that actively follow proxy news. See Press Release, Institutional S’holder Servs., Institutional Shareholder Services Introduces Governance Weekly (Jan. 11, 2006), available at http://www.issproxy.com/pdf/GovernanceWeekly011106.pdf (introducing Governance Weekly and noting that it continues in the steps of The Friday Report and Corporate Governance Weekly).

168. See GEORGESON, supra note 130, at 10, 13 (Listing figures for sponsorship of governance proposals in 2005 and 2006).

169. See id. at 13 (Displaying types of sponsors of governance proposals in 2005 and 2006); see also Bratton, supra note 10, at 1403 (Noting that the average proxy contest costs between $250,000 and $1 million).

170. See GEORGESON, supra note 130, at 13 (Displaying types of sponsors of governance proposals in 2005 and 2006). See generally Romano, supra note 82, at 796 (Arguing that public pension fund managers “must navigate carefully around the shoals of considerable political pressure to temper investment policies with local
3. Index funds

Another reason for the lack of monitoring by public equity funds may be the revolution that has occurred with respect to indexed investing since the early 1990s. Index mutual funds and their more recent cousin, exchange-traded funds (“ETFs”), both hold investment portfolios that are designed to match—rather than outperform—the results of particular market indices.171 Because they seek only to mirror market performance, such funds cannot be expected to engage in oversight activities or other activist trading strategies.172 Thus, to the extent they expand their influence, such funds will suck capital away from funds that might be more prone to engage in active monitoring. Moreover, even those mutual funds that are not indexed considerations, such as fostering in-state employment, which are not aimed at maximizing the value of their portfolios’ assets).

Examples of the mix of politics and pension fund management are many. For example, former California state treasurer Phil Angelides, who was considering running for governor in 2006, was accused of causing the California Public Employees’ Retirement System (“CalPERS”) to engage in shareholder activism in order to fuel his political ambitions. See Stephen M. Bainbridge, Pension Funds Play Politics, TCS DAILY, Apr. 21, 2004, http://www.techcentralstation.com/042104G.html (noting that unions and public pension funds, such as CalPERS, have political goals as well as financial ones, and so are likely to be activist shareholders (quoting Aaron Lucchetti & Joann S. Lublin, Calpers Targets Directors Who Neglect Holders, WALL ST. J., Apr. 16, 2004, at C1)). Meanwhile, the Department of Labor under President Clinton encouraged state and local pension funds to make “targeted investments” intended to achieve some social goal rather than turn a profit. Jim Saxton, A Raid on America’s Pension Funds, WALL ST. J., Sept. 29, 1994, at A12. More recent examples of the infusion of politics into public pension fund investing may be found in the growing number of shareholder resolutions related to global warming, especially at carbon-intensive companies such as ExxonMobil, Ford and General Motors. See, e.g., Craig Karmin, Missouri Treasurer’s Demand: ‘Terror-Free’ Pension Funds, WALL ST. J., June 14, 2007, at C1 (discussing the passage, in a dozen states, of legislation to compel pension funds to divest from companies who do business with state sponsors of terrorism and noting that pension funds are beginning to take the issue seriously); see also Harwell Wells, The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century, 51 U. KAN. L. REV. 77, 113–18 (2002) (discussing the history and events surrounding “Campaign GM,” a push in the late-1960s and early-1970s which never gained more than three percent of shareholder votes, to demand that corporations, most notably General Motors, to adopt polices for social good).

171. INVESTMENT COMPANY FACT BOOK, supra note 33, at 31.
172. Indeed, much of the appeal of indexed investing is that it offers competitive returns at extremely low cost. See, e.g., STANDARD & POOR’S, STANDARD & POOR’S INDICES VERSUS ACTIVE FUNDS SCORECARD, FIRST QUARTER 2007 3 (Apr. 25, 2007), available at http://www2.standardandpoors.com/spi/pdf/index/SPIVA_2007_q1.pdf (reporting that, over the prior five years, the S&P 500 index had outperformed approximately three-quarters of all actively managed funds).
are heavily diversified, reducing their incentives to monitor in much the same way.\footnote{173} The growth of indexed investing has been explosive. In 1976 there was only one index fund, derided by some as “Bogle’s Folly,” and by 1984 there were still only two.\footnote{174} Today, however, over seventeen percent of all equity fund assets—more than $1 trillion—is held by index mutual funds.\footnote{175} Just over $31 billion in new cash flowed into index mutual funds during 2006.\footnote{176} In an eerily similar pattern, it took several years after the first ETF was founded in 1993 for the second to be established.\footnote{177} However, today, there are at least 359 ETFs holding over $422 billion of assets.\footnote{178} Moreover, pension plans increasingly appear to be relying heavily on indexed investments as well.\footnote{179} All told, institutional investors have thus far remained passive, doing relatively little to change the fundamental nature of corporate governance or to improve the performance of individual firms. In fact, several empirical studies have found that what little institutional investor monitoring there is has produced no measurable effect on stock prices or earnings.\footnote{180} It is also true that, although there are mutual funds that engage in active monitoring, their response to evidence of poor performance is to exit the investment rather than to

\footnote{173}{See Black, supra note 11, at 834 (noting that some institutional investors “own a thousand or more ‘names’”); see also Louis Lowenstein, Sense and Nonsense in Corporate Finance 217 (1991) (noting that one pension fund holds shares in 1400 different companies).}


\footnote{175}{See INVESTMENT COMPANY FACT BOOK, supra note 33, at 39 (listing yearly net cash flow to index mutual funds for 1993 through 2006).}

\footnote{176}{Id.}

\footnote{177}{Id. at 32 (listing yearly numbers of ETFs for 1993 through 2006).}

\footnote{178}{Id. at 32–33 (listing yearly numbers of ETFs for 1993 through 2006 and amount of assets in ETFs for 1993 through 2006).}

\footnote{179}{See Gilson & Kraakman, supra note 20, at 863–64 (estimating that CalPERS would soon devote as much as eighty-five percent of its portfolios to passive indexed investments).}

\footnote{180}{See, e.g., Bernard S. Black, Shareholder Activism and Corporate Governance in the United States, in The New Palgrave Dictionary of Economics and the Law 459, 462 (Peter Newman ed., 1998) (finding “no strong evidence of a correlation between firm performance and percentage of shares owned by institutions”); Black, Empirical Evidence, supra note 10, at 917–24 (finding minimal research into the impact of oversight by institutional investors); Roberta Romano, Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance, 18 YALE J. ON REG. 174, 177 (2001) (highlighting the dearth of studies that found oversight by institutional investors to have a positive impact on stock prices).}
take action against management. Therefore, institutional investors in general, and public equity funds in particular, have thus far failed to seize their historic opportunity to become active monitors of corporate wrongdoing.

II. PRIVATE EQUITY FUNDS

In Part I of this Article, the focus was on public equity funds. When one traces their recent history, it becomes readily apparent that, despite their promise and despite several attempts by the SEC to make the exercise of shareholder voice less burdensome, public equity funds remain today extremely passive in their outlook. Rather than expend resources on corporate oversight, most are either indexed or widely diversified. They keep costs low and sell when performance lags. The promise of institutional investor voice thus remains largely unfulfilled.

Part II shifts the focus to private equity funds. It first provides an overview of their typology and history, regulatory environment, and legal structure. It then sets forth their unique compensation structure.

A. Overview and History

An investment fund is a business entity whose only important asset is its capital and whose primary business purpose is to acquire securities or other assets in the hope that they will appreciate. By


182. Omitted from the discussion in Part II are funds of funds, which invest primarily in other private equity funds, as well as university endowments. For corporate governance purposes, funds of funds are largely irrelevant. They simply serve as a conduit for diversifying investments and so do little to change the incentives of fund managers. University endowments are more complicated. Some are quite large and sophisticated, but many are neither. As a result, they defy easy classification and lack homogeneity. Depending upon their particular size and investment outlook, then, they may be assumed to mimic the governance, behavior and incentive structure of other categories of funds. See generally James M. Schell, Private Equity Funds: Business Structure and Operations § 1.06, at 1-32 to -35 (2006); (describing how a Fund of Funds is organized, operates, and invests); Thomas Meyer & Pierre-Yves Mathonet, Beyond the J-Curve: Managing a Portfolio of Venture Capital and Private Equity Funds ch. 5 (2005).

183. See Schell, supra note 182, § 8.03, at 8-36 to -38 (noting that investment companies such as mutual funds and private equity funds engage primarily in the business of investing and reinvesting in the securities of other companies). Note that private equity funds typically pursue a long-only investment strategy. Unlike traditional hedge funds, which may take both long and short positions in a given stock, private equity funds seek to gain from capital appreciation only. See Schell, supra note 182, § 1.03[1], at 1-19 (discussing the investment strategies of venture capital funds).
contrast, a bank or insurance company, while also being predominantly a pool of cash, utilizes its capital to engage in a variety of other businesses, such as loan origination and the underwriting of risk. If an investment fund purchases primarily equity securities, as opposed to real estate or other assets, it can be referred to as an equity fund. If it is exempt from most federal regulation, it is commonly known as a private equity fund.

The term “private equity fund” is a business term, not a legal one. Therefore, there is no one standard definition for this group of investors. However, the term is generally used to refer to a category of investment funds that seek to avoid regulation under various federal securities laws, most notably the Investment Company Act and the Investment Advisers Act. Private equity funds also commonly seek to acquire control over a limited portfolio of corporations. Once control is established, they cause management to take actions that favor shareholder interests, thus reducing agency costs. In order to pursue different investment strategies, private equity funds have developed into several distinct categories—venture capital

---

184. See generally Milton R. Schroeder, The Law and Regulation of Financial Institutions (1995) (distinguishing investment funds from other financial entities such as banks and insurance companies).

185. Thus, for example, a real estate investment trust or “REIT,” though also primarily a pooled investment vehicle, differs from an equity fund in that it invests primarily or exclusively in real estate. See generally Schell, supra note 182, § 1.06[A], at 1-38 to -39 (describing, among other things, the investment strategy and organizational structure of real estate funds).

186. See infra Part II.B (describing the complexity of the regulatory environment for equity funds).

187. Jack S. Levin, Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions, ¶ 102, at 1–3 (2005); Schell, supra note 182, § 1.04[1], at 1-25 (2006); see George W. Dent, Jr., Venture Capital and the Future of Corporate Finance, 70 Wash. U. L.Q. 1029, 1035–64 (1992) (describing methods by which venture capital funds exercise de facto control over their portfolio of companies without owning a majority of the shares). But see Brav, Jiang, Partnoy & Thomas, supra note 7, at 4 (finding that most activist hedge funds do not seek to acquire a majority of their targets’ stock). For a discussion of the unique nature of hedge fund oversight, see Kahan & Rock, supra note 7, at 1021 (arguing that hedge fund monitoring is both strategic and ex ante, rather than incidental and ex post). For examples of contractual terms that permit private equity funds with a minority position to effectively wield power, see Douglas G. Smith, The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?, 65 Tenn. L. Rev. 79, 107–35 (1997); Shannon Wells Stevenson, The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties, 51 Duke L.J. 1139, 1155–64 (2001).

188. See Brav, Jiang, Partnoy & Thomas, supra note 7, at 2–3, 37 (finding that hedge fund activism “can reduce the agency costs of equity by focusing managers on creating shareholder value instead of pursuing other agendas”).
funds, leveraged buyout funds and, in certain cases, hedge funds. There is also a great deal of variation within each category. Venture capital funds typically invest in a limited number of early stage companies with the expectation that most will ultimately fail. However, given the potential for huge profits, it only takes one Google to make an entire fund profitable. Venture capital funds


Considerably less has been written on the history of the hedge fund industry. The most notable (and controversial) exception is Barton Biggs, Hedgehogging (2006). Another colorful source is Joseph Nocera, The Strange Inner Workings of the Too-Good-to-Last? Hedge-Fund Machine, N.Y. Times Magazine: The Money Issue, June 5, 2005, at 44.


190. For example, venture capital funds may invest primarily in early stage companies or more mature companies. Likewise, their focus is often limited to a particular industry or market segment.


192. See, e.g., Rebecca Buckman, Silicon Valley’s Backers Grapple With Era of Diminished Returns, Wall St. J., Apr. 3, 2006, at A1 (comparing current rates of return with the profits generated by the Google IPO); Andrew Clark, Sequoia Grows Another Golden Fruit for the Welshman with the Midas Touch, The Guardian, Oct. 19, 2006, at 29 (noting the enormous success of San Francisco based Sequoia Capital, which made billions from its investment in Google); Gary Rivlin, So You Want to be a
are long-term investors, with a time horizon often ranging between seven and ten years, and they generally prefer to acquire a majority of the outstanding equity of a given portfolio company. Alternatively, they often acquire a smaller stake coupled with various contractual rights of control. They generally seek to exit their investments by means of an initial public offering or a sale or other business combination involving the portfolio company.

Leveraged buyout funds generally seek to acquire control of more mature companies, frequently in industries that are out of favor with Wall Street. Often in conjunction with existing management, they may take public corporations private or acquire divisions of public companies in privately negotiated transactions. They generally utilize significant leverage, limiting the equity portion of the purchase price to as little as twenty to forty percent or less. LBO funds frequently cause their target companies to sell various assets...
Shortly after closing in order to pay off a portion of the debt, the remainder is secured by the target companies’ assets. Thereafter, they hope to fund the remaining debt payments from a combination of corporate profits and tax savings. As an exit strategy, LBO funds generally sell off their portfolio companies to another buyer or via a public offering of stock, often after six or seven years.

Hedge funds have typically been thought to acquire more esoteric investments, such as derivative securities, commodities and currencies. Indeed, hedge funds that engage in such investments are not properly thought of as private equity funds. More recently, however, as profitable investment opportunities have become scarcer—even as more money has poured into the hedge fund industry—many hedge funds have become more active in acquiring corporate equities. One notable example of this trend is Cerberus Capital Management, which recently agreed to acquire eighty percent of Chrysler.

---

199. See Robert F. Bruner, Applied Mergers & Acquisitions 394–95 (2004) (noting that LBOs are often concentrated in firms suffering from financial distress which therefore lend themselves to improved efficiency and the disposition of unnecessary assets).


201. See David Cay Johnston, Tax Loopholes Sweeten Deal for Blackstone, N.Y. Times, July 13, 2007, at A1 (describing the tax savings obtained by Blackstone); Steven Kaplan, Management Buyouts: Evidence on Taxes As a Source of Value, 44 J. Fin. 611, 611–32 (1989) (noting the importance of tax benefits as a source of wealth gains in management buyouts). For data on post-LBO corporate profits, see generally Steven Kaplan, Management Buyouts: Efficiency Gains or Value Transfers 43–45 (University of Chicago Working Paper No. 244, 1988) (“Post-buyout investors, in those buyout companies which can be valued, earn returns in excess of the market return.”); Bruner, supra note 199, at 56 ex. 3.11 (summarizing data on profits from five separate empirical studies).


203. See id. at 33 (noting that a number of hedge funds “adopt traditional, long-only strategies similar to those used by most registered investment companies”); see also Brav, Jiang, Partnoy & Thomas, supra note 7, at 2 (reviewing the corporate governance activities of 131 activist hedge funds); Gina Chon, Jason Singer & Jeffrey McCracken, Driver’s Seat: Chrysler Deal Heralds New Direction for Detroit: Cerberus Takes Gamble on Union Concessions; GM, Ford May Benefit, WALL ST. J., May 15, 2007, at A1 (noting that “[p]rivate-equity firms like Cerberus, which often buy public equity companies and slash costs, have amassed large war chests of capital and have been aiming for bigger and bigger targets”).

206. See, e.g., Emily Thornton, What’s Bigger Than Cisco, Coke, or McDonald’s?, BUSINESSWEEK, Oct. 3, 2005, at 100 (following the “secretive” Cerberus in its usual
years, has purchased a controlling stake in such American icons as Sears Roebuck and Kmart. Thus, to the extent hedge funds move into the territory traditionally held by LBO and venture capital funds, they may also be considered private equity funds.

Prior to the 1970s, private equity investing was extremely limited, never exceeding more than a few hundred million dollars in any given year. Originally dominated by wealthy families such as the Phippes, Rockefellers, Vanderbilts, and Whitneys, the industry gradually gave way to more professional investors, with the first formal private equity funds being organized in the years following World War II. Although they scored some notable successes, these early funds attracted relatively little capital from traditional institutional investors.

All this began to change in the late 1970s and early 1980s, as institutional capital began to be available to private equity funds.
Although the flow of investment dollars ebbed and flowed unevenly, this period saw the rise of the modern venture capital industry, centered in large part on Sand Hill Road in California’s Silicon Valley. It was during this period that soon-to-be industry giants such as Cisco, Genentech, Microsoft, and Sun Microsystems all received their initial funding. Leading the way were venture capital funds such as Sequoia Capital and Kleiner Perkins Caufield & Byers.

Meanwhile, LBO funds were cataloguing their own string of successful turn-arounds, especially in the 1980s. The combination of cheap credit available through the issuance of junk bonds, lax antitrust enforcement under the Reagan Administration, and changing attitudes as to proper corporate behavior led to a boom of takeovers, many of which were structured as leveraged buyouts.

Initially, LBO specialists like the Carlyle Group, the Blackstone Group, and Kohlberg Kravis Roberts were dominant. Investment banks have also joined the game using their own in-house capital. Moreover, although private equity was for many years a largely interpretations had left uncertain whether pension funds could safely invest in venture capital and other high-risk asset classes. However, in 1979, the Department of Labor issued a release that clarified the standard to permit such investments. Mercer Report, supra note 9, at 73. Another factor may have been the rise of limited partnerships, which—unlike Small Business Investment Companies—were not restricted in investment options, and which made possible performance-based fee arrangements. Id.

212. Sand Hill Road, which connects El Camino Real with Interstate 280 in Menlo Park, California, has come to symbolize the venture capital industry much in the way that Wall Street symbolizes high finance. See Clark, supra note 192 (calling Sand Hill Road “Silicon Valley’s equivalent of Wall Street”). It is home to some of the world’s most famous venture capital funds, including Kleiner Perkins Caufield & Byers and Sequoia Capital. See Laura M. Holson, Investing: Still Feeding an Internet Frenzy, N.Y. TIMES, June 6, 1999, (Sunday Business) at 1 (referring to Kleiner Perkins Caufield & Byers as “the godfather of Silicon Valley”).


214. See, e.g., Lerner, Hardymon & Leamon, supra note 7, at 1–3 (summarizing the history of the private equity industry in the United States, with particular emphasis on the spike in activity in the early 1980s).

215. See Gaughan, supra note 197, at 55–59 (providing data and historical analysis regarding the “fourth wave” of merger activity occurring between 1981 and 1989).


217. See id. at 64 (noting that some investment banks have invested their own capital in private equity investments); see also Jenny Anderson, Goldman Bets Hedge Money of Its Own, N.Y. TIMES, July 27, 2007, at C1 (describing Goldman Sachs’s creation of, and investment in, a new hedge fund).
American phenomenon, European firms have increasingly gained ground.\textsuperscript{218}

The overall private equity market continues to be both vibrant and growing. The past two years, for example, have witnessed nine of the ten largest leveraged buyouts in history.\textsuperscript{219} Only the epic $25 billion buyout of RJR Nabisco in 1989 remains on the top-ten list.\textsuperscript{220} Meanwhile, an estimated $215 billion flowed into the coffers of private equity funds during 2006, an increase of thirty-three percent over the prior year and far above the record $177 billion raised in 2000.\textsuperscript{221} In total, the industry is estimated to actively manage as much as $3 trillion in investment capital.\textsuperscript{222}

\section*{B. Regulatory Environment}

Under normal circumstances, an equity fund of any sort would be the subject of multiple and extensive federal regulations. The Investment Company Act of 1940\textsuperscript{223} would govern the fund itself,
while the Investment Advisers Act of 1940\textsuperscript{224} would regulate the fund’s managers. Offerings of fund securities to potential investors would be subject to regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934.\textsuperscript{225} In addition, depending on their particular investment strategies and the nature of their investors, investment funds could be subject to the Employee Retirement Income Security Act (“ERISA”),\textsuperscript{226} the Commodities Futures Trading Act,\textsuperscript{227} the Gramm-Leach-Bliley Financial Services Modernization Act,\textsuperscript{228} and even the USA PATRIOT Act,\textsuperscript{229} among other potentially...
applicable federal statutes. State law also applies. Public equity funds may therefore be considered among the most highly regulated of American businesses.

Private equity funds, by contrast, typically seek to avoid the brunt of each of these regulatory schemes. By limiting themselves to fifteen “clients,” for example, a private equity fund manager may be exempt from regulation under the Investment Advisers Act. Similarly, the fund may avoid the limitations imposed by the Investment Company Act by either permitting fewer than one hundred “accredited investors” to purchase interests, or restricting membership to those meeting the test for “qualified clients.” Other structuring techniques are available to avoid most of the other applicable regulatory schemes, thereby making the private equity fund a largely unregulated, if highly stylized, investment vehicle.

In fact,


231. But see Conwell, supra note 34, at 664–65 (characterizing the regulation of mutual funds as “mild,” at least in comparison to the original draft of the Investment Company Act).

232. Investment advisers that would otherwise be subject to regulation under the Investment Advisers Act are generally exempt from registration if they have fewer than fifteen clients within a rolling one-year period. 15 U.S.C. § 80b-3(b)(3) (2000). For purposes of the exemption, a private equity fund is normally treated as a single client. 17 C.F.R. § 275.203(b)(3)-1(a) (2007). In practice, this means that a fund manager can advise up to fifteen funds at any one time and still remain exempt from federal registration.

233. Private equity funds typically utilize one of two different exemptions in order to avoid registration under the Investment Company Act, 15 U.S.C. § 80a-1 to -52 (2000). So-called 3(c)(1) funds are prohibited from having more than one hundred beneficial owners. 15 U.S.C. § 80a-3(c)(1). Although there are complicated look-through and integration rules to avoid manipulation, for purposes of this exemption, investors that are entities or husband-and-wife teams are typically counted as a single investor. 15 U.S.C. § 80a-3(c)(1)(A). So-called 3(c)(7) funds are not limited in the number of investors, but may only accept investments from qualified purchasers. 15 U.S.C. § 80a-3(c)(7) (adopted as part of the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416). To be a “qualified purchaser,” an individual must own at least $5 million in investments, and an entity must own at least $25 million in investments. 15 U.S.C. § 80a-2(a)(51). The term “investments,” for this purpose, does not include most cash or mixed-use assets such as real estate that the investor uses as a residence or for business purposes. 17 C.F.R. § 270.2a-51-1 (2007). Interestingly, section 3(c)(7)(E) of the Act permits the creation of side-by-side 3(c)(7) and 3(c)(1) funds—each with the same adviser—such that a family of related funds is generally able to admit an unlimited number of qualified purchasers and up to one hundred other investors. See infra notes 250–252 and accompanying text (describing other uses for a dual-fund structure). Note, however, that in order to utilize the rule 506 exemption from registration under Regulation D of the Securities Act, even the investors who are not qualified purchasers must nonetheless be “accredited investors.” See infra note 234 (outlining a venture capital fund’s preferred investment structure).

234. For example, to avoid registration of the limited partnership interests under the Securities Act, most funds avoid general solicitation and advertising and only accept investments from accredited investors. See 17 C.F.R. § 230.501(c)(1)(iv)

235.
considering the lengths to which they contort themselves in order to qualify for the various exemptions, private equity funds may arguably be considered either highly regulated or highly unregulated. Semantics aside, however, and despite increasing calls for greater regulation—particularly of hedge funds—235—they remain at present exempt from nearly all disclosure requirements and are free to engage in any risky or exotic investment strategies to which their investors consent.236

C. Structure and Organization

As a result of their ability to avoid most federal disclosure requirements, private equity funds are frequently able to avoid the limelight, typically keeping their activities obscured from the general public. Indeed, more than half of buyout funds require their investors to agree to be kept in the dark regarding the nature of the fund’s activities.237 Thus, data regarding private equity funds tends to be either self-reported or estimated, and accurate empirical

(2006) (excluding accredited investors for purposes of calculating the number of purchasers under rules 505(b) and 506(b)). The definition of “accredited investor” includes banks, insurance companies, broker-dealers, business entities having total assets in excess of $5 million, and individuals with total assets in excess of $1 million. 17 C.F.R. § 293.501(a). It is also necessary to have fewer than 500 investors in any fund so as to avoid the public reporting requirements of the Securities Act. See 15 U.S.C. § 78(l)(g)(1)(B) (2000) (requiring firms with $1 million in assets and over 500 shareholders to file periodic reports with the SEC and the public). Having ninety-nine or fewer investors also permits a fund to utilize a safe harbor to avoid being taxed as a publicly traded partnership. Treas. Reg. § 1.7704-1(h)(1). For a general discussion of the taxation of publicly traded partnerships, including private equity funds that do not satisfy the safe harbor requirements, see SCHELL, supra note 182, § 5.01[2], at 5-3 to -9.


236. See infra Part IV.C.1 (comparing the disclosure rules applicable to private and public equity funds). An interesting development on the disclosure side has arisen due to a series of recent lawsuits filed under state Freedom of Information Acts. The result is that state pension funds and university endowments are increasingly required to disclose information regarding their investments in private equity funds. See generally Steven E. Hurdle, Jr., A Blow to Public Investing: Reforming the System of Private Equity Fund Disclosures, 53 UCLA L. REV. 239, 254-59 (2005) (describing how public institutional investors in Michigan, California, and Texas have been forced to disclose details of their investments in private equity funds). Whether the funds will acquiesce in such disclosures or instead prohibit investments from applicable state pension funds and university endowments remains to be seen. See id. at 259-67 (detailing winners and losers in a system of increased disclosure).

237. PRIVATE EQUITY TERMS & CONDITIONS, supra note 196, at 58. This has apparently occurred in response to recent attempts by certain public pension fund managers to disclose publicly information regarding the private equity funds in which they invest. Id. at 57-59.
information regarding private equity markets is difficult to acquire.\footnote{238} Even the SEC remains unclear as to exactly how many private equity funds exist, how large they are, and how often they fail.\footnote{239} Partly as a result of this secrecy, a discrete group of national law firms has thus far been able to maintain a stranglehold on the market for private equity legal work.\footnote{240}

Paradoxically, although they operate in a secretive world, private equity funds are subject to significant market forces.\footnote{241} This is because they tend to compete for the investment dollars of the same group of wealthy individuals and institutions. In fact, given that interests in private equity funds are generally offered on a take-it-or-leave-it basis, fund managers often find themselves negotiating

\footnote{238}{In an effort to acquire more accurate information about the market for private equity investments, a group of nine state retirement and pension funds commissioned a report in 1996 by the consulting firm William M. Mercer, Inc. See MERGER REPORT, supra note 9 (exploring contractual issues and investment practices in private equity funds and the relationship between general partners and limited partners in those funds). Dow Jones, the publisher of The Private Equity Analyst, has since undertaken an annual survey of prevailing terms and conditions among venture capital and buyout funds. See PRIVATE EQUITY TERMS & CONDITIONS, supra note 196 (summarizing the typical terms of private equity partnerships, such as fund formation, fees and expenses, profit sharing, and governance, among other issues). Both are excellent sources for attorneys and other advisers to private equity funds.}

\footnote{239}{SEC HEDGE FUND REPORT, supra note 5, at x (noting that the SEC “lacks information about hedge fund advisers” and “has only indirect information about these entities and their trading practices”). In order to improve its understanding of the hedge fund industry, the SEC in 2004 expanded the definition of an investment adviser in a manner intended to catch hedge funds but not private equity funds. See 17 C.F.R. §§ 275, 279 (2007) (re-defining “client” to be any natural person, thereby effectively eliminating the fifteen client exemption for funds that permit redemptions within the first two years of operation). The purpose of the rule was to gather information about hedge funds by requiring their advisers to register with the SEC. See generally Sue Ann Mota, Hedge Funds: Their Advisers Do Not Have to Register with the SEC, But More Information and Other Alternatives are Recommended, 67 LA. L. REV. 55 (2006) (providing an overview of the current hedge fund regulatory environment and recommending policy changes to protect individual investors). However, the rule was struck down in 2006 by the U.S. Court of Appeals for the District of Columbia Circuit, on the grounds that the SEC lacked the authority to change the definition of a term contained in a federal statute. Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 883 (D.C. Cir. 2006).}

\footnote{240}{See, e.g., Peter Lattman, Cutting Hedge: Law Firm Grows with Funds, WALL ST. J., Jan. 3, 2006, at Cl (reporting on the increasingly large revenue source hedge funds are proving to be for major law firms). For a list, see Most Active Law Firms, DOWJONES PRIVATE EQUITY ANALYST Apr. 2007, reprint at http://webreprints.djreprints.com/16 86610715025.pdf (providing rankings of the most number of deals closed in 2005 based on self-reported data).}

\footnote{241}{See SCHELL, supra note 182, § 1.02, at 1-9 (noting that the relationship between investors and fund managers in private equity funds is characterized by voluntary agreement, rather than dictated by regulation, and so is the result of negotiations that take place within a market for pooled investments). Market information remains difficult to obtain, however. See SEC HEDGE FUND REPORT, supra note 5, at x (noting the SEC’s lack of information on hedge fund industry data).}
against themselves. If their offering documents differ too much from the market standard, for example, potential investors will simply seek other investment opportunities. As a result of such market forces, the legal structure and compensation arrangements of private equity funds have become highly uniform.

This is even the case across fund categories; the structure and fees of a typical hedge fund look very much like those of a typical venture capital fund.

Private equity funds are typically structured as limited partnerships with a limited liability company as the general partner. Wealthy investors contribute most of the capital and receive limited

---

242. See Mercer Report, supra note 9, at 63 (noting that existing "standards' will ebb and flow with market conditions and supply and demand forces"); see also Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers: Mutual Funds and Advisers § 12.03[C], 12–67 (2d ed. 2001) (noting that investment adviser fees are not negotiated at arm's length).

243. See Mercer Report, supra note 9, at 70 ("The basic premise underlying our [study] was that general partners will attempt to negotiate terms and conditions that the market will bear.").

244. See SEC Hedge Fund Report, supra note 5, at 8 (giving a brief description of the structure and purpose of a venture capital fund). The differences in fund structure between venture capital, LBO, and hedge funds occur primarily as a result of their different investment strategies. Thus, for example, because hedge funds often purchase liquid securities, hedge funds are generally able to permit their investors to make voluntary redemptions on a periodic basis after some initial lock-up period. Schell, supra note 182, § 9.04, at 9-15 to -16. Venture capital and LBO funds, on the other hand, make illiquid investments and so generally prohibit such redemptions. Id. Similarly, hedge fund profits are easier to calculate on an ongoing basis than venture capital or LBO profits because hedge fund investments are more readily valued. Id. § 2.02[2][d], at 2-11 to -14. However, to the extent that a hedge fund behaves more like a traditional private equity fund, it is likely to have terms that are more similar to those traditionally adopted by venture capital and LBO funds. Id.

245. Id. § 9.01, at 9-2; Meyer & Mathonet, supra note 182, at 29. Given the flexibility of most modern limited liability company statutes, it is also possible that the fund would be structured as an LLC. See Mercer Report, supra note 9, at 52–53 (discussing the benefits of an LLC for public funds). Still, the structure of such an LLC would closely resemble that of a limited partnership, with the fund managers retaining operational control over the fund and the remaining investors being largely passive, and the tax and liability results would be essentially the same. Id. Perhaps as a result, private equity funds have largely resisted what may be the general market temptation to prefer LLCs over limited partnerships. Mutual funds, although similar to private equity funds in being essentially pooled investment vehicles, are more commonly organized as Massachusetts business trusts. See Sheldon A. Jones, Laura M. Moret & James M. Storey, The Massachusetts Business Trust and Registered Investment Companies, 13 Del. J. Corp. L. 421, 422 (1988) (reporting that half of new investment companies who registered under the Investment Company Act of 1940 from July 1985 to December 1987 were in the form of Massachusetts business trusts); cf. Tamar Frankel, The Delaware Business Trust Act Failure as the New Corporate Law, 23 Cardozo L. Rev. 325, 330 (2001) (noting that commercial and manufacturing enterprises generally do not utilize the Delaware Business Trust Act because other legal forms of organization are more amenable to change and the Delaware Act offers no tax advantages).
partnership or similar interests in return. Such interests are passive, with very few control rights, and highly illiquid. Depending on the type of fund, a limited partner may be restricted from redeeming her interest for as many as seven to ten years. The fund managers, through their ownership of the fund’s general partner, control its affairs and investment decisions. They also typically invest a significant portion of their personal net worth directly in the fund as limited partners in order to discourage them from taking excessive risks with the fund’s capital.

246. Schell, supra note 182, § 3.01[4], at 3-8 to -10.1. Traditionally, the passivity of the limited partners was a response to the requirement that they be generally passive in order to maintain their limited liability. Id. § 3.01[4], at 3-8. However, the law in this regard has evolved toward a presumption of limited liability. Id. § 3.01[4], at 3-8 to -9. The Delaware Revised Uniform Limited Partnership Act, for example, contains a list of activities that fall within the statutory safe harbor and so do not jeopardize the limited liability of limited partners. Del. Code Ann. tit. 6, § 17-303(b) (2007). Protected activities include, among other things, transacting business with the limited partnership, advising the general partner with respect to the business of the limited partnership, guaranteeing the debts of the limited partnership, serving on a committee of the limited partnership, and voting on matters of limited partnership business. Id.

247. See Schell, supra note 182, § 2.04[1], at 2-20 (finding that “holding periods of three to seven years are common”). The typical timeline for a venture capital fund, for example, is such that it might take three to five years for all of the capital to be invested, after which point the fund changes to a liquidation mode. Id. § 2.05[2], at 2-30 to -31. During that time, it is hoped that one or more of the investments results in a profitable exit. Hill & Power, supra note 191, at 11. However, the bulk of the investments are expected to take as many as seven to ten years to pay off. Id. Thus, venture capital funds typically prohibit redemptions during that period, but may make early payouts to the extent the fund returns a profit prior to being wound up. Schell, supra note 182, § 1.03[7], at 1-24, 2.04[2], at 2-22. See generally Private Equity Terms & Conditions, supra note 196, at 17–20 (reporting that most private equity partnerships have a term of ten years and an investment period of five or more years). Some funds also provide for extensions of two or three years. Mercer Report, supra note 9, at 45.

Traditional hedge funds, which invest primarily in liquid, marketable securities, are able to permit redemptions at almost any time. SEC Hedge Fund Report, supra note 3, at ix. For administrative convenience, however, they generally require that redemptions be made only on set dates, often quarterly. Id. In addition, to ensure the viability of the fund, redemptions are generally prohibited during the first year or so of the fund’s existence. Id. Such hedge funds, however, are not properly thought of as private equity funds within the meaning of this Article. See supra notes 205–207 and accompanying text (explaining that hedge funds have greater liquidity than most private equity funds). Thus, their shorter time horizon and greater flexibility with respect to redemptions are outside the norm of the private equity community. Presumably, hedge funds that operate more like private equity funds would require a longer lock-up period. See Schell, supra note 182, § 1.05[7], at 1-32 (noting that, although typical lock-up periods may last from one to three years, “to the extent a particular Hedge Fund is allowed to invest in non-marketable securities or other non-marketable assets, the ability to fund redemption requests on short notice may be impaired”).


249. Schell, supra note 182, § 3.02[2], at 3-21. Historically, for tax purposes, general partners were required to contribute at least one percent of the fund’s
For regulatory purposes, a single “fund” is often actually structured as a family of several funds, each with the same fund manager/general partner but each with different limited partners. For example, funds that sell interests to not-for-profit corporations, non-U.S. entities, and/or ERISA pension plans may seek to isolate such investors in separate legal entities. Each separate limited partnership would then make the same investments, pro rata, to account for their differing sizes. As a result, from an economic standpoint, the funds operate as one, even though they are structured as distinct legal entities for regulatory purposes.

D. Alignment of Interests

The overriding goal of private equity fund governance is to align the interests of the fund managers with the interests of their investors. In fact, the alignment of interests within private equity funds is much closer than in a typical corporation. As a result, the internal agency costs are generally much lower.

capital. Id. More recently, this tradition has continued as a way to ensure that fund managers have some downside risk, so that they will not lose their aversion to excessive risk whenever the fund’s value drops below its historical value. See generally infra notes 263–267 and accompanying text.

250. SCHELL, supra note 182, § 3.02[4], at 3-25 to -26.

251. See id. §§ 5.04[2], at 5-26 to -28 (tax-exempt investors), 8.07[1]-[4], at 8-66 to -72 (non-U.S. investors), 8.06[4], at 8-63 to -65 (ERISA plan investors).

252. Id. § 3.02[4], at 3-26.

253. See, e.g., id. § 1.02[3], at 1-14 (“The concept of alignment of interest can provide an important element of consistency to the consideration of the numerous financial and other terms embedded in the contracts governing the organization and operation of a private equity fund. It can also provide a basis for identifying economic and other terms that, even if widely accepted as 'market,' should be resisted when possible.”); MERCER REPORT, supra note 9, at 2 (“The carried interest represents a financial alignment of interests.”); PRIVATE EQUITY TERMS & CONDITIONS, supra note 196, at 7 (“Private equity finance derives its strength from an organizational characteristic that sets it apart from most other types of finance: It is structured so that the entrepreneurs, the investment managers, and the providers of capital all benefit in very material ways from the success of the businesses receiving financing. This alignment of interest ensures, at least in theory, that all decisions are made in a way that is likely to maximize the success of the business being financed.”).

254. See infra note 272 and accompanying text. The alignment of interests between the portfolio company and the private equity fund are also quite strong. See Gilson, supra note 189, at 1083–84 (“Perhaps more starkly than any other organizational or contractual technique, the portfolio company’s compensation structure creates extremely high-powered performance incentives that serve to align the incentives of the portfolio company management and the venture capital fund.”).

255. See Jensen, supra note 7, at 65 (arguing that post-LBO companies, with their close monitoring, have an incentive structure that is superior to that of public corporations); see also BRUNER, supra note 199, at 56 (summarizing several empirical studies that found increased value in transactions where managers had more at stake, including leveraged buyouts); Black, Empirical Evidence, supra note 10, at 924 (noting
The linchpin of private equity fund compensation is the so-called “carried interest.” The concept behind a carried interest is a formula for dividing profits that has developed as the marketplace norm. A fund’s investors are typically entitled to receive distributions equal to their pro rata portion of one hundred percent of the profits of the fund until their investments are completely paid back. To use a numerical example, if investors purchase interests equal to $10 million and the fund returns only $10 million, the investors go home even, having neither gained nor lost anything. However, once their initial investment has been returned in full, they are entitled to only eighty percent of any profits thereafter, leaving twenty percent for the fund managers.

Thus, to continue the example, if the fund yielded a net profit of $5 million (after the initial $10 million was recouped), the investors would receive collectively $14 million (their initial $10 million investment plus $4 million of the profit) and the managers would receive $1 million. If the profit in this example were repeated the following year, the split would again be $4 million for the limited partners and $1 million for the fund managers, making the overall two-year split $18 million for the investors and $2 million for the managers.

The existence of “substantial evidence suggesting that LBOs often led to improved corporate performance, at least up through about 1986”.

256. This is sometimes also referred to as a “promote,” “promoted interest,” or an “override.” SCHELL, supra note 182, § 2.02, at 2-5. See generally MERCER REPORT, supra note 9, at 12-14 (defining a carried interest as “the share of the partnership profits received by the general partner” and discussing how the carried interest motivates the general partner).

257. See Schell, supra note 182, § 2.02[1], at 2-5 (noting a carried interest of twenty percent is the current market standard for hedge funds). Increasingly, many funds also vary the percentage payable to the fund advisers depending on the fund’s performance. For example, a firm might charge a twenty percent carried interest if the internal rate of return is below twenty percent, but a twenty-five percent carried interest if performance exceeds the twenty-five percent level. PRIVATE EQUITY TERMS & CONDITIONS, supra note 196, at 39.

258. SCHELL, supra note 182, § 2.02[1], at 2-7. Occasionally, this structure leads to complicated timing questions, especially in venture capital funds where an early investment might pay off quickly while others die a slower death. The result is that fund managers and investors have developed a complicated set of provisions—including so-called “clawbacks”—that ensure that the economics of the fund balance correctly over its life, even if one party or another is inadvertently paid too much at one time or another. See id. § 2.04, at 2-23 (explaining that a typical clawback provision may require the general partner to return excess distributions of carried interest).

259. Id. § 2.02[1], at 2-5 to -8. In fact, the actual percentage may in many cases be far higher, as it is industry practice for the fund managers to invest a portion of their own net worth in the funds they manage. Id. § 3.02[2], at 3-22. Thus, not only are they likely to receive their twenty percent share of the profits, but they are also likely to receive an additional eighty percent share with respect to any capital they invested.

260. During the 1980s, buyout fund advisers typically calculated their carried interest on each individual investment. PRIVATE EQUITY TERMS & CONDITIONS, supra
The result of this scheme is such that the fund managers have a strong incentive to make profitable investments. If there is no profit, as in the first example above, the fund managers are paid nothing. Moreover, because the fund managers earn an extra twenty cents for every additional dollar they are able to squeeze out of their investments, the incentives continue to operate even after the fund has returned a profit. In other words, the incentive never disappears or decreases, no matter how high the profits. Thus, the interests of private equity fund investors and fund managers are closely aligned—both primarily seek profit enhancement.

The basic structure of the carried interest does have two flaws, however, which serve to undermine somewhat this otherwise elegant alignment of interests. As a result, the typical compensation structure of private equity managers has evolved two additional elements aimed at ameliorating such flaws.

The first risk is that a straight carried interest, without more, could encourage excessive risk taking, especially when a fund’s activities are yielding a loss. At that point, one might worry that a fund manager would engage in highly risky speculation since she would have nothing more to risk. For a manager who is only paid a percentage of the profit, a large loss is the same as a small one—both equal no compensation for the manager.

Note 196, at 7. This meant that they could earn a profit on successful investments while avoiding any major loss on unsuccessful ones. Id. Over time, however, the operation of private equity capital markets resulted in the current practice of charging the carried interest on the aggregate of all fund investments, as had been the tradition among venture capital funds. Id.; Mercer Report, supra note 9, at 6.

Schell, supra note 182, § 2.02[1], at 2-5 to -8. It should be noted, however, that private equity funds typically charge, in addition to the incentive-based carried interest, a flat management fee. Id. § 2.05[1], at 2-27. The management fee is intended to be just large enough to cover the expenses of the fund. Id. It is usually based on the total assets under management and typically ranges between 1.5% and 2.5%, depending on the size of the fund. Id. Thus, in the example in the text, although the fund managers do not take home any profit, the management fee should be sufficient to cover their expenses such that they do not suffer a financial loss. In addition, because fund managers are generally expected to invest a sizeable portion of their net worth in the fund, the fund managers also risk losing their own capital. See infra notes 265-267 and accompanying text.

These incentives can be quite large in practice. Witness the incredible pay packages for the top hedge fund managers. See Taub, supra note 9, at 41–42 (reporting that the top twenty-five hedge fund managers each earned over $240 million in 2006).

Schell, supra note 182, § 3.02[2], at 3-22 (noting many investors see large capital contributions by the general partner as fundamental to ensuring a fund’s success).

Id.
To address this possibility, fund managers are usually required to invest a significant portion of their personal wealth in the fund.\textsuperscript{265} In addition, they also frequently co-invest their own capital in portfolio companies alongside the fund.\textsuperscript{266} Thus, the typical private equity compensation structure already accounts for the down-side risk by giving the managers something to lose.\textsuperscript{267} The fund managers are themselves investors with their own capital at risk.

The second additional element limits the ability of private equity fund managers to receive the benefit of general market movements. For example, the carried interest would presumably yield a relatively high profit for the fund managers even if they simply purchased low-yield treasury bills or passive index funds.\textsuperscript{268} But why should investors pay a premium for an investment strategy that they could easily duplicate at a much lower cost? Again, the market for private equity fund fees has produced an answer.

Many fund managers, including most of the bigger and more profitable ones, charge a carried interest only to the extent that fund profits exceed a so-called “hurdle rate” or “priority return” (such as the London Interbank Offered Rate or the yield on twelve-month treasury bills).\textsuperscript{269} Thus, the fund managers receive their twenty

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{265} See \textit{PRIVATE EQUITY TERMS & CONDITIONS}, supra note 196, at 23 (reporting that the mean contribution by advisers in the survey was 3.25% for buyout funds and 2.1% for venture capital funds). Historically, the typical investment by the general partners was slightly lower. See \textit{MERCER REPORT}, supra note 9, at 9–10 (noting that the industry standard is that general partners commit one percent of the fund in either cash or capital); MEYER & MATHONET, supra note 182, at 34–35 (stating that a one percent investment is typical). Note, however, that such an investment by a public equity fund manager would probably violate the prohibition against self-dealing. See 29 U.S.C. § 1104(a)(1) (2000) (explaining the duties of a fiduciary to act “solely in the interest of the participants and beneficiaries”).
\item\textsuperscript{266} See \textit{PRIVATE EQUITY TERMS & CONDITIONS}, supra note 196, at 24–25 (reporting that thirty percent of buyout fund advisers, and 15.7% of venture capital fund advisers, retain the option of co-investing).
\item\textsuperscript{267} SCHELL, supra note 182, § 3.02[2], at 3-21 to -23.
\item\textsuperscript{268} See id. § 2.03, at 2-15 (arguing that investors are less likely to contribute capital unless the carried interest is linked to superior performance because money market funds would produce the same results with less risk). However, some fund advisers have argued that priority returns force them to make more conservative investments than they might otherwise, thereby reducing the profits for fund investors. \textit{PRIVATE EQUITY TERMS & CONDITIONS}, supra note 196, at 42.
\item\textsuperscript{269} See \textit{PRIVATE EQUITY TERMS & CONDITIONS}, supra note 196, at 41–42 (reporting that eighty-eight percent of buyout funds, and forty-two percent of venture capital funds, in the survey provided for the payment of priority returns before the advisers earned their carried interest). See generally \textit{MERCER REPORT}, supra note 9, at 25–28 (discussing hurdle rates and noting that they have reached as high as twenty-five percent); MEYER & MATHONET, supra note 182, at 33–34 (stating that the rationale for preferred returns is to ensure general partners are only compensated for superior performance). But see Victor Fleischer, \textit{The Missing Preferred Return}, 31 J. CORP. L. 77, 86 (2005) (noting that venture capital funds, unlike leveraged buyout funds, typically do not calculate fund manager compensation by reference to a preferred return).
\end{itemize}
\end{footnotesize}
percent profits interest only to the extent they are able to produce returns that exceed the yield on debt securities.\(^{270}\) The portion of the fund’s success that is not attributable to the fund’s performance is factored out of the equation unless and until the priority return is met.\(^{271}\) In this sense, private equity fund fees are far superior to most corporate stock options which allow corporate managers to share in the upside of general market movements.\(^{272}\)

Private equity funds also typically charge their investors a management fee that is intended to pay for the firm’s expenses.\(^{273}\) These fees are generally in the range of two to three percent, with smaller funds charging larger fees, but with downward pressure on management fees overall.\(^{274}\) Additionally, many funds are structured such that the fund’s advisers must return the management fees to their investors, in addition to the investors’ invested capital, before

\(^{270}\) Thus, for example, if a $10 million fund returned $15 million during its first year, and if the hurdle rate were set at five percent, the first $10 million would be returned to the investors as repayment of their initial capital, as would five percent of the $5 million profit (or $250,000). The remaining $4.75 million—which is attributable to the effort and skill of the fund managers—would then be split eighty-twenty between the fund investors and the fund managers. At the end of the day, then, the investors would receive $14.05 million ($10 million plus $250,000 plus $3.8 million) while the fund managers would receive $950,000.

\(^{271}\) Most funds that provide for priority returns also adjust the calculation of the carried interest to permit the fund advisers to “catch up” once they have satisfied the priority amount. PRIVATE EQUITY TERMS & CONDITIONS, supra note 196, at 42 (providing a mathematical example).

\(^{272}\) See Jensen, supra note 7, at 65 (arguing that post-LBO companies, with their close monitoring, have an incentive structure that is superior to that of public corporations); Mark Maremont & Charles Forelle, Bosses’ Pay: How Stock Options Become Part of the Problem, WALL ST. J., Dec. 27, 2006, at A1 (discussing the related problems of stock reloads, re-pricings and backdating). Stock options also create significant opportunities for fraud. See, e.g., Walter M. Cadette, How Stock Options Lead to Scandal, N.Y. TIMES, July 12, 2002, at A19 (describing the powerful incentives that options create to produce fraudulent accountings); Hannah Clark, Stock Scandal: Who’s Next?, FORBES, July 24, 2006, available at http://www.forbes.com/home/leadership-brocade-backdating-cx_hc_0724stockscandalwhosnext.html (reporting that more than eighty companies are under investigation by the U.S. Securities and Exchange Commission and many more are likely to follow); Aaron Siegel, Backdating Scandals Seen as Tapering Off, INVESTMENT NEWS, Jan. 15, 2007, at 14, available at http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070115/REG/70111011/-1/INIssueAlert04&ht= (detailing the recent backdating scandals of many major corporations).

\(^{273}\) See Meyer & Mathonet, supra note 182, at 33 (quoting industry wisdom that fund managers generally “eat sandwiches on the management charges, and caviar on the carry”). See generally MERCER REPORT, supra note 9, at 19–24 (defining and discussing traditional fees, budgeted fees, sliding-fee scales, and transaction fees).

\(^{274}\) See PRIVATE EQUITY TERMS & CONDITIONS, supra note 196, at 30–31 (noting that Blackstone Group’s newest fund will charge a management fee of 1.5% for the first $6 billion and one percent for the remainder of the fund).
taking their carried interest. Thus, management fees are intended to have a neutral impact on the fundamental alignment of interests between fund managers and fund investors.

A final source of income for private equity fund managers—which is not necessarily tied to fund performance—is transaction fees. They include break-up fees for transactions that are not consummated, investment banking fees, and consulting fees. These are typically charged to portfolio companies and so are not paid directly by fund investors. Until the early 1990s, fund managers generally retained the entire amount of such fees. More recently, however, fund investors have begun to claim as much as eighty percent of such fees so as to neutralize their impact on the incentives of the fund advisers. Performance therefore remains by far the most significant element in the compensation of private equity fund managers.

III. PUBLIC AND PRIVATE EQUITY FUNDS COMPARED—INTERNAL CHARACTERISTICS

As described in Part II, private equity funds are active investors who seek to bring discipline to the companies in which they invest. Their particular investment strategy involves acquiring control of a target company and then utilizing that control position to reduce corporate agency costs. In this respect, at least, they are an ideal corporate monitor. Public equity funds, meanwhile, are passive investors who do little or no monitoring. Despite their resources and sophistication, they prefer to sell when a portfolio company’s performance lags rather than expend effort at improving such performance.

This juxtaposition creates a near-perfect natural experiment. To better understand the incentives of public equity funds, there is no need to contrast them to their foreign counterparts, where language, culture and history make such comparisons difficult and at times suspect. Rather, a cleaner approach would be to compare the

275. See id. at 38 (noting that eighty-seven percent of funds surveyed calculated the carried interest net of management fees and other expenses).
276. Id. at 35.
277. Id.
278. Id.
279. Id.
280. Id. at 35–36.
281. The larger question of whether it would be desirable from an overall standpoint to enlist public equity funds as monitors remains open, however. For a discussion of some of the concerns that have been voiced with respect to institutional investor monitoring, see Coffee, supra note 2, at 1329–36.
characteristics and regulation of public equity funds with those of private equity funds. Both are pools of money that professional fund managers use to purchase securities on behalf of passive investors. Both would therefore appear to have the potential to act as monitors of errant corporate managers. However, only private equity funds do so. Why, then, the difference?

Parts III and IV compare and contrast the internal characteristics and external regulatory regimes that impact public and private equity funds. In doing so, they attempt to uncover the factors that explain the funds’ different investment strategies. My goal is to explore ways in which the law could be amended to incentivize public equity funds to join their private counterparts by participating in a deeper market for good corporate governance.

A. Size and Resources

Perhaps the most obvious trait that distinguishes most public and private equity funds is their relative size. In one study, the average sized venture capital fund had as little as $122 million in capital. For buyout funds, the numbers were larger, with the average fund managing slightly over $1 billion. However, because of the presence in the sample of several enormous funds, the median buyout fund held only $415 million. Thus, most private equity funds remain relatively modest in size. Moreover, there appears to

282. See Lerner, Hardymon & Leamon, supra note 7, at 1 (explaining how private equity funds usually form by seeking prospective investors much in the same manner as public funds); Investment Company Fact Book, supra note 33, at 145 (“An investment company is a corporation, trust, or partnership organized under state law that invests pooled shareholder dollars in securities appropriate to the entity’s—and its shareholders’—investment objective.”).

283. Private Equity Terms & Conditions, supra note 196, at 11.

284. Id.

285. Id. According to a recent survey by Private Equity International, for example, six buyout funds had assets in excess of $20 billion, with another sixteen having assets in excess of $10 billion. Private Equity International, supra note 216, at 62-63. The top six were, in order: The Carlyle Group, Kohlberg Kravis Roberts, Goldman Sachs Principal Investment Area, The Blackstone Group, TPG, and Permira. Id. at 62. Meanwhile, seven hedge funds managed assets in excess of $20 billion. Britt Erica Tunick, Capital Gains, Alpha, May 2007, at 39 (ranking the world’s one hundred largest hedge funds).

286. Blackstone Group may be the largest U.S. buyout fund, having raised over $15 billion in 2006. See Dennis K. Berman & Nicole Lee, Blackstone Fund Sets a Record at $15.6 Billion, Wall St. J., July 12, 2006, at C4 (charting the fund-raising success of so-called “megafunds”—funds with assets in excess of $3 billion). Europe’s largest appears to be Permira Advisers Ltd., with $14 billion. Id. The largest ever first-time fund was Centerbridge Partners LP, which raised $3.2 billion in 2006. Henny Sender, EGL Nears Buyout Led by Its Chief, Wall St. J., Mar. 19, 2007, at B6.
be a trend among venture capital funds toward slightly smaller asset pools. At first glance, mutual funds do not appear to be significantly larger than private equity funds. For example, according to the Investment Company Institute, the median sized mutual fund managed $221 million in assets, while the top ten percent of mutual funds averaged $2.2 billion in capital.

These numbers are misleading, however, because mutual fund complexes tend to be broken down into a number of individual sub-funds, each with its own investment objective. These might include, for example, growth funds, aggressive growth funds, sector funds, income equity funds and international equity funds. Thus, a single sponsor, such as Fidelity, might operate hundreds of sub-funds, each a legally distinct entity, but each operating as part of a larger unit and subject to the ultimate control of Fidelity’s senior management. As a result, for purposes of monitoring potential, a more significant number is the size of a mutual fund complex, where the numbers are much larger. Thus, for example, three mutual fund families—Fidelity, Vanguard, and American Funds—each manage over $1 trillion in assets.

Individual pension funds, meanwhile, are generally not subdivided in the manner of the mutual fund industry. However, their greater number and variety tends to make for a more varied landscape.

---

287. PRIVATE EQUITY TERMS & CONDITIONS, supra note 196, at 6.
288. INVESTMENT COMPANY FACT BOOK, supra note 33, at 52.
289. Id. at 51.
290. According to its website, Fidelity boasts of sponsoring over 2300 funds. See Fidelity Investments, http://personal.fidelity.com/products/wealth/content/howit works/how_investment_team.shtml.vcr (last visited Oct. 1, 2007) (“In-depth research and analysis results in a pool of over 2300 funds and other investments that make up our managed portfolios.”).
291. Thus, while the median sized mutual fund has only $221 million, and the largest ten percent of mutual funds average only $2.2 billion, INVESTMENT COMPANY FACT BOOK, supra note 33, at 52, several mutual fund complexes have over $1 trillion. Infra note 292 and accompanying text.
292. See Muralikumar Anantharaman, Fidelity Lags Main Rivals But Slow Recovery Seen, REUTERS, Jan. 10, 2007, http://www.reuters.com/article/companyNewsAndPR/idUSN1031582020070110 (reporting that the Fidelity family of funds manages about $1.3 trillion of assets, Vanguard more than $1.1 trillion, and American Funds about $1 trillion); Murray Coleman, Profit Rises at Four Mutual-Fund Firms, WALL ST. J., Apr. 27, 2007, at C11 (reporting that Fidelity’s assets had risen nineteen percent to $1.77 trillion, American Funds had exceeded $1 trillion in stock and bond mutual fund assets, and Vanguard had $989 billion under management); see also INVESTMENT COMPANY FACT BOOK, supra note 33, at 16 (noting that the share of assets managed by the twenty-five largest mutual funds has been above seventy percent since at least 1985).
293. See Roe, supra note 2, at 23–24 (noting that the pension fund industry is highly fragmented). Pension funds, for example, may be sponsored either by a state or local governmental entity, in which case they are referred to as public pension
Although many are quite small, the nation’s largest public pension fund, the California Public Employees’ Retirement System (“CalPERS”), has about $244 billion in total assets.\(^{294}\) In addition to having larger individual funds, the public equity fund industry is also much larger than the private equity fund industry. U.S.-registered investment companies managed over $11 trillion at year-end 2006, with mutual funds accounting for ninety-three percent of the total.\(^{295}\) At the same time, approximately $3 trillion was held by public pension funds.\(^{296}\) Private equity funds, in contrast, appear to have managed closer to $1.8 trillion.\(^{297}\)

Size, however, would appear to favor public equity funds—rather than private ones—as effective corporate monitors. The sheer size of a large mutual fund complex should provide it with both the sophistication and the financial resources to engage in an active investment strategy. Moreover, the economies of scale that would accrue to a large fund would likely be sufficient for it to devote consistent and broad-based efforts toward corporate monitoring.\(^{298}\) Thus, it is unlikely that the larger size of public equity funds can adequately explain their passivity.

Larger funds would also appear to be better able to balance active investment strategies with a preference for diversification. Venture capital funds, for example, are often thought to invest in as few as ten companies.\(^{299}\) A large mutual fund or public pension fund, on the other hand, would be able to invest in many more. The average size of the top one hundred companies listed on the New York Stock
Exchange, measured in terms of market capitalization, is a little under $6 billion. 300 This number is dwarfed by the size of many of the large pension funds and mutual fund complexes. 301 Thus, even without the boost that would come from leverage, a large pension fund or mutual fund complex (if legally permitted) could buy outright a large number of such companies and still remain adequately diversified. 302 The larger the fund, the easier it would appear to be to engage in active corporate monitoring while avoiding the downside risks associated with an overly concentrated investment portfolio. If anything, then, size would appear to have an inverse relationship to passivity.

A different possibility, however, is that size operates in a more subtle fashion, incentivizing smaller funds to be more active investors. Perhaps the relatively smaller size of private equity funds forces them to invest in fewer companies, thereby making it more critical that they closely monitor those few companies. 303 In other words, active monitoring by private equity funds might be more of a necessity than a choice.

Intriguing though this possibility may be, it does not hold up to close scrutiny. Modern corporate finance theory suggests that ninety-five percent of the benefits from diversification can be obtained by owning as few as twenty different stocks, while ninety-nine percent of the benefits attain from owning as few as one hundred. 304 Thus, even

---

300. According to the New York Stock Exchange, the one hundred largest listed companies have a combined market capitalization of $5.95 trillion, making the mean average $5.95 billion. NYSE U.S. 100 Index, http://www.nyse.com/marketinfo/indexes/nyid.shtml (last visited Oct. 1, 2007).

301. See Coleman, supra note 292, at C11 (providing examples of three mutual funds with assets totaling $989 billion, $1.77 trillion, and $1 trillion, respectively).

302. For a $1 trillion mutual fund complex, purchasing one hundred companies for $6 billion each—assuming this could be accomplished—would cost $600 billion, leaving $400 billion to invest in other assets. Modern corporate finance theory holds that ninety-nine percent of the benefits that accrue from diversification are obtained by owning as few as one hundred different stocks. See John L. Evans & Stephen H. Archer, Diversification and the Reduction of Dispersion: An Empirical Analysis, 23 J. Fin. 761, 767 (1968) (arguing, based on empirical analysis, that there are doubts as to whether increasing portfolio diversity beyond ten securities is economically justified); Harry Markowitz, Portfolio Selection, 7 J. Fin. 77, 89 (1952) (explaining that the benefits of diversification do not depend solely on the number of different stocks held but also on holding stocks in diverse industries). Thus, even a massive acquisition program would be unlikely to have much impact on the diversification of such a large fund.

303. This approach was espoused by no worse an entrepreneur than Andrew Carnegie. See Andrew Carnegie, The Empire of Business 17 (1902) (“The concerns which fail are those which have scattered their capital, which means that they have scattered their brains also. . . . ‘Don’t put all your eggs in one basket’ is all wrong. I tell you ‘put all your eggs in one basket, and then watch that basket.’”).

304. Notably, some finance textbooks state that as few as eight stocks are sufficient to provide reasonable diversity. See Gerald D. Newbould & Percy S. Poon, The
a relatively small $100 million private equity fund is more than large enough to pursue a strategy of low-cost, passive diversification.\(^{305}\) Moreover, if smallness truly does lead to activism, it does not explain why mutual fund complexes do not engage partly in activist monitoring and partly in diversified investing. Raw size, in other words, appears to have little impact on monitoring ability.

**B. Use of Leverage**

Closely related to the relative size of public and private equity funds is their differing use of the power of leverage. Mutual funds and pension funds are prohibited from using borrowed capital to purchase securities.\(^{306}\) It is considered by regulators to be too risky. Venture capital funds similarly abstain from the use of leverage.\(^{307}\)

Leverage buyout funds, by contrast, use primarily borrowed capital to purchase control over large corporate enterprises.\(^{308}\) As the term suggests, their use of leverage significantly magnifies the power and impact of their equity.\(^{309}\) Through leverage, LBO funds are able to acquire control of much larger companies than would otherwise be possible.\(^{310}\) As a result, they are often involved in “going private”

---

Minimum Number of Stocks Needed for Diversification, 3 FIN. PRAC. & EDUC. 85, 85 (1993) (surveying the recommendations of twelve prominent finance textbooks). The idea is that firm-specific risks will be minimized or even eliminated in a balanced portfolio of stocks whose risks are negatively correlated, leaving only market-wide risks. For a classic example, assume that high oil prices will be good for oil stocks but bad for airline stocks. Presumably, the changes in the price of the two stocks will offset one another. A sagging economy, by contrast, will be bad for both. \(^{305}\) See generally Markowitz, supra note 302, at 87–89 (arguing investors should diversify over different economic sectors to lessen their economic risk); Evans & Archer, supra note 302, at 761 (finding that an investor may be sufficiently diversified while possessing as few as ten different securities).

\(^{306}\) See generally Evans & Archer, supra note 302, at 761 (finding a stable relationship between the number of securities in a portfolio and the level of portfolio dispersion); Markowitz, supra note 302, at 87–89 (finding that holding a variety of securities is just as important for diversification purposes as examining the individual securities’ interrelationships in the marketplace).

\(^{307}\) Although the Investment Company Act does not expressly prohibit the use of leverage, the SEC has interpreted its prohibition against open-end mutual funds issuing “senior securities” broadly to include debt or preferred stock. 15 U.S.C. § 80a-18(f) (2000). See generally KIRSCH, supra note 230, § 11:3.5, at 11-11.

\(^{308}\) One notable, but isolated, exception is the use of short-term bridge loans that are sometimes used to cover firm expenses between scheduled capital calls. SCHELL, supra note 182, § 1.03[8], at 1-24.

\(^{309}\) See GAUGHAN, supra note 197, at 314–21 (discussing financing sources and techniques for leveraged buyouts and noting that common stock may account for as little as one to twenty percent of the total capital).

\(^{309}\) See RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 454–57 (1996) (discussing the impact of leverage on earnings).

\(^{310}\) One of the major results of the innovations leading to leveraged buyouts was that smaller companies, through the issuance of junk bonds and other financing techniques, could acquire larger ones.
transactions, wherein the fund, generally with the assistance of management, refines a public company with debt and then purchases the remaining equity.\textsuperscript{311}

Much like size, however, leverage does not seem to offer an adequate explanation for the relative passivity of public equity funds. Although such funds typically do not use leverage, their immense resources nonetheless provide them the capacity to acquire controlling positions in quite large companies.\textsuperscript{312} Admittedly, an additional benefit of leverage is that it permits LBO funds to commit less of their capital to any one project.\textsuperscript{313} Again, however, public equity funds are large enough that even an acquisition of one hundred percent of the equity of a medium-sized public company would not commit a disproportionately large percentage of their capital.\textsuperscript{314} Moreover, because public equity funds regularly purchase equity securities from corporations which themselves are partly financed with debt, one could even argue that mutual funds and pension funds are themselves partly leveraged. However one looks at the matter, leverage alone does not seem to be enough to explain the different monitoring strategies of public and private equity funds.

One impact that leverage may have, however, is in the nature of monitoring that public and private equity funds would undertake. One of the central insights of corporate finance theory is that equity holders in a highly leveraged firm should prefer the firm to engage in higher risk strategies than would equity holders in a less leveraged firm.\textsuperscript{315} Thus, were public equity funds to engage in greater monitoring, they might encourage the firms in which they invest to take on relatively less risk than would highly leveraged private equity investors.

\textbf{C. Need for Liquidity}

Another plausible explanation for the continued passivity of public equity funds \textit{vis-à-vis} their private counterparts may lie in their

\begin{itemize}
  \item \textsuperscript{311} See Gaughan, supra note 197, at 297-300 (describing management buyouts); Haynes, Thompson & Wright, supra note 197, at 219 (noting that many buyouts occur as a result of management’s decision to refocus and narrow its strategy and summarizing research regarding the causes of such a decision).
  \item \textsuperscript{312} See supra note 292 and accompanying text (providing details regarding the size of the world’s largest mutual funds).
  \item \textsuperscript{313} This, in turn, minimizes the impact of any one acquisition on a fund’s ability to diversify its risk.
  \item \textsuperscript{314} See supra note 302 and accompanying text (explaining the effect acquisitions have on diversification).
  \item \textsuperscript{315} See Coffee, supra note 2, at 1333 (applying the work of Stephen Prowse to the question of institutional investor monitoring).
\end{itemize}
greater liquidity requirements. Unlike private equity funds, mutual funds and pension funds must be ready to redeem their investors’ capital on short notice. Open-end mutual funds—the most popular and common of mutual funds—must be ready to redeem their shares on a daily basis and to pay redeeming shareholders within seven days of receiving a request. To satisfy such requirements, mutual funds must therefore retain a high degree of liquidity. Although there is no express statutory requirement as to the required level, the SEC has stated that it would be prudent for a mutual fund to limit its holdings of illiquid securities to fifteen percent of the fund’s net assets. Pension funds are similarly constrained in that they must retain sufficient liquidity to meet plan obligations. These limitations are in sharp contrast to the illiquid nature of most private equity funds, which commonly prohibit redemptions for as many as seven to ten years.

As Coffee pointed out, the need for liquidity over the short term makes active monitoring both less attractive and less viable. Monitoring is less attractive to a short-term investor because the benefits from improved corporate governance are likely to accrue over the long-term. Moreover, monitoring is less viable because a short-term investor may not retain her stake in a given company long enough to take successful action against underperforming managers (or to make a credible threat of such action). To use the language

317. KIRSCH, supra note 230, § 11:3.3, at 11-10 (“[T]o meet the redemption requests, a mutual fund must maintain a high degree of portfolio liquidity.”).
318. Id. (citing 1992 revisions to the Guidelines to Form N-1A).
321. Coffee, supra note 2, at 1318–21 (describing the impact that a lack of liquidity or thin equity may have on a fund’s monitoring ability).
322. In this way, liquidity is closely related to investment horizons. An investor willing to maintain a given position for a long period may obtain a better return but at the cost of lower liquidity. See BREALEY & MYERS, supra note 309, at 180 (explaining that investors require a higher return for a given investment in order to compensate for greater risk); BRUNER, supra note 199, at 457 (“Whenever liquidity and/or control change, value changes.”); see also University Endowments: The Ivory Trade, ECONOMIST, Jan. 20, 2007, at 81–82 (noting that large university endowments earned average returns of over fifteen percent in 2006, largely because of their extremely long-time investment horizons).
of Albert Hirschman, as exit becomes more viable, voice becomes less so.\(^{324}\) Public equity funds may therefore be passive for the simple reason that they must remain liquid.

Public equity funds do not require so much liquidity as to interfere with their monitoring ability, however. From a statutory standpoint, public equity funds are not required to maintain any particular level of liquidity.\(^{325}\) Rather, their need for liquidity arises from their need to satisfy redemption requests. However, many—perhaps even most—investors in mutual funds are retail investors with long-term goals.\(^{326}\) They tend to be saving for retirement or perhaps for a child’s education. Thus, on any given day, relatively few mutual fund investors will redeem their shares.\(^{327}\) A public equity fund could therefore conduct an actuarial analysis to determine what level of liquidity is actually necessary.\(^{328}\) Just as a bank does not in practice need to stand ready to return all of its depositors’ cash on any given day, a mutual fund or pension fund need retain only a portion of its investments in liquid form.\(^{329}\)

Additionally, the scale of many public equity funds already reduces their liquidity because there is an inherent trade-off between liquidity and the size of an investment.\(^{330}\) Once an investment becomes too large, the number of potential purchasers—and hence the market for such security—becomes smaller. Thus, even a small fractional stake in a public company would be too large to exit quickly. Likewise, one is left to wonder to whom Cerberus will be able to sell Chrysler, even if it is successful in turning around the failing automobile manufacturer.\(^{331}\) The number of potential buyers is not large. As a

\(^{324}\) See generally Hirschman, supra note 29, at 3–5 (introducing the interplay between exit and voice).

\(^{325}\) See Kirsch, supra note 230, § 11:3.3, at 11–10 (noting that, although the SEC at one point stated that it would be prudent for mutual funds to limit illiquid securities to ten percent, a later statement suggested that a fifteen percent level would also be prudent (citing 1992 changes to the Guidelines to Form N-1A)).

\(^{326}\) See Investment Company Fact Book, supra note 33, at 15 (noting that “U.S. households’ growing reliance on stock, bond, and hybrid mutual funds reflects investor desire to meet long-term personal financial objectives such as preparing for retirement”).

\(^{327}\) Cf. id. at 107 (showing historic liquidity ratios for mutual funds from 1984 to 2006).

\(^{328}\) Cf. id. at 117 (showing historic redemption rates for long-term mutual funds from 1985 to 2006).

\(^{329}\) See id. at 107 (reporting that mutual funds have seldom maintained more than ten percent of their assets in liquid form).

\(^{330}\) See Tirole, supra note 196, at 207–13 (calculating the decrease in liquidity that results from an increase in investment size).

\(^{331}\) See supra note 206 (describing the conditions under which Cerberus bought Chrysler from Daimler).
result, the larger mutual funds are already forced to make very illiquid investments to invest all of their capital.\footnote{332}{See Black, supra note 2, at 568 (describing the substantial stakes that many institutions own in single companies).}

Their greater apparent need for liquidity does not therefore suggest that public equity funds are \textit{incapable} of long-term monitoring so much as it suggests that they are incapable of \textit{only} monitoring. Certainly, some degree of liquidity must be maintained. However, the size of most public equity funds is such that their need for liquidity, like their preference for diversification, can easily co-exist with a strategy of active monitoring. For example, even if a Fidelity or Vanguard were to conclude that seventy-five percent of its assets might be subject to call on any given day—an amount that seems clearly excessive—that would still leave each with as much as $250 billion of capital that could be actively invested (and monitored) over the long-term.

What this analysis misses, however, is that liquidity itself, at any level, is a choice. Within statutory limits, public equity funds could easily contract to limit the withdrawal rights of their investors. Certainly, such a fund would be less attractive because its relative lack of liquidity would increase its level of risk. In the event an investment went sour, investors would find it more difficult to exit at a time of their choosing or at all. For this reason, closed-end mutual funds trade at a significant discount to open-end mutual funds.\footnote{333}{See Reinier Kraakman, \textit{Taking Discounts Seriously: The Implications of \textquoteleft Discounted\textquoteleft Share Prices as an Acquisition Motive}, 88 COLUM. L. REV. 891, 901–08 (1988) (reporting discounts as high as twenty percent that were attributable to a decrease in liquidity).} However, this is simply a function of the fundamental relationship between risk and reward. As the risk caused by short-term illiquidity increases, a greater potential reward is needed to induce investors to hazard an investment.\footnote{334}{See Brealey & Myers, supra note 309, at 173–203 (discussing the relationship between risk and return); see also Mercer Report, supra note 9, at 74 (\textquoteleft Most private equity investors expect to earn 15\% to 20\% in order to be compensated for the added risks and illiquid nature of private equity.\textquoteright\).} Thus, a public equity fund could successfully contract for fewer redemption rights only if it offered its investors the promise of a greater return.

In fact, this is exactly the strategy pursued by private equity funds. Investors in such funds agree to have their assets locked up for lengthy periods only because the fund managers promise to translate their freedom to make long-term investments into proportionately

---

\footnote{332}{See Black, supra note 2, at 568 (describing the substantial stakes that many institutions own in single companies).}
\footnote{333}{See Reinier Kraakman, \textit{Taking Discounts Seriously: The Implications of \textquoteleft Discounted\textquoteleft Share Prices as an Acquisition Motive}, 88 COLUM. L. REV. 891, 901–08 (1988) (reporting discounts as high as twenty percent that were attributable to a decrease in liquidity).}
\footnote{334}{See Brealey & Myers, supra note 309, at 173–203 (discussing the relationship between risk and return); see also Mercer Report, supra note 9, at 74 (\textquoteleft Most private equity investors expect to earn 15\% to 20\% in order to be compensated for the added risks and illiquid nature of private equity.\textquoteright\).}
greater annual returns.\textsuperscript{335} Put differently, private equity funds choose their illiquidity and then use it to create increased profits through corporate monitoring. Within limits, public equity funds could make the same choice.

What this means for corporate governance is that their preference for liquidity does not cause public equity funds to be passive. Rather, public equity funds choose to be passive because they believe it is more profitable for them to offer their investors a low-risk, low-reward investment strategy.\textsuperscript{336} Their preference for liquidity is not a necessary precondition of their status. It is, instead, nothing more than a response to prevailing market forces. Private equity funds are more aggressive monitors, then, not because they lack liquidity or because public equity funds require it. Rather, they are more active because they believe it to be a more profitable strategy. The need for liquidity, then, does not explain the different investment strategies of public and private equity funds. Instead, the different investment strategies explain their different approaches to liquidity.

\textbf{D. Investment Culture}

The culture of mutual funds and pension funds is very different from the culture of private equity funds. Public equity fund managers typically invest with the goal of slow, steady returns, and their outlook reflects this attitude.\textsuperscript{337} Unlike managers of private equity funds, they are not used to active monitoring and are unlikely to view their jobs as involving efforts to improve the performance of the companies in which they invest.\textsuperscript{338} Even the language they use reflects this difference in attitude and outlook. The name Fidelity, for example, “implies strict and continuing faithfulness to an obligation, trust, or duty.”\textsuperscript{339} In contrast, Cerberus is the name that

\begin{itemize}
\item \textsuperscript{335} See Mercer Report, supra note 9, at 74 (noting that “annual returns range from 0% to more than 30%, with an average of 10% to 20%, far surpassing that 9% to 10% average returns historically realized by common stock investors”).
\item \textsuperscript{336} In other words, the retail investment market currently offers only one basic choice for retirement savings in terms of the risk-reward tradeoff. The goal of deregulating public equity fund compensation would be to permit the market to offer true alternatives.
\item \textsuperscript{337} See Black, supra note 11, at 885 (“Despite the recent surge of interest in corporate governance, many money managers still hope to beat the market by trading rather than by monitoring corporate managers.”).
\item \textsuperscript{338} See id. at 886 (describing how cultural factors delay monitoring); see also Coffee, supra note 12, at 859 (comparing fund managers to civil servants in a large bureaucracy and observing that “they have a rational reason to be risk averse, because a visible mistake could be embarrassing (if a large investment were to fail), but a below-market performance will not cost them their jobs”).
\item \textsuperscript{339} Merriam-Webster’s Collegiate Dictionary 432 (10th ed. 1998) (defining fidelity as synonymous with “allegiance, fealty, loyalty, devotion, piety”).
\end{itemize}
Greek mythology gives to the three-headed dog that guards the gates of hell.\textsuperscript{340} Indeed, one could even question whether public equity fund managers are capable of effective monitoring. Though they are sophisticated players in financial markets, few have honed the skill set necessary to bring discipline to errant corporate managers.\textsuperscript{341}

Culture, however, is less likely to explain the difference in outlook and behavior between public and private equity funds as it is to reflect such difference. Moreover, although culture may present an impediment to active monitoring, it is one that would probably be overcome in time were other obstacles removed.\textsuperscript{342} Wall Street would hardly overlook an opportunity for significant profit simply because such opportunity had not been pursued in the past. Certainly the relatively staid culture of bond traders changed in the early 1980s after Federal Reserve Board Chairman Paul Volcker announced that interest rates—and hence bond prices—would no longer be fixed.\textsuperscript{343} Similarly, and more relevant to my thesis, when the U.S. Department of Labor agreed in 1979 to permit pension funds to invest in venture capital funds, pension fund managers quickly changed their behavior and poured money into the more risky venture funds, thereby greatly accelerating the growth of the private equity market.\textsuperscript{344} Thus, culture, while perhaps likely to slow the pace of change, is nonetheless inadequate to explain the drastically different approaches to monitoring taken by public and private equity funds.

\textsuperscript{340} THOMAS BULFINCH, BULFINCH'S MYTHOLOGY: THE AGE OF FABLE, THE AGE OF CHIVALRY, LEGENDS OF CHARLEMAGNE 83 (1993). For the etymology of the name, see William Safire, On Language: A Sop to Cerberus, NY. TIMES MAG., June 3, 2007, at 16 (“There were six guys when we started, and the name sounded pretty cool, but nobody really researched it.” (quoting Tim Price, one of the managing directors of Cerberus Capital)).

\textsuperscript{341} See Black, supra note 11, at 886 (noting that the culture of money managers is such that most have not developed the skills necessary to monitor corporate managers).

\textsuperscript{342} See id. (“Cultural factors, though, are more likely to delay monitoring than to prevent it altogether.”).

\textsuperscript{343} See LOWENSTEIN, supra note 173, at 1–5 (describing the transformation of financial markets that took place in the 1970s and 1980s); Boyer, supra note 21, at 1000 (“After Volcker’s speech... the bond market was transformed from a backwater into a casino.” (quoting MICHAEL LEWIS, LIAR’S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET 35 (1989))). Lewis’s book describes in colorful detail the aggressive, macho culture that developed at the bond trading desk of Solomon Brothers after Federal Reserve announced that the money supply would be fixed and interest rates would float. Lewis, supra, at 35. The story of JM’s subsequent career as a principal of the notoriously failed hedge fund Long-Term Capital Management is continued in ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000) [hereinafter LOWENSTEIN, WHEN GENIUS FAILED].

\textsuperscript{344} MERCER REPORT, supra note 9, at 73–74.
IV. PUBLIC AND PRIVATE EQUITY FUNDS COMPARED—EXTERNAL REGULATORY ENVIRONMENT

Part III of this Article examined various internal characteristics that differentiate public and private equity funds, including their size, use of leverage, need for liquidity and investment culture. In each case, I concluded that these characteristics are a result, rather than the cause, of the funds’ initial choice of investment strategy. Such differences therefore do not seem sufficient to explain the funds’ different approaches to monitoring. Thus, the real question remains: why did public equity funds develop a passive strategy while private equity funds developed an active one?

Black and Roe posited that the most important explanation for institutional investor passivity was the web of legal rules that make monitoring burdensome and expensive. Part IV tests this hypothesis by comparing the legal regimes that impact public and private equity funds. To the extent legal rules create different incentives for the two categories of funds, it may be possible to infer that such rules are the cause of their different investment strategies.

The legal rules affecting public equity fund monitoring may be divided into three categories. The first includes those rules that create impediments to the exercise of shareholder voice, primarily with respect to the proxy system. They are discussed in Part IV.A. The second includes those rules that may limit the ability of certain funds to acquire a controlling stake in a particular corporation. They are discussed in Part IV.B. The third are those rules that regulate the internal structure and governance of the funds themselves, including their compensation structures. They are discussed in Part IV.C.

In Part IV, I conclude that, just as Black and Roe posited, legal rules are critical to a fund’s decision of whether to actively monitor its investments. Without some degree of reform, active monitoring is likely to remain out of reach for most public equity funds. However, the crucial set of rules are those that govern the compensation of fund managers. Private equity fund managers are active monitors because the lack of regulation has allowed a market to develop that creates incentives for such managers to engage in active oversight. Public equity fund managers, however, are largely prohibited from entering that market. While the removal of legal barriers may be a necessary precondition to their entering the market, they are likely to

---

345. See supra notes 83–89 and accompanying text (illustrating the various ways in which legal rules make exercising shareholder voice expensive).
continue their strategy of passive investing unless they are given clear incentives to do otherwise.

A. Rules Limiting Voice

Corporate law is replete with rules that limit the ability of investors to actively exercise their voice. For the most part, these have already been catalogued by Black and Roe, and so there is little to be gained by simply repeating the list here. Suffice it to say that the law limits voice in two primary ways. First, it makes communication among shareholders expensive. Second, it imposes burdens and risks on shareholders who acquire more than five (or sometimes ten) percent of the stock of a particular company.

In the first place, federal proxy rules have generally imposed significant expenses on shareholders who seek to communicate with one another regarding an outstanding proxy proposal. Despite regulatory reforms over the past two decades, they also make it difficult for shareholders to make proxy proposals on their own. Such proposals tend to either be limited to an advisory role or require a full-blown proxy contest, with associated costs frequently reaching seven figures.

The second set of legal impediments are those that make it burdensome or risky for an investor to acquire more than five (or sometimes ten) percent of the equity of a given public company. Most notable among these is Exchange Act § 16(b). It prohibits a ten-percent shareholder from purchasing and selling securities of a single issuer within a rolling six-month period, thereby drastically

346. See, e.g., Black, supra note 2, at 530–66 (discussing the many rules and procedures governing shareholder voting); Roe, supra note 2, at 16–31 (discussing the various regulatory impediments to activism on the part of institutional investors); see also supra notes 83–89 and accompanying text (describing the monetary constraints on shareholder activism).

347. Cf. supra note 88 and accompanying text.

348. See supra notes 84–85 and accompanying text (listing requirements that apply to shareholders who acquire more than five and ten percent of a given company’s stock).

349. See Black, supra note 2, at 536 (maintaining that the proxy rules impose costs, delays, and risks on communication efforts). But see generally supra Part I.C (finding that the ease with which shareholders may communicate with one another has improved since Black was writing in 1991).

350. See Coffee, supra note 12, at 840–41 (noting that “proxy reform has radically reduced the cost of shareholder communications” since 1990).

351. See Bratton, supra note 10, at 140 (revealing that the average contest is estimated to range between $250,000 and $1 million). Meanwhile, the recent proxy fight over the merger of Hewlett-Packard and Compaq is estimated to have cost over $100 million. Steve Lohr, He Said. She Said. It Just Gets Uglier., N.Y. TIMES, Mar. 17, 2002, at B1.

reducing such shareholder’s short-term liquidity. Other important hurdles include rule 10b-5, which makes it risky for an institutional investor to control one of the issuer’s board seats lest they be deemed to be engaged in insider trading. State antitakeover statutes also discourage investors from amassing too great a share of a given stock.

Although the rules affecting the acquisition and exercise of influence over corporate policy are real, numerous and oftentimes onerous, they do not explain the relative passivity of public equity funds vis-à-vis private equity funds. This is because, on their face, the same rules apply equally to any investor. For example, anyone who acquires ten percent of a public company, including any private equity fund, must confront the limited liquidity imposed by section 16(b). Thus, private equity funds appear to be engaged in active monitoring despite the cumulative impact of these rules. The rules

353. Id. The same rule applies if the sale precedes the purchase during the rolling six-month period. Id.
354. 17 C.F.R. § 240.10b-5 (2007). The risk is that the knowledge of the director will be imputed to the institution, whether or not such knowledge is actually transferred. As a result, an otherwise innocent trade might be deemed to have been made on the basis of non-public information in contravention of insider trading rules. Black, supra note 2, at 545–48.
355. Currently, over forty states have some form of antitakeover legislation. See Roberta Romano, The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters, 23 YALE J. REG. 209, 215 tbl.1 (2006). State antitakeover laws come in four basic forms: control share acquisition statutes, fair price provisions, rights of redemption, and business combination statutes. BNS Inc. v. Koppers Co., Inc., 683 F. Supp. 458, 463 (D. Del. 1988). Of particular importance for corporate governance purposes are the control share acquisition statutes, like the one at issue in BNS. Typically, such statutes work much like a poison pill, imposing massive dilution on, or removing voting rights from, shareholders who acquire more than a fixed percentage of the issuer’s stock without prior approval of the issuer’s board of directors. E.g., IND. CODE ANN. §§ 23-1-42-3, 23-1-42-7, 23-1-42-10(b) (West 2007). Delaware’s control statute takes a different approach, prohibiting “business combinations” between unapproved stockholders and the target corporation for three years following the initial purchase. DEL. CODE ANN. tit. 8, § 205(a) (2007). It is modeled after New York’s statute. N.Y. BUS. CORP. LAW § 912 (McKinney 2007). Initially, many such statutes were effectively invalidated on Commerce Clause grounds by the Supreme Court’s decision in Edgar v. MITE Corp., 457 U.S. 624 (1982). However, the so-called “second generation” statutes, which were re-drafted in light of Edgar, have thus far passed constitutional muster. See, e.g., BNS, 683 F. Supp. at 472–73 (upholding the constitutionality of the Delaware antitakeover statute).
356. See Black, supra note 2, at 545–47 (noting that Exchange Act section 16(b), 15 U.S.C. § 78p(b) (2000), requires a company’s ten percent shareholders to report to the SEC their purchases and sales of such company’s stock and to forfeit any profits that result from any “short-swing” trades they make during any given six-month period).
357. As an alternative explanation, one might argue that the failure of private equity funds to invest in public equities other than to acquire control suggests that section 16(b) and rule 10b-5 do indeed serve as deterrents to corporate monitoring. However, this phenomenon is probably better understood as being the result of a
themselves, however burdensome, are therefore insufficient to explain the continued passivity of public equity funds.

Before dismissing the impact of this set of legal rules altogether, however, it is worth asking how private equity funds address the risks and burdens these rules pose. In fact, private equity funds avoid the direct impact of many of these rules by leapfrogging over mere influence and instead acquiring outright control. Put differently, the rules appear to constitute a much greater hurdle in a system characterized by limited shareholder voice than by one characterized by full-blown shareholder control. This operates in two ways.

First, unlike public equity funds, private equity funds have already chosen to sacrifice liquidity and so are not negatively impacted by rules that reduce their ability to exit a given investment. Put concretely, an LBO fund with a seven-year investment horizon is not inconvenienced by the six-month delay caused by purchasing shares subject to section 16(b).

Second, many of the rules that make the acquisition and exercise of influence burdensome apply only to targets that are publicly traded. Private equity funds, however, generally purchase companies that do not list their shares on a national exchange, such as early stage companies and subsidiaries of public companies.

preference for control acquisitions intended to take full advantage of the carried interest. Supra notes 185–186 and accompanying text.

358. See generally Part II.A (providing an overview of private equity funds).

359. See generally Part II.C (detailing the typical governance structure of private equity funds).

360. See, e.g., Black, supra note 2, at 536–50 (cataloguing the effects on a fund’s monitoring ability of federal proxy and insider trading rules that apply only to publicly traded companies). One example of this relates to insider trading liability under section 10b-5. The risk here is that a director who is appointed by an institutional investor would occasionally be privy to non-public information regarding the portfolio company. That information would then be imputed to the institution, even if the director did not in fact pass it along. Thus, the institution would constantly risk violating the insider trading rules by innocently making a sale or purchase while the director (and the director alone) is in possession of material non-public information. Id. at 547–48. One impact of the various federal anti-fraud provisions is to impose a duty on insiders who are deemed to possess non-public information to disclose such information publicly or to abstain from trading. SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert denied Kline v. SEC, 394 U.S. 976 (1969). For private equity funds, however, part of the purpose of acquiring control over a company is to obtain non-public information. Therefore, a disconnect between what the fund knows and what its portfolio company managers know would be much less likely. See, e.g., Roe, supra note 2, at 14 (noting that “management would more willingly reveal proprietary information to the large long-term shareholder, who has the incentive to maintain secrecy”). Inadvertent insider trading would therefore not be much of a risk.

361. Haynes, Thompson & Wright, supra note 197, at 219 (noting that many buyouts occur as a result of management’s decision to refocus and narrow its strategy, and summarizing research regarding the causes of such a decision).
Alternatively, when private equity funds do acquire public companies, it is often in a going-private transaction that results in the company no longer being listed on a national securities exchange. Thus, by acquiring control, private equity funds completely negate the impact of many otherwise burdensome securities rules.

The legal rules identified by Black and Roe are therefore more likely to deter investors who seek to exercise voice, as opposed to control. Voice contemplates a cooperative effort by large but fractional shareholders to exercise influence short of control. Voice, in other words, impacts the margin, shifting a relatively impotent investor into a position of real, but limited, power.

The goal of many proponents of voice, however, is expressly to add to the power of fractional shareholders to influence management. In a sense, they seem to want to have it both ways—limit shareholders’ power by forcing them to maintain small fractional stakes, but increase their power by bestowing greater influence upon such stakes. Undoubtedly, at some level, whether at five percent, ten percent or higher, shareholder influence becomes strong enough that rules like section 16(b) are needed to limit abuse. Arguments to lessen the impact of these rules may therefore be simply delaying the moment of reckoning. If section 16(b) should be changed to exclude certain categories of ten-percent investors, it should still apply to fifteen-percent investors, and so on. The real problem, in other words, is that rules like section 16(b) accomplish what they were intended to accomplish: they limit the liquidity of shareholders who attain influence short of control.

In fact, the problem with voice may be that it adds too little power. Shareholders who cross the five-percent threshold by only a small margin gain few of the benefits of increased influence while suffering a significant loss in liquidity. The power of shareholder control, the investment strategy pursued by private equity funds, is that the loss of liquidity is coupled with a dramatic, not incremental, increase in influence—influence that can be converted directly into higher profits. The implication, then, is that a system of institutional

---

362. See Gaughan, supra note 197, at 291 (noting that a typical leveraged buyout “frequently involves taking a public company private”).
363. See Gilson, Gordon & Pound, supra note 67, at 33 (arguing that it is more difficult for a shareholder to elect a minority of the directors than to replace the entire board).
364. See supra note 17 and accompanying text (defining institutional voice in contrast to institutional control).
365. See Coffee, supra note 2, at 1343 (noting that the “threat of a six-month period of illiquidity deters most institutional holders from crossing the ten percent threshold”).
investor voice may be attractive but not feasible. Policymakers may therefore be forced to confront the difficult choice of accepting the current system of institutional investor passivity or enabling public equity funds to actually take control of the reins of corporate America.\footnote{366}

None of this, however, explains the different trading strategies of public and private equity funds. Rather, the discussion echoes the discussion of liquidity in Part III.C.\footnote{367} Shareholder passivity is not caused by the rules. Rather, it follows from the initial choice of whether to pursue a low-reward strategy that benefits from low cost, low risk, and high liquidity, or a high-reward strategy that must overcome high cost, high risk, and low liquidity. Once that initial decision is made, presumably on the basis of market factors, the impact of the rules on either strategy is minimal. The extremes of passivity and control are unaffected by these legal rules. Rather, what the rules do is place burdens on the middle ground of voice. Thus, the rules explain why public equity funds do not exercise voice, but they do not explain why they shun control.

It should be noted, however, that while most of these rules have little impact on a fund’s decision to choose between passivity and control, they do have the impact of limiting control to friendly control. As Grundfest and others have noted, truly hostile takeovers are largely impossible under today’s legal regime.\footnote{368} Thus, if public equity funds were to enter the world of LBOs, they would be able to

\footnotesize{366. Interestingly, evidence of this possibility may be found in John Coffee’s 1991 survey of the corporate governance systems that were prevalent in the United States, Japan, Germany, Sweden, Canada, and the United Kingdom. See id. at 1290–1318 (contrasting the role of investors in countries with external versus internal capital markets). Coffee tentatively put these countries on a continuum, with one pole representing systems that privilege liquidity but inhibit institutional investor control, and the other pole representing systems that permit financial institutions to dominate industrial countries but at the expense of decreased liquidity. Id. at 1287. In fact, however, his results suggested that there was very little middle ground. Instead, most of the countries were on one pole or the other. Id. at 1290–1318. Even Sweden and Canada, the two countries he placed nearest the middle of the continuum, were actually just mixtures of the two poles, with some Swedish and Canadian entities benefiting from control but not liquidity, while other entities reflected the opposite approach. Id. at 1306–09. What was missing was the true middle ground of voice—a system characterized by financial institutions that exercise moderate influence at the expense of some liquidity.

367. See supra Part III.C (noting that public equity funds choose greater liquidity—in part because investors prefer low-risk and low-reward investments—a strategy which inhibits effective monitoring).

368. See, e.g., Bebchuk, Coates & Subramanian, supra note 52, at 889–91 (examining data from 1996–2000 and noting the frequency with which staggered boards of directors prevented hostile bids).}
invest only in deals where management acquiesced.\textsuperscript{369} Certainly, this would pose a significant limitation on the impact that such investments could have on the overall market for good corporate governance. Presumably, the worst-run companies would be the least likely to agree to an acquisition as their managers would be in the greatest peril of losing their jobs.

However, while this may limit the ability of public equity funds to change underperforming management, it does not necessarily mean that they cannot improve management performance. For example, there are a number of empirical studies that have found that leveraged buyouts create strong efficiency gains, even if the buyout has the blessing of management.\textsuperscript{370} LBOs and other private equity acquisitions also invariably involve a substantial premium over the target’s market price.\textsuperscript{371} Presumably, the size of this premium is related to the purchaser’s expectations regarding its ability to reduce agency costs. Thus, the management of many underperforming companies may be more than willing to accept such a premium. Certainly, that seems to be the case today, with nine of the ten largest LBOs in history being announced over the prior two years.\textsuperscript{372}

Although a regime of institutional investor control could never encompass all American companies, the more it improved performance at some companies, the starker the difference would be \textit{vis-à-vis} other underperforming companies, and the greater the pressure that would build on the poor performers to improve. Indeed, a study of the impact of the shareholder activist group United Shareholders Association suggested that the $22.75 million it spent in monitoring a targeted group of underperforming companies contributed to a general net wealth gain of $1.3 billion.\textsuperscript{373} Thus, even

\textsuperscript{369}. Hostile takeover attempts, unless they are later converted into friendly bids, are today generally impossible given the strength and array of management’s defenses. \textit{See id.} (examining the effectiveness of staggered boards of directors as impediments to takeovers).
\textsuperscript{370}. \textit{See, e.g.}, Jensen, \textit{supra} note 7, at 65 (arguing that post-LBO companies, with their close monitoring, have an incentive structure that is superior to that of public corporations); \textit{see also} Bruner, \textit{supra} note 199, at 56 (summarizing several empirical studies that found increased value in transactions where managers had more at stake, including leveraged buyouts); Black, \textit{Empirical Evidence, supra} note 10, at 924 (noting the existence of “substantial evidence suggesting that LBOs often led to improved corporate performance, at least up through about 1986”).
\textsuperscript{371}. \textit{See} John C. Coates IV, \textit{Empirical Evidence on Structural Takeover Defenses: Where Do We Stand?}, 54 U. MIAMI L. REV. 783, 794 (2000) (citing a study by J.P. Morgan that average premiums paid to companies with poison pills was fifty-one percent and average premiums paid to companies without poison pills was thirty-six percent).
\textsuperscript{372}. Sorkin, \textit{supra} note 219.
\textsuperscript{373}. Strickland, Wiles & Zenner, \textit{supra} note 161, at 336.
by monitoring only the poorest performers, public equity funds have the power to improve the operations of the entire marketplace.

B. Rules Limiting Control

Although many legal rules appear to impact both public and private equity funds in a similar manner, many do not. Chief among those whose impact is disparate are rules that restrict mutual funds and pension funds from engaging in certain types of investments. To the extent such investment restrictions block public equity funds (but not private equity funds) from acquiring control over a given corporation, they might explain the public equity funds’ continued passivity. If such were the case, the rules would need to be relaxed—or a safe harbor created—before mutual fund and pension fund managers could become active in the oversight of corporate managers. Their amendment, in other words, would be a precondition to the ability of public equity funds to engage in active oversight of corporate managers. Their removal, however, would not create any direct incentives to monitor.

The following two Sections, respectively, address the impact of ERISA on pension funds and of the Investment Company Act and Investment Advisers Act on mutual funds. Private equity funds, meanwhile, are generally structured so as to be exempt from these two regulatory schemes.

1. ERISA

Congress enacted the Employee Retirement Income Security Act in 1974 in response to concerns that pension funds were not being sufficiently regulated by the states. The goal of ERISA was to statutorily extend the common law of trusts to union- and employer-sponsored pension plans. Among other things, it made the security of pension promises a basic goal of federal policy by regulating the riskiness of pension investments and by providing a government-run insurance program for all qualifying pensions.

Pension funds’ relationship with private equity investments has always been complicated. Initially, for example, many observers read

374. See supra Part II.B (noting that private equity funds avoid the limitations and regulations to which public equity funds are subject by, inter alia, limiting membership and clientele).
376. Id.
ERISA as prohibiting pension funds from investing in private equity funds. In 1979, however, the Department of Labor issued a ruling that expressly permitted such investments, provided the pension fund remained sufficiently diversified. More recently, private equity funds that wished to accept investments from pension plans had to be structured around ERISA's broad definition of a fund manager. This meant structuring the private equity fund as a “venture capital operating company” or limiting the amount of capital it received from all pension funds to twenty-five percent or less of the total fund commitments. These rules were loosened somewhat in 2006, however, by exempting funds of funds and making it easier for private equity funds to accept subscriptions from non-ERISA pension plans.

ERISA does not contain a comprehensive list of specific rules relating to investment risk. Rather, it relies upon two broad and relatively vague fiduciary requirements to regulate the behavior of ERISA fund managers. First, it requires ERISA fund managers to act “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” This fiduciary standard has been called “the highest known to law.” Second, ERISA fund managers are required to diversify the investments of the plan “so as to minimize the risk of large losses.” By contrast, private

---

378. MERCER REPORT, supra note 9, at 73.
379. Rules and Regulations for Fiduciary Responsibilities, 44 Fed. Reg. 50,363 (proposed Aug. 28, 1979); see also Frankel, supra note 295, at 944–52 (describing the period from 1975 to 2000 as one in which federal regulators largely cooperated with fund managers).
381. Id.
382. Id.
385. 29 U.S.C. § 1104(a)(1)(C). The duty can be traced back to the common law. See Appeal of Dickinson, 25 N.E. 99 (Mass. 1890) (holding that trustees may not take the same risks as owners in search of greater profit). ERISA fiduciaries are also required to act “solely in the interest of the participants and beneficiaries” of the plan. 29 U.S.C. § 1104(a)(1). For purposes of this Article, however, the “solely in the interest” requirement is less significant as it is assumed that private equity investments are in fact made primarily for the benefit of fund investors. Meanwhile,
equity fund managers, while being fiduciaries under state partnership law, are not required to satisfy ERISA’s prudence standard or its diversification requirement.\footnote{386}

Neither the prudence standard nor the diversification requirement are likely to interfere directly with an ERISA plan manager’s desire to exercise voice. As contemplated by its proponents, shareholder voice involves shareholders with small fractional stakes—generally under five percent—using the proxy process to influence management, either on their own or collectively with other similar shareholders.\footnote{387} Thus, unless the pension plan were quite small, acquiring a fractional share of a public company would seem unlikely to impact the plan’s diversification in any meaningful way. Similarly, inexpensive or informal attempts to influence management conduct would not seem particularly imprudent.\footnote{388}

In fact, pension plan advisers may even find it less risky to adopt a strategy of profit-driven monitoring than to use fund assets to pursue particular social goals.\footnote{389} Indeed, one of the bright spots on the horizon of shareholder activism is the role being played by the large public pension plans such as CalPERS.\footnote{390} Such funds have acted as leaders among shareholder activists and have been the catalysts for

the Act permits deviation from the diversification requirement only if it is clearly prudent. 29 U.S.C. § 1104(a)(2).

\footnote{386. Because most private equity funds are organized as limited partnerships, with the fund corpus being the partnership itself and the fund managers serving as the general partner, the fund managers are generally subject to the normal fiduciary duties of partners. These are generally thought to entail “[n]ot honesty alone, but the punctilio of an honor the most sensitive.” Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). Nonetheless, though a high standard, it is generally thought to be a lower standard than ERISA’s “prudent investor” standard. \textit{See Reich}, 837 F. Supp. at 1273 (describing ERISA’s fiduciary standard as “the highest known to law” (quoting Donovan v. Bierwirth, 680 F.2d 263, 272 n.8 (2d Cir. 1982))).

387. \textit{See supra} note 17 and accompanying text (defining institutional voice in contrast to institutional control).

388. Indeed, the most recent Restatement of Trusts expressly approves of ERISA funds seeking out “individual bargains within the highly efficient markets as well as in the less efficient ones.” \textit{Restatement (Third) of Trusts: Prudent Investor Rule § 227, general note to cmts. e-h} (1992) (emphasis added).


390. \textit{See Romano, supra} note 82, at 797 (acknowledging that public pension funds have been “more active than other institutional investors in corporate governance over the past few years, offering shareholder proposals and engaging in other highly publicized activities to influence management actions”).
much change.\textsuperscript{391} It is for this reason that Coffee and others focused their reform efforts on public pension funds.\textsuperscript{392}

Private equity investments, on the other hand, involve quite a bit more than mere influence. They involve the acquisition and exercise of some degree of control. Thus, in order to uncover why public equity funds behave differently than private equity funds, one must consider the impact of ERISA’s prudence standard and diversification requirement on control acquisitions.

As a technical legal matter, it is unclear whether an acquisition of control by a pension plan would violate ERISA. Courts have consistently limited the prudence standard to a procedural test.\textsuperscript{393} Thus, liability will not turn on the success of a particular investment, but on the quality of the investigation.\textsuperscript{394} Likewise, Department of Labor regulations state that the prudence standard requires consideration only of whether the particular investment strategy is reasonably designed to further the purposes of the plan, including with respect to the overall projected return.\textsuperscript{395} It does not specify what those purposes must be. In fact, ERISA fund managers are already permitted to invest in private equity funds.\textsuperscript{396} Provided they maintain a proper level of diversification, it does not appear to be significantly less prudent to make such investments directly rather than through an intermediary. It may even be less expensive.

A similar analysis seems to apply to the diversification requirement. It is a tenet of modern finance theory that a well-designed portfolio containing as few as twenty stocks can provide ninety-five percent of

\textsuperscript{391} See Coffee, supra note 12, at 846 (predicting that public pension funds will act as catalysts of corporate governance reform).

\textsuperscript{392} See, e.g., Coffee, supra note 2, at 1336 (suggesting that public pension funds might be the “optimal corporate monitors” because they are relatively free from conflicts of interest, have large enough stakes in corporations, and prefer longer investment horizons).

\textsuperscript{393} See, e.g., Brock v. Robbins, 830 F.2d 640, 648 (7th Cir. 1987) (finding a violation of the prudence requirement where the fund managers approved a $10 million investment under ten minutes without any investigation); Ulico Cas. Co. v. Clover Capital Mgmt., Inc., 335 F. Supp. 2d 335, 340 (N.D. N.Y. 2004) (requiring fund managers “(1) to employ proper methods to investigate, evaluate and structure the investment; (2) to act in a manner as would others who have a capacity and familiarity with such matters; and (3) to exercise independent judgment when making investment decisions”).


\textsuperscript{395} 29 C.F.R. § 2550.404a-1 (2007). The Department of Labor, in public statements, has also appeared to approve of the modern portfolio approach to investments. Koppes & Reilly, supra note 383, at 437.

\textsuperscript{396} MERCER REPORT, supra note 9, at 73.
the benefits that arise from diversification. Thus, provided the pension fund is large enough relative to the target company, it would seem logical that it could safely engage in a control acquisition without sacrificing the overall diversity of its portfolio.

For corporate governance purposes, however, the real impediment is the non-obvious reading sometimes given to the prudence standard and diversification requirement. Prudence, though defined, is defined broadly and subject to interpretation. For example, Roe argues that a fund manager who sat on the board of a portfolio company would be open to lawsuits seeking to apply ERISA’s heightened fiduciary standard to her actions on the board. Moreover, the definition expressly contemplates a comparison of the fund manager’s conduct to that of other fund managers “acting in a like capacity.” This creates the risk (or at least the perception) that the first pension fund manager to engage in an LBO or like transaction could be held to have violated the prudence standard for no other reason than because she was the first. In other words, if no one else is engaging in such transactions, then there is the real possibility that the novelty alone would be cause for a violation.

397. See supra note 304 (referencing textbooks which state that as few as eight stocks can provide sufficient diversity and suggesting that this holds true when portfolios hold stocks whose risks are negatively correlated).

398. Koppes & Reilly, supra note 383, at 437 (“Thus, under ERISA, trustees may prudently choose to make new or non-traditional investments if certain factors are met. DOL regulations specify these factors. For one thing, expected returns must justify the additional risk, taking into account the overall purpose of the pension plan. Also, the portfolio as a whole must be adequately diversified and sufficiently liquid to meet payout requirements.”); see also Roe, Private Pensions, supra note 66, at 97 (arguing that the diversification requirement, in light of modern portfolio theory, is not a significant barrier to pension fund activism).

399. See generally Serota, in ERISA FIDUCIARY LAW, supra note 319, at 4, 19–20 (citing the standard and explaining the prudence rule).

400. Roe, Private Pensions, supra note 66, at 102–03.


402. See ROBERT A. HAUGEN, THE NEW FINANCE: THE CASE AGAINST EFFICIENT MARKETS 114–16 (1995) (noting that fund managers may seek to avoid taking actions that might differentiate them from other fund managers); Roe, supra note 2, at 24 (“Commentators suggest that the rule looks to prevailing investment practices, to the average, but with a substantial conservative drag: preservation of principal, even in the face of reduced return, is critical.” (citing B. LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 21, 29, 39–40 (1986))); Roe, Private Pensions, supra note 66, at 97–99 (arguing that ERISA creates a conservative feedback loop that reinforces existing practices, whatever they may be). But see Steven L. Willborn, Public Pensions and the Uniform Management of Public Employee Retirement Systems Act, 51 RUTGERS L. REV. 141, 143–44 (1998) (discussing a 1997 Uniform Law Commissioners model act that was “designed to permit and encourage” the application of modern portfolio theory by pension fund managers).
And even if such were not truly the case, it would be reasonable for a risk-averse fund manager to fear that it might be. The same is true of diversification. Though a diversified portfolio might not be inconsistent with the occasional acquisition of control, the fact is that most funds are, if anything, over-diversified. Some funds, for example, appear to hold more than a thousand different stocks, when no more than twenty are absolutely necessary. Moreover, the language of the statute makes the issue even cloudier. The degree of diversification that is required is that which is necessary “to minimize the risk of large losses.” Read broadly, this could easily be interpreted to mean that any large investment—even one below the five-percent threshold—would violate ERISA because the losses could potentially be large. Alternatively, it could be interpreted to mean that any risk of loss that is objectively large would be improper, even if the loss would be subjectively small relative to the size of the overall fund.

One explanation for the continued passivity of public pension funds may therefore lie in a risk-averse interpretation of ERISA’s prudence standard and diversification requirement. Whether or not they would be violated by an activist monitoring strategy, such rules appear to impose significant risks (and hence costs) on pension fund managers. Unless and until Congress and/or the Department of Labor clarifies their application to LBOs and similar transactions, these rules will continue to limit the ability of public pension fund managers to engage in control acquisitions.

That being said, these requirements by themselves do not appear to constitute a sufficient explanation for the general passivity of most public pension fund managers. For example, mutual funds, which are exempt from ERISA but which mimic public pension funds in most other ways, are nonetheless passive investors. It is likely, in other words, that even if an appropriate safe harbor were designed to

403. See Black, supra note 2, at 562-64 (discussing the culture of fund managers that makes them averse to legal risk).
404. See Black, supra note 11, at 834 (noting that even a relatively small portfolio with as few as one hundred stocks would protect institutions from most firm-specific risk).
405. See id.; see also supra note 304 (suggesting that, so long as a fund holds stocks whose risks are negatively correlated, a small number is sufficient for diversification purposes).
407. See also Koppes & Reilly, supra note 383, at 436 (noting that, at common law, prudence is measured each transaction at a time).
408. See Roe, Private Pensions, supra note 66, at 99–101 (discussing the impact of anti-netting rules that in certain cases prohibit managers from offsetting a significant loss against a significant gain).
permit ERISA-regulated pension plans to invest in private equity-type transactions, public pension fund managers would continue to see little profit potential in active monitoring. In other words, ERISA may explain why public pension fund managers believe they cannot invest directly in private equity-style transactions, but it does not shed any light on whether they would desire to do so.

2. The 1940 Acts

Mutual funds are governed primarily by the Investment Company Act of 1940409 while mutual fund managers—also referred to as advisers—are governed by the Investment Advisers Act of 1940.410 Both Acts had their roots in the original New Deal securities legislation of the 1930s, and both impose broad and detailed regulatory schemes.411 Thus, a mutual fund manager must comply with an extensive body of regulation, covering not merely fraud but everything from registration and disclosure obligations to recordkeeping requirements and limitations on incentive compensation and permissible investments.412 Private equity funds, by contrast, are structured so as to be largely exempt from all but the fraud requirements of these two statutes.

Although the two 1940 Acts, like ERISA, subject mutual funds to a system of broad and onerous regulation, their impact on corporate monitoring is likely to be less significant. In the first place, it is doubtful that mutual fund managers owe fiduciary duties to their investors that are significantly higher than the duties owed by private equity fund managers.413 In the second place, the Investment Company Act’s diversification requirement is fairly easily circumvented.

413. See supra Part II.B (noting that private equity funds avoid the limitations and regulations to which public equity funds are subject by, inter alia, limiting membership to a selected clientele).
Currently, most mutual funds prefer to be categorized as “diversified” because investors generally consider such funds to be less risky.\(^{415}\) To qualify as such, a fund is required to devote seventy-five percent of its assets to diversified investments. It is then prohibited from using these monies to acquire more than ten percent of any one company or to acquire an interest in a single company that would exceed five percent of the fund’s total assets.\(^{416}\)

However, a diversified mutual fund is permitted to invest the unregulated twenty-five percent of its assets in any manner it chooses, including in a single, non-diversified security.\(^{417}\) Given the near-gargantuan size of many mutual fund complexes, even this twenty-five percent would be enough to make a number of significant control acquisitions. Moreover, if a fund were to choose to adopt a strategy of seeking to control a limited portfolio of target companies, it would want to advertise that fact. Thus, it would probably desire to buck tradition and adopt the non-diversified label. Doing so would therefore exempt such fund from any limitations on the concentration of its investments.\(^{418}\)

Subchapter M of the Internal Revenue Code, which applies to mutual funds, presents much the same story. Generally speaking, mutual funds seek to be treated as “regulated investment companies” under section 851 of the Code so as to be eligible for pass-through tax treatment.\(^{419}\) Without such treatment, dividends earned by the mutual fund would be taxed three times: once at the company level, again at the level of the mutual fund, and a third time when distributed to the mutual funds’ investors.\(^{420}\) A mutual fund that satisfies the Code’s diversification requirement is taxed only twice.\(^{421}\)

Like the Investment Company Act, the Code divides the assets of a regulated investment company into two pools. The first pool must be invested in a diversified portfolio, such that not more than five

\(^{415}\) See Roe, supra note 2, at 20 (“Mutual funds are designed for unsophisticated investors who cannot assemble a diversified portfolio or evaluate the mutual fund’s portfolio.”).


\(^{417}\) Id. § 80b-5(b)(2).

\(^{418}\) See Audrey C. Talley & James L. Love, Restrictions on Investments, in MUTUAL FUND REGULATION, supra note 412, § 8:2.2, at 8-9 to -10 (explaining the requirements for a diversified classification and further noting that non-diversified funds may invest more than five percent of their total assets in any one issuer).

\(^{419}\) I.R.C. § 851(b)(3) (2007); Talley & Love, in MUTUAL FUND REGULATION, supra note 412, at § 8:2.2, at 8-9 to -10; see Roe, Mutual Funds, supra note 66, at 1478–80 (examining subchapter M of the Code and noting that only diversified mutual funds are eligible for pass-through tax treatment).

\(^{420}\) Roe, supra note 2, at 20–21.

percent of the fund’s total assets are invested in any one company and such that the fund does not own more than ten percent of the equity of any one company. Obviously, this presents a real limitation on the ability of such a fund to adopt a strategy of control acquisitions. However, the other pool is unregulated, except that the fund is generally prohibited from investing more than twenty-five percent of its total assets in any one company. Thus, although most mutual funds, for tax purposes, elect to keep at least half of their assets diversified, there is nothing to stop them from investing the other half in a few highly concentrated investments. Again, given that some mutual fund complexes have enormous sums at their disposal, this would not seem to be an overly tight restriction on their ability to engage in active oversight strategies. Moreover, as taxes on capital gains approach zero, it is possible that an aggressive mutual fund might be willing to forego pass-through treatment and devote a greater portion of its assets to active corporate monitoring.

Slightly more significant for corporate governance purposes are the Investment Company Act’s prohibitions against certain transactions. These apparently represent a policy choice to limit the risk to which mutual fund investors are exposed. In particular, section 12(a) of the Investment Company Act generally prohibits registered investment companies—i.e., mutual funds but not private equity funds—from effecting short sales of securities and from purchasing securities on margin. However, because the SEC has thus far failed to adopt the necessary implementing rules, mutual funds are currently free to participate in these practices. In fact, many mutual funds have been formed for the express purpose of selling securities short or for hedging their investments by means of a long-short strategy.

Even if such rules were actively enforced, however, the inability of public equity funds to make such investments would not adequately

422. Id. § 851(b)(3)(A).
423. Id. § 851(b)(3)(B).
424. Roe, supra note 2, at 20.
425. See id. at 20–21 (demonstrating that the marginal tax burden applicable to non-exempt mutual funds is relatively small).
426. 15 U.S.C. § 80a-12(a)(1)-(2) (2000). Exceptions exist for short sales “in connection with an underwriting in which such registered company is a participant” and for purchases on margin where “such short-term credits as are necessary for the clearance of transactions.” Id.
explain their passivity. In fact, although private equity funds may make such investments, they typically do not.\footnote{Hedge funds that routinely invest in short sales and other derivative securities are expressly not categorized as private equity funds for purposes of this Article. \textit{See supra} notes 203–204 and accompanying text.} Rather, when acquiring a company, they generally invest in its common stock in order to take control, or in preferred stock that is convertible into common.\footnote{See \textit{Levin}, \textit{supra} note 187, ¶ 202, at 2-9 to -25 (outlining a venture capital fund’s preferred investment structure with respect to a hypothetical start-up transaction).} Additionally, venture capital funds also frequently acquire debentures or other debt securities.\footnote{See id. (describing certain tax advantages that arise from holding debt rather than equity).} Each of these securities is, of course, a permissible form of investment under the Investment Company Act. Thus, while the rules regarding permissible investments may appear to point to a potential distinction between public and private equity funds, in practice any such distinction is probably quite minor.

\section*{C. Governance Rules}

The third category of legal rules that could explain the different investment strategies of public and private equity funds is the set of rules applicable to fund governance. Rules regarding disclosure, for example, as well as rules relating to who is eligible to invest in a fund, differ markedly between public and private equity funds. More importantly, rules regarding the permissibility of incentive fee arrangements differ, providing what appears to be the most likely explanation for the activist monitoring undertaken by private equity funds and the passivity that is prevalent among public equity funds. Each of these sets of rules is discussed separately below.

\subsection*{1. Disclosure rules}

Private equity funds are typically structured so as to be exempt from all but the most basic of disclosure requirements.\footnote{Private equity funds generally seek exemptions from the disclosure requirements of the Investment Company Act, the Investment Advisers Act, the Securities Act of 1933 and the Securities Exchange Act of 1934. \textit{Schell}, \textit{supra} note 182, §§ 8.01-04, at 8-3 to -43. Admittedly, some funds do pursue strategies that require them to register under the Investment Advisers Act. \textit{Id.} § 8.02(3), at 8-23 to -35. However, under most circumstances, these disclosures require little substantive information from such advisers and no information regarding investment strategies or techniques or other similarly sensitive information. \textit{Id}.} Mutual funds, on the other hand, must register with the SEC and make ongoing and extensive disclosures regarding their structure and
Pension funds have similarly extensive disclosure requirements. Despite these differences, however, disclosure rules appear largely unconnected to monitoring ability.

Admittedly, the behavior of different fund managers might differ if they were required to disclose sensitive investment policies. Thus, for example, secrecy may be very important for hedge funds that engage in proprietary trading strategies that could easily be copied by others with the same information. In fact, such funds frequently decline to disclose their trading positions even to their own investors. For most public and private equity funds, however, a requirement to disclose the types of transactions in which a fund seeks to invest would not seem particularly onerous given that the strategy itself is fairly obvious. The value lies in the execution. Thus, the risk of disclosure would seem unlikely to be significant. Moreover, to the extent a public or private equity fund were to seek to acquire control of a public company, section 13(d) of the Securities Act would require prompt disclosure of its intention. Thus, again, the rules do not appear to operate in a manner that would privilege corporate monitoring activities by private equity funds over public equity funds. Their impact is instead mostly neutral.

2. Eligible investor rules

From a securities law standpoint, anyone can invest in a mutual fund or pension fund, regardless of their wealth or sophistication. Private equity funds, on the other hand, in order to remain exempt from various regulations, generally limit their investors to those who

433. See generally Michael Glazer, Prospectus Disclosure and Delivery Requirements, Shareholder Reports, in Mutual Fund Regulation, supra note 412, at chs. 4–5 (detailing the federal registration and prospectus disclosure requirements for mutual funds under the 1933 and 1934 Acts and discussing the requirements mutual funds must meet in providing reports to their shareholders).

434. See generally Peter O. Shinevar, W. Fulton Broemer & Jayne Zanglein, Reporting and Disclosure, in 1 ERISA Basics D-1 to -57 (American Bar Association 2000) (outlining the reporting and disclosure requirements imposed on pension funds by ERISA and highlighting the requirements of the annual report provisions).

435. See SEC Hedge Fund Report, supra note 5, at 49–50 (noting that hedge fund managers frequently choose not to share securities positions and holdings with their own investors because such information does not benefit the investors and may compromise the hedge fund’s competitive advantage in the market).


437. The one proviso to this is that the investor must be eligible to participate in the particular pension fund or mutual fund. Thus, for example, if a pension fund is sponsored by General Motors, it is likely to be limited to employees of General Motors. However, among those employees, there is no requirement that they be wealthy or sophisticated in order to participate.
are “qualified purchasers” (or at least “accredited investors”). Participation in a private equity fund is therefore limited in practice to wealthy investors and fund insiders. Most retail investors are ineligible. In fact, many funds actually require their investors to satisfy wealth requirements that exceed the statutory minimums.

How this distinction impacts monitoring ability, however, is unclear. One possibility is that private equity funds can take on greater risk because their more wealthy investors are likely to be better diversified and thus are better able to suffer a complete loss of their private equity investment. As this Article has demonstrated, however, a large public equity fund that devoted a portion of its assets to an active monitoring strategy could nevertheless remain completely diversified, thus diminishing the risk of a total loss. Moreover, it would still be possible for a retail investor to allocate her assets partly to activist funds and partly to other asset categories.

Another possibility is that the smaller number and greater sophistication of private equity fund investors means that they will be superior monitors of the fund managers. As a result, the fund managers can be trusted to take greater risks with the knowledge that their investors will not tolerate shirking. However, this again appears to be more a function of market forces than an explanation for the variance in investment strategies. If the alignment of interests between the fund managers and the fund investors is sufficiently great, the number of investors and their level of sophistication should be irrelevant. Certainly, private equity funds have fewer and wealthier investors, but such difference on its own is insufficient to explain their aggressive oversight strategies nor the continued passivity of public equity funds.


439. Others, however, are seeking to increase their size by reducing eligible investor requirements to the statutory minimum. E.g., Eleanor Laise, Private Equity Targets Littler Guy, WALL ST. J., Nov. 8, 2006, at D1.

440. Indeed, most private equity funds require their investors, in order to be eligible, to represent that they are capable of suffering a complete loss of their investment. See supra note 304 (recognizing the benefits of a diverse portfolio and realizing that holding shares in as few as eight companies may be sufficient to reap those benefits).

441. See id. (providing an example of how portfolios can be diverse and still find a balance between risky and more predictable investments).
Managers of mutual funds and pension funds face severe limitations on the types of fees they are permitted to charge. These are imposed, respectively, by the Investment Advisers Act and ERISA. The goal of this policy is to minimize incentives for fund managers to take overly speculative risks with client savings.443 Private equity fund managers, by contrast, are subject to no such restrictions.

Section 205(a)(1) of the Investment Advisers Act prohibits a registered investment adviser from receiving compensation "on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client."444 In general, this means that a manager of a mutual fund may not charge a fee based on the fund’s performance.445 Also prohibited by section 205(a)(1) are contingency fees.446 Instead, the manager would be limited to transaction fees and/or management fees that are based on the value of the assets being managed. Although the SEC chose not to require that the fees be “reasonable,” as was once proposed, it did impose a fiduciary standard on fund managers when establishing the fees.447 As a result, mutual fund fees cannot be excessive.

At the same time, although ERISA does not specifically prohibit performance fees, the Department of Labor has interpreted the Act as banning most incentive compensation arrangements that do not meet each of eight specified criteria.448 Most importantly for

443. 2 FRANKEL & SCHWING, supra note 242, § 12.03[A], at 12-59. Interestingly, prior to 1970, performance fees were common among advisers to institutional investors. INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 92-64, pt. 2, at 254 (1971). It was not until 1970 that Congress applied the Investment Advisers Act to advisers of mutual funds. 2 FRANKEL & SCHWING, supra note 242, § 12.03[F], at 12-106.6 to -109.

444. 15 U.S.C. § 80b-5(a)(1) (2000). Note, however, that fees based on a percentage of the assets under management are not deemed to be "on the basis of a share of . . . capital appreciation," even though the fees would necessarily increase as the account appreciates. Id.; KIRSCH, supra note 230, § 9:4.3[A], at 9-16.

445. Note, however, that this section does not prohibit fees based on other measures of performance. KIRSCH, supra note 230, § 9:4, at 9-6.


447. See generally 2 FRANKEL & SCHWING, supra note 242, § 12.05[D], at 12-76 to -97 (explaining that the fiduciary duty standard is one of common-law reasonableness and discussing factors that must be considered to determine if fees comply with this standard).

corporate governance purposes, the compensation must be based on the net appreciation of plan assets during a pre-established valuation period.\textsuperscript{449} In other words, pension fund managers, like the managers of mutual funds, are generally prohibited from charging performance-based fees.

There are two exceptions to the general prohibition against performance fees that apply in the mutual fund context. The first is for funds that limit their membership to “qualified clients.”\textsuperscript{450} These include individuals and companies (not including other mutual funds) with a net worth in excess of $1.5 million or at least $750,000 under the management of the investment adviser.\textsuperscript{451} For purposes of this exception, each investor in a mutual fund would need to satisfy the wealth requirements in order for the manager to charge a performance fee.\textsuperscript{452} The second is for so-called “fulcrum fee” arrangements, which permit the manager of a mutual fund to adjust the base advisory fee depending on how the fund performs relative to a stipulated market index.\textsuperscript{453} The key to the fulcrum fee is that the percentage charged cannot merely increase when performance exceeds expectations—it must also decrease proportionately when performance lags.\textsuperscript{454}

These exceptions have relatively little impact on the ability of public equity funds to engage in a strategy of active corporate governance, however. In the first place, in order to qualify for the wealth exception, a mutual fund would have to refuse subscriptions from all but highly wealthy investors. Given that the primary purpose (and value) of most mutual funds is to invest retail dollars, this

\begin{itemize}
  \item \textsuperscript{449} See KIRSCH, supra note 230, § 9:5, at 9-21 to -22 (listing the other criteria set forth by the Department of Labor as: (1) the plan assets must be large; (2) investment should be in securities with available market quotations; (3) when market quotations for securities are not available, valuation must be done by a third party; (4) arrangement must comply with Advisers Act rule 205-3; (5) a sophisticated fiduciary must approve the compensation agreement; (6) the agreement must be reasonable; and (7) compensation payments must be predetermined).
  \item \textsuperscript{450} 17 C.F.R. § 275.205-3(a) (2007). This rule was amended in 1998 to remove several additional requirements for advisers to qualified clients, including the requirement that the advisory contract be negotiated at arm’s length, and to increase the dollar thresholds. KIRSCH, supra note 230, § 9:4.3[C], at 9-19 to -20.
  \item \textsuperscript{452} 17 C.F.R. § 275.205-3(b) (2007).
  \item \textsuperscript{453} 15 U.S.C. § 80b-5(b)(2) (2000). This exception was created in 1970, at the same time that the general prohibition against incentive compensation was extended to mutual fund advisers. DIV. OF INV. MGMT., U.S. SEC. & EXCH. COMM’N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 238 (1992).
  \item \textsuperscript{454} KIRSCH, supra note 230, § 9:4.3[B], at 9-16 to -17.
\end{itemize}
prospect appears neither practical nor desirable. In fact, such a requirement would effectively convert a mutual fund into a private equity fund. In the second place, fulcrum fees are in practice generally limited to much smaller percentages than a typical carried interest.\textsuperscript{455} In addition, the SEC has promulgated extensive regulations regarding when such fees may be considered fair.\textsuperscript{456} As a result, their impact on monitoring ability is severely muted.\textsuperscript{457}

Mutual funds generally charge their shareholders two types of fees.\textsuperscript{458} Sales loads are a type of brokerage fee intended to compensate financial advisers for a particular transaction.\textsuperscript{459} They are paid either at the time of purchase (front loads) or occasionally when the shares are redeemed (back loads). However, as more and more investors have purchased mutual funds through employer-sponsored savings plans, sales loads have decreased in frequency and amount; hence, their significance has generally waned.\textsuperscript{460} More common are fees for ongoing expenses. These are paid from fund assets, rather than directly by the shareholders, and tend to decrease as the fund achieves economies of scale.\textsuperscript{461} Total mutual fund fees—ongoing expenses plus an annualized portion of any sales loads—decreased from an average of 2.32\% of fund assets in 1980 to 1.07\% of fund assets in 2006.\textsuperscript{462}

Pension fund managers are generally limited to fees for ongoing expenses. This is because transaction fees of the kind charged by mutual funds would likely violate ERISA’s strict prohibition against

\begin{itemize}
\item \textsuperscript{455} 2 FRANKEL & SCHWING, supra note 242, § 12.03[A], at 12-59.
\item \textsuperscript{456}  See generally id. § 12.03[F][5], at 12-118 to -122 (expanding upon the factors the SEC considers to determine the fairness of fees, including, generally, the fairness of the fulcrum fee, the index used to determine performance for the fulcrum fee, and the time period over which performance is calculated).
\item \textsuperscript{457}  See Eisinger, supra note 13, at C1 (noting that, as of 2005, only three percent of mutual funds charged a performance fee and that such funds accounted for less than eight percent of all mutual fund assets).
\item \textsuperscript{458}  See 2 FRANKEL & SCHWING, supra note 242, § 12.03[A], at 12-58 to -61 (discussing the development of “wrap fee” arrangements and other advisory fees).
\item \textsuperscript{459}  INVESTMENT COMPANY FACT BOOK, supra note 33, at 22, 47.
\item \textsuperscript{460}  See id. at 48 (finding the growth of no-load funds and increased competition in the mutual fund industry as additional causes of the decline in the use of sales loads).
\item \textsuperscript{461}  Id. at 47–48, 52. Fees for ongoing expenses typically include an advisory fee, an administrative fee, and so-called 12b-1 fees designed to offset the costs of marketing and distribution of fund shares. John Howat & Linda Reid, Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure, 12 Fordham J. Corp. & Fin. L. 685, 693–96 (2007).
\item \textsuperscript{462}  INVESTMENT COMPANY FACT BOOK, supra note 33, at 47.
\end{itemize}
related party transactions. Thus, most pension fund managers receive a salary or other compensation based on a percentage of the assets under management.

Both of these structures are in sharp contrast to the compensation paid to private equity fund managers. As was discussed in greater detail above, private equity funds typically charge their investors a carried interest that represents a twenty-percent equity stake in any profits that result from the fund’s investments. Although in many cases the twenty-percent fee applies to all of the fund’s profits, many larger and more successful funds apply the carried interest only to the extent fund profits exceed a specified benchmark rate. In fact, this appears increasingly to be the trend in private equity fund formation. Either way, if the fund does not yield profits (or profits above the level of the benchmark), then the fund’s managers receive no compensation. On the other hand, to the extent the fund is successful, the carried interest can create significant wealth for the managers. Thus, there are strong and direct incentives for managers to enhance fund performance.

463. 29 U.S.C. § 1104(a)(1) (2000); Donald J. Myers & Michael B. Richman, Class Exemptions from Prohibited Transactions, in ERISA FIDUCIARY LAW, supra note 319, at 267–68, 283–94. This restriction would also apply to transaction, consulting and other fees that many private equity fund managers charge their target companies as compensation for brokering a leveraged buyout. Supra notes 276–280 and accompanying text. Thus, a pension fund that engaged in a leveraged buyout would not have access to such fees, thereby decreasing its overall profit from the deal. On the other hand, the same underlying economics could probably be achieved by simply adjusting the parties’ allocation of profits. Moreover, investors have increasingly demanded that most or all of such fees be paid to the investors rather than retained by the fund managers. MERCER REPORT, supra note 9, at 19–24.


465. See supra Part II.D (expanding upon the use of carried interest to compensate managers and explaining how such a system aligns manager’s interests with those of investors and provides incentive for high-yield investments).

466. See supra notes 269–271 and accompanying text (explaining that the use of such benchmarks ensures that private equity fund managers do not benefit from general market movements and will only receive their share of profit after the “hurdle rate” is met).

467. See supra note 270 and accompanying text. However, private equity funds also typically charge a management fee intended to cover the fund’s expenses. See supra notes 273–275 and accompanying text (noting that private equity fund managers usually charge a management fee of two to three percent). Thus, although fund managers are unlikely to profit from an underperforming fund, they are also unlikely to suffer a loss.

468. See Taub, supra note 9, at 42 (reporting that the highest paid hedge fund manager received $1.7 billion in annual compensation in 2006); see also Jenny Anderson, Blackstone Founders Due Billions, N.Y. TIMES, June 12, 2007, at C1 (reporting that the two founders of the private equity fund are due to receive approximately $8
The ability to charge incentive compensation goes straight to the issue of incentives—as opposed to barriers—and so appears to be the key difference that explains why private equity funds pursue an activist investment strategy while public equity funds shun most such monitoring activities. Much like the stock options granted to corporate management, a carried interest generates significant incentives to improve performance. It therefore appears that private equity fund managers monitor and discipline corporate managers because they are paid by their investors to do so. Public equity fund managers receive no such compensation and so have no such incentive.

If public equity fund managers are not incentivized by their compensation structure to engage in monitoring, the question remains what are their incentives. Part V explores the incentives created by a system of flat fees.

V. IMPLICATIONS FOR GOVERNANCE REFORM

In Parts III and IV, I drew the preliminary conclusion that the key distinction that explains the different approaches that public and private equity funds take to monitoring is the general prohibition against incentive compensation for the managers of mutual funds and pension funds. This finding would have important implications for corporate governance. In particular, it suggests that if policymakers were to deregulate fund manager fees—while at the same time adjusting any regulations that might limit the exercise of institutional investor control—the behavior of public equity funds might change. Indeed, were their managers incentivized to pursue

---

469. See Levin, supra note 187, ¶ 103, at 1-3 to -6 (characterizing incentive compensation as a primary distinguishing factor of private equity investing).

470. Unlike corporate stock options, however, a carried interest is more difficult to manipulate and is more closely tied to actual firm performance. See supra note 272 (noting that a lack of similar restrictions on stock options presents a greater opportunity for fraud).

471. See Schell, supra note 182, § 1.02[3], at 1-12 to -14 (noting that private equity funds are structured to maximize the alignment of interest between a fund’s managers and its equity investors).

472. See Coffee, supra note 2, at 1362-63 (recommending that pension fund fees be deregulated in order to encourage more activist investment strategies).
control acquisitions of underperforming companies, they might evolve into the active corporate monitors that many have hoped they would become. Even better, they might help to foster a deeper market for good corporate governance.

Part V.A therefore explores the incentives that the legal prohibition against incentive compensation creates for public equity fund managers. In it, I conclude that the legal framework plays a significant role in shaping their incentives and that efforts to alter the framework could in fact help to foster a deeper and more active market for corporate control. Indeed, from a corporate governance standpoint, the current regulatory regime creates exactly the wrong incentives for public equity fund managers, encouraging them to shun monitoring rather than to embrace it.

Finally, Part V.B reviews the corporate governance implications of the existing incentives. In it, I conclude that one impact of regulatory efforts aimed at deregulating public equity fund compensation would be to deepen and intensify the market for corporate monitoring.

A. Existing Incentives for Fund Managers

Like corporations, mutual funds and pension funds are themselves fictional legal entities that suffer from their own internal agency costs. The interests of a fund’s managers, in other words, may differ from the interests of a fund’s investors, often substantially. Thus, in order to understand the monitoring and investment behavior of public equity funds, one must first consider the incentives facing the individuals who manage such funds. Presumably, such individuals will seek to maximize their level of compensation, even if their conduct is partially at odds with the best interests of the fund. Simply removing barriers to the exercise of influence is therefore unlikely to change fund behavior, as some have suggested, unless there are adequate incentives for managers to expend the time and resources necessary to discipline corporate managers. It is not...
enough that funds be capable of monitoring. The fund managers must also desire to monitor.

The general subject of money manager incentives is not a new one and much ground has previously been covered. My goal in Part V.A is therefore not to revisit all of the overlapping incentives facing fund managers, but to focus on those related to the structure of their compensation. To the extent their fees create disincentives for monitoring, this would bolster my tentative conclusion in Parts III and IV that deregulating such fees would encourage fund managers to reshape mutual funds and public pension funds into active corporate monitors.

The managers of mutual funds and pension funds, as was previously noted, generally charge their clients a fee based on the assets that they manage. Thus, regardless of the manager’s performance, a larger fund means a larger fee. In other words, mutual funds are primarily aggregators of capital. For purposes of corporate governance, then, fund managers will be incentivized to engage in oversight activities only to the extent they believe that their efforts will lead to a larger pool of assets and, thus, a larger management fee. Monitoring is expensive, burdensome, and at times risky. Unless they believe that they can profit personally from an active investment strategy, fund managers will continue to pursue passive diversification.

There are two basic methods for public equity funds to achieve asset growth, neither of which hold much promise for improved corporate governance. First, they can realize growth by generating increased profits, provided those profits are reinvested in the fund. Second, they can realize growth by attracting new investors (or surely do more monitoring if legal reform facilitates institutional voice. The only question is how much more.”).

477. See, e.g., Baumol, Goldfeld, Gordon & Kohn, supra note 411, at ch. 5 (contemplating whether the competitive nature of the market is enough to drive managers to act in accordance with investor interests or if regulation is needed to monitor manager behavior); Black, supra note 11, at 873–82 (asserting that public equity fund money managers have some incentives to monitor, including the desire to perform well, to receive peer recognition, and to gain positive publicity for high returns); Coffee, supra note 2, at 1362–66 (arguing in favor of incentive compensation for pension fund managers).

478. See generally supra Part IV.C.3 (explaining that public fund managers are severely restricted by the Investment Advisers Act and ERISA from charging fees based on performance).

479. Due to scale economies, however, the relative size of the fee decreases as the size of the fund increases. Coffee, supra note 2, at 1362–63.

480. Black, supra note 2, at 523.

additional dollars from existing investors). In fact, given that the true role played by public equity funds in financial markets is simply to aggregate investments at a low cost and so efficiently provide the benefits of diversification to retail investors, the real incentive for public equity fund managers may be to focus on cost-cutting. These issues are discussed in turn below.

Note, however, that the subject is made somewhat cloudier by the fact that many funds effectively subcontract many of their investment decisions to numerous outside managers. Thus, the incentives of these sub-managers may differ at times from those of the managers ultimately charged with a fund’s administration. Still, for corporate governance purposes, it is the incentives of those ultimately in control that count. If the senior managers see value in monitoring, they will direct the behavior of their sub-managers accordingly. Likewise, if they view monitoring as a distraction or unnecessary cost, their instructions to their sub-managers will reflect this attitude as well.

1. Profit growth

Profits, of course, will lead to a larger fund and yield a larger fee. Thus, for example, if a $1 billion fund were to grow by five percent due to the investment decisions of its managers, the fund would thenceforth have assets totaling $1.05 billion and the management fee would increase proportionately. Note, however, that such growth only occurs if the profits are reinvested in the fund. Were the additional monies to be withdrawn from the fund in the form of a dividend or other distribution, then the managers’ successful investment would have no impact on the size of the fund (and hence on the size of their annual management fee).

A strategy of profit growth, however, is unlikely to lead to any significant amount of monitoring. If one assumes an annual management fee in the range of one percent, the addition of $50 million in the example above would thenceforth increase the annual management fee.

483. Investment Company Fact Book, supra note 33, at 10–11, 143; see also supra note 34 and accompanying text.
484. See generally Rock, supra note 1, at 464–78 (examining the agency costs associated with intermediaries and questioning whether agents’ interests are aligned with their principals’ interests).
485. But see Coffee, supra note 12, at 845, 862–66 (arguing that the important agency problem is not at the corporate manager level, but at the financial intermediary level).
management fee payable to the fund’s managers by only $500,000. A change in investment strategy that produces a five percent return—such as a decision to become an active monitor of the fund’s investment portfolio—is therefore profitable only to the extent it costs the fund managers less than $500,000 to produce. Given that mutual funds may hold as many as a thousand different stocks at any given time, $500,000 would be likely to purchase only the most general level of oversight for any one company. It is uncertain, however, whether such minimal monitoring could produce enough of a boost to performance to justify the expense.

In fact, the likelihood that fund managers will provide oversight over any one company becomes even smaller when one considers that the fund is unlikely to own more than five percent of any such company. Thus, if a mutual fund tried to discipline a $1 billion manufacturing company of which it held four percent, and if such efforts doubled the value of the company—an unlikely scenario to be sure—the mutual fund would only garner four percent of the extra $1 billion, or $40 million. Thus, the result of this incredible achievement would be to add $400,000 to the annual management fee. If, however, such efforts yielded a more realistic ten percent increase in the value of the manufacturing company, the fund would receive only $4 million for its efforts and the management fee would increase by a mere $40,000. Considering that a contentious proxy contest can easily cost upwards of seven figures, such numbers suggest that there is little incentive for fund managers to engage in costly—not to mention uncertain—monitoring when they personally have so little to gain. Rather, they are likely to see greater value in a

486. Of course, if the gain accrues on an annual basis, the effort to monitor would be worthwhile to the extent the current expense is less than the present value of the future stream of profits. Thus, permanent improvements gained through monitoring can justify a much higher expenditure on oversight than temporary or one-time improvements.

487. This may account for the scholarly interest in promoting institutional investor voice, as opposed to control, and in utilizing economies of scale to achieve greater monitoring.

488. See Black, supra note 2, at 530 (“Owning 5% is easy if you’re passive; hard if you’re active. Owning 10% is hard even if you’re passive, but much harder if you’re active.”).

489. The average contest is estimated to range between $250,000 and $1 million. Bratton, supra note 10, at 1403. Meanwhile, the recent proxy fight over the merger of Hewlett-Packard and Compaq is estimated to have cost over $100 million. Lohr, supra note 351, at 31.

490. In contrast, a private equity fund manager earning a twenty-percent fee would have received an $8 million fee in the first example and an $800,000 fee in the second.
more passive investment strategy, selling—rather than reforming—investments that turn sour.

Of course, one might object to these examples by suggesting that many mutual fund complexes are much larger, thereby increasing the magnitude of even minor fluctuations in value. A $1 trillion mutual fund complex, for example, might be able to absorb the cost of a little monitoring, even if a $1 billion fund might not be. Moreover, as Black and others have suggested, certain types of oversight—such as monitoring board composition and structure—might lend themselves to economies of scale.\footnote{Black, \textit{supra} note 2, at 580–84, 589–91.}

The point of these observations, however, is not to suggest that there are no incentives to increase profits. Surely, such incentives do exist. Rather, the point is that such incentives are unlikely to be large or transparent, even to sophisticated fund managers. The results of monitoring will be both uncertain and uneven, but their costs immediate and concrete. Therefore, in a world of flat fees, even those fund managers who are inclined to take a more active role in oversight must conduct a cost-benefit analysis to determine whether such efforts are likely to be rewarded.

2. \textit{Growth through advertising}

Public equity fund managers can also achieve growth by substituting advertising for profits. This is because the size of the fund will increase as it attracts new investors or additional capital contributions from existing investors. For example, if the average mutual fund investor maintains a balance of $48,000, then the addition of ten new investors through advertising would contribute $480,000 to the fund’s assets, thereby adding an additional $4,800 to its annual management fee.\footnote{See \textit{INVESTMENT COMPANY FACT BOOK}, \textit{supra} note 33, at 57 (reporting that the median amount households with mutual funds invest in them is $48,000).} New capital, in other words, leads to increased fees for the fund managers just as surely as do increased profits. The only question is the relative cost and impact of advertising, something knowable only on a case-by-case basis.

Certainly, fund performance—achieved in some cases through better monitoring—matters for advertising. This is especially true for those investors who compare data on results when selecting an investment fund.\footnote{For a discussion of this relationship, see generally Rock, \textit{supra} note 1, at 445. \textit{See also} Prem C. Jian & Joanna Shuang Wu, \textit{Truth in Mutual Fund Advertising: Evidence of Future Performance and Fund Flows}, 55 J. FIN. 937, 938 (2000) (noting that}
signal the quality of its managers and thus retain current investors or attract new ones. It would be difficult, therefore, for a fund to completely ignore performance.

An advertising campaign, however, does not need to be linked entirely to performance data in order to be successful in attracting additional capital. Instead, a fund may attempt to attract new investors based on its perceived reputation for integrity, its particular investment strategy, or some other unusual or defining characteristic. It is also possible for investors to be swayed by the same type of advertising techniques that are used by Madison Avenue to sell other products. Were this not the case, we would see fewer television commercials featuring famous spokespeople from the 1960s as well as graphics and music that are so obviously intended to appeal to the crucial Baby Boom generation. In fact, there is

advertisements can provide investors with information as they decide where to place their money.

494. Several empirical studies suggest that mutual funds increase their advertising following a year with strong performance. Cf. id. at 937 (finding funds that advertise perform better than those that do not advertise).

495. TD Waterhouse, for example, which recently merged with Ameritrade, has used several actors from the TV drama Law & Order as spokesmen in order to sell a reputation for fair and honest dealing. The first, Steven Hill, played the role of Manhattan District Attorney (“DA”). More recently, Sam Waterston, who portrayed the DA’s chief prosecutor, has taken over the role. See Gothamist.com, Sam Waterston TV Commercial, http://gothamist.com/2003/11/18/sam_waterston_tv_commercial.php (Nov. 18, 2003) (last visited Oct. 26, 2007).

496. Appeals to the Baby Boom generation through references to the pop culture of the 1960s and 1970s have become de rigueur in mutual fund advertising. For example, one television commercial currently airing for Ameriprise Financial features an aging Dennis Hopper—an actor best known for his role as Billy in the 1969 counter-cultural road film “Easy Rider”—standing in a field of yellow flowers while music from The Spencer Davis Group’s 1967 hit “Gimme Some Lovin’” plays loudly in the background. Its tag line: “Flower power was then. Your dreams are now.” See Ameriprise Financial, Commercial: Wildflower, http://www.ameriprise.com/amp/global/about-ameriprise/commercials.asp (last visited Oct. 1, 2007).

empirical evidence to suggest that the size of investments in mutual funds is largely unrelated to their level of performance. 497 The one main exception to this observation is for the best-performing funds, exactly the ones most likely to attract capital from investors who closely track the data. 498

More importantly, as an advertising device, profits matter only on a relative basis, not an absolute one. How well a fund performed in a given period is irrelevant. What matters is whether the fund outperformed its competitors. 499 Or, to be more exact, what matters is that mutual fund and pension fund investors be unaware of differences in performance. So long as a fund’s results are roughly equivalent to those of its competitors, performance ceases to be a distinguishing characteristic. 500 In fact, a cynic might interpret the fragmentation of most large mutual fund complexes into multitudinous sub-funds and share classes as a means for impeding easy comparisons of returns. 501 So many data points, each fluctuating constantly, remove the transparency that might otherwise be present in mutual fund returns. 502

What this ascendancy of advertising over performance means for corporate governance is that public equity fund managers are unlikely to see much value in attempts to compete based on their ability to bring discipline to corporate managers. Why expend the

eonion.com/content/opinion/theres_no_more_reassuring_voice. (last visited Oct. 1, 2007) (“Dennis Hopper’s television spots for Ameriprise Financial are so reassuring . . . . When I hear him in those commercials, it’s the familiar voice of a coke-dealing, LSD-fueled hippie cowboy biker putting me at ease.”).

497. Sirri & Tufano, supra note 481, at 190.
498. See id. (noting that consumers tend to react to very high performance but not very low performance).
500. See Sirri & Tufano, supra note 481, at 190–98 (identifying new products, distribution methods and low fees as differentiation strategies).
501. At the end of 2006, for example, there were 8,120 U.S. mutual funds offering investors 21,260 share classes, or an average of 2.6 share classes per fund. INVESTMENT COMPANY FACT BOOK, supra note 33, at 93. Moreover, the average fund complex sponsors many sub-funds. Vanguard, for example, offers its investors no fewer than three hundred investment choices. Vanguard.com, Find Similar Vanguard Funds, https://personal.vanguard.com/VGApp/hnw/funds/tools/findsimilarfund (last visited Oct. 1, 2007).
502. Indeed, empirical studies suggest that investors are very slow to redeem their shares after periods of substandard performance. See, e.g., Richard A. Ippolito, Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry, 35 J.L. & ECON. 45, 61 (1992) (reporting a 0.35% decrease in growth rate following poor fund performance compared to a 0.90% increase in growth rate following high positive performance); Sirri & Tufano, supra note 499 (explaining that gathering and analyzing data about mutual funds requires consumer time and effort and analyzing the consumer costs associated with investment decision making).
resources on risky and uncertain monitoring when the results may have no more of an effect on the managers’ compensation than does their spokesperson’s particular karma with Baby Boomers? Admittedly, the best funds are probably those that privilege performance above all else. However, at a minimum, this ability to hide lackluster results in a slick advertising campaign mutes the incentives to engage in active oversight.

3. Incentives to cut costs

The ability to attract new capital through advertising may also tend to shift the focus of fund managers away from performance and onto cost. This is because comparing performance is difficult, while comparing fees is not. For one thing, profits fluctuate from period to period, as do general economic conditions. Even personnel may change. Keeping up with such changes may be an enjoyable diversion for some, and may seem like second nature to finance professionals, but is likely to be beyond the capacity and interest of most public equity fund investors. Moreover, each of these factors is exacerbated by the plethora of options now available to investors, even within the same family of funds. An informal review of the Vanguard website, for example, shows hundreds of sub-funds, each of which can be combined at various percentage levels with other sub-funds, and most of which have multiple asset classes. Choice, in other words, can become bewildering. Even those investors who are sophisticated enough to slog their way through the performance data face a significant challenge. As we lawyers are fond of reminding people, past performance is not a guarantee of future profits.


504. See Jennifer Levitz, When a Fund Manager Leaves Investors Fret—For Good Reason, WALL ST. J., June 4, 2007, at R1 (reporting that “manager musical chairs,” in the words of one investor, is a common concern among mutual fund investors).

505. This may be one reason for the growth of funds of funds: investment funds that diversify not by acquiring a portfolio of securities but by acquiring a portfolio of other investment funds. See INVESTMENT COMPANY FACT BOOK, supra note 33, at 26 (noting that U.S.-registered funds of funds have increased from 45 in 1996 to 604 in 2006, while their assets have increased over the same period from $13 billion to $471 billion).


507. It is, of course, common practice in the securities industry to print such warnings in boldface or other large-type on the cover of offering documents.
Indeed, this focus on cost appears to be bolstered by the revolution in corporate finance that has taken place over the past few decades. According to the efficient capital markets hypothesis, markets for many corporate securities are sufficiently liquid as to be efficient.\footnote{508} The implication of this finding is that for large, widely followed stocks, the price incorporates all of the available information and thus its future direction will be random.\footnote{509} The price, in other words, is a consensus price that cannot be consistently bested by an investor unless that investor has access to information that the market lacks.\footnote{510}

The underlying lesson for retail investors is therefore roughly as follows: You cannot consistently beat the market, and neither can your financial adviser.\footnote{511} Thus, you should avoid paying a high fee for investment advisory services that cannot be rendered. Instead, you should seek out a reputable firm and invest your savings in a safe, low-cost, diversified public equity fund.\footnote{512}

The focus of mutual fund advertising on the size of fees rather than on the quality of returns thus appears to have some basis in sound economic theory. Proof that investors have learned this lesson can be found not only in the nature of fund advertising but also in the explosion of index funds and ETFs, which expressly shun active management.\footnote{513} Rather than seek to achieve profit growth through stock picking acumen, they embrace the lessons of the efficient capital markets hypothesis and reject any efforts to actively follow

\footnote{508} See Brealey & Myers, supra note 309, at 324 (noting that the article in which the theory first appeared was Maurice G. Kendall, The Analysis of Economic Time-Series, Part I: Prices, 96 J. ROYAL STAT. SOC’Y 11 (1953)). Harry Roberts has identified three forms of the efficient capital markets hypothesis: weak, semistrong, and strong. Id. § 13-2, at 329. See generally Lawrence A. Cunningham, From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis, 62 GEO. WASH. L. REV. 546, 551–70 (1994) (tracing the history and development of the efficient capital market theory).

\footnote{509} Brealey & Myers, supra note 309, at 328 (explaining that since prices are based on all relevant information, they change when new information is available and the unpredictability of this new information’s arrival makes the changes unpredictable).

\footnote{510} Id. at 336 (noting that, although there is disagreement at the margins, “we believe that there is now widespread agreement that capital markets function well and that opportunities for easy profits are rare”).

\footnote{511} See id. at 337 (“In an efficient market you can trust prices, for they impound all available information about the value of each security. This means that in an efficient market there is no reason for most investors to achieve consistently superior rates of return. To do so, you not only need to know more than anyone else; you need to know more than everyone else.”).

\footnote{512} See id. at 344 (“In an efficient market investors will not pay others for what they can do equally well themselves.”).

\footnote{513} Investment Company Fact Book, supra note 33, at 34–35.
their investments. Instead, they purchase a portfolio of stocks intended to mimic the results of some market index or category, such as the S&P 500 or the Nasdaq. Their chief value is not in exceeding the returns of actively managed funds, but in mirroring them at a lower cost. Currently, it is estimated that over ten percent of equity fund assets—more than $1 trillion—are held by index funds.

Cost cutting, of course, is anathema to monitoring. Even if corporate oversight were to become less costly and burdensome as a result of proxy reform, some risk and expense would always remain. Thus, even those public equity fund managers who might be inclined to discipline errant corporate managers would be faced with the question of whether the lower cost route of exit would be preferable. In fact, for an index fund, any effort to actively manage investments is counter to its stated goal of mimicking the market. Thus, monitoring, however cheap and easy it may become as a result of proposed legal reforms, is unlikely to coexist comfortably with a regime characterized by competition over low fees.

B. The Promise of Public Equity Fund Oversight

As demonstrated by Part V.A, public equity fund managers are not paid to monitor their investments. They are paid to attract new capital through a combination of advertising and cost-cutting. So long as a fund’s profits are in the vicinity of those of its competitors, performance—and hence monitoring—matters to public equity fund managers only to the extent it provides fodder for further advertising.

Indeed, there is a sort of symbiosis among profits, advertising and cost-cutting. Low costs and high profits are both worthy ends in their own right, but both also provide fuel for advertising campaigns. Advertising, for its part, can be used to signal the high quality of a fund’s investments or to obscure less-than-inspiring results. By restricting public equity fund managers to a percentage of the assets they manage, legal rules distort the market’s incentives and shift the focus of fund managers away from the quality of their investment decisions. Profits become a means rather than an end.

Moreover, the quality of public equity fund governance has itself been seriously questioned. For example, scholars have for many years questioned the impact of the efficient capital markets hypothesis on institutional investors.

514. Id.; see Gilson & Kraakman, supra note 20, at 865 (noting the impact of the efficient capital markets hypothesis on institutional investors).
515. See Diva Gullapalli, ETF Price War Looms as Vanguard Looks to Catch Up, WALL ST. J., July 7–8, 2007, at B1 (reporting on Vanguard’s plan to market an ETF similar to a Barclay Global Investors ETF but at lower cost).
516. INVESTMENT COMPANY FACT BOOK, supra note 33, at 35.
517. See generally supra Part I.D.
years doubted whether the fiduciary duties applicable to mutual fund managers are adequate. As a result, many have advocated an increased monitoring role for disinterested directors. Meanwhile, Joel Seligman has pointed out that SEC oversight of the mutual fund industry has often proved lax. In fact, peaking around 2003 but continuing to the present, the mutual fund industry has been rocked by a series of scandals related to late trading, market timing, and the selective disclosure of information to investors. The result has been a flurry of hearings, litigation and rulemaking.

518. See Langevoort, supra note 11, at 1017 (noting that the abuses of 2003 reignited long-standing concerns about enforcing fiduciary obligations in mutual funds).

519. See, e.g., Rosenblat & Lybecker, supra note 482, at 649–54 (proposing a role for disinterested directors in regulating joint transactions between investment companies and their affiliates); Joel Seligman, Should Investment Companies be Subject to a New Statutory Self-Regulatory Organization?, 83 WASH. U. L.Q. 1115, 1126 (2005) (advocating the imposition of a statutory self-regulatory organization to oversee the mutual fund industry). But see Langevoort, supra note 11, at 1019 (questioning the efficacy of disinterested directors in disciplining mutual fund managers); Martin E. Lybecker, Enhanced Corporate Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration, 83 WASH. U. L.Q. 1045, 1047–50 (2005) (arguing that recent governance reforms regarding mutual funds were both unjustified and of questionable efficacy).

520. See Seligman, supra note 519, at 1115 (citing a report by the General Accounting Office that, prior to 1998, "each mutual fund was inspected an average of once every twelve to twenty-four years").

521. See Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before the Fin. Mgmt., the Budget, & the Int'l Sec. Subcomm. of the S. Comm. on Governmental Affairs, 108th Cong. 9 (2003) (statement of Stephen M. Cutler, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n) (reporting the preliminary results of investigations into abuses by mutual fund complexes, brokerage firms and insurance companies selling mutual funds); Lybecker, supra note 519, at 1061–79 (discussing the 2003 and 2004 market-timing, revenue-sharing and directed brokerage scandals and the resulting settlements); Mahoney, supra note 13, at 176–80 (detailing legal and regulatory strategies to address improper mutual fund trading by fund managers, brokers and traders). Other problems have arisen as well, including issues of variable products, director independence, soft dollars, volume discounts, portfolio manager conflicts, and revenue sharing with broker-dealers. Seligman, supra note 519, at 1116–17.

The point of this is not to prove, or even argue, that there are substantial agency costs in mutual funds and public pension funds. This is obvious and generally well understood. The point is to suggest that the incentives facing fund managers are at best opaque, even to the managers themselves. At worst, the incentives are exactly the opposite of what advocates of institutional investor monitoring would hope for. Public equity fund managers remain passive in their investment philosophy because they are paid not to monitor but to cut costs.

Compare this to an incentive fee world such as exists for private equity funds. There, growing the fund is largely irrelevant, except to the extent that it allows fund managers to work with more money. Neither cutting costs nor advertising improve the managers’ bottom line. However, they receive a twenty-percent share of any increases in performance. Whereas a public equity fund manager would just as soon exit an underperforming investment, a private equity fund manager earns her living by improving such performance.

The most likely result of deregulating public equity fund compensation would therefore be the expansion of the market for good corporate governance. Public equity funds, like their private brethren, would be empowered to compete based on their ability to identify and reform underperforming companies. To the extent a given company suffered from significant agency costs, it could expect to receive offers from a variety of potential suitors, each promising its own set of cures for the company’s perceived ills. Those public equity funds that were best able to bring about positive change in the performance of their portfolios would produce the highest returns and attract the most capital. Thus, retail dollars could be expected to join the assets of the more well-heeled in the fight to bring discipline to corporate managers.

Indeed, public equity funds that charged a fee based on performance would be doubly incentivized to take an active role in corporate monitoring. First, they would have greater reason to improve their funds’ performance because they would personally and directly benefit from such improvements. Second, and perhaps

523. Some of these costs may be political. See supra note 170 (providing examples of how politics may influence investment decisions). But see Camara, supra note 4, at 236–39 (describing “investors [who] are insulated from market and political forces by some combination of wealth, social position, training, and disposition”).

524. See generally supra notes 261–262 and accompanying text.
more importantly, they would need to achieve greater returns in order to justify their higher fees and avoid a flight of capital. 525

A fee structure that rewards success is both more equitable and better able to align the interests of fund managers and fund investors than is one which is uncoupled from performance. Thus, regulatory efforts intended to deregulate public equity fund compensation are likely to expand and intensify the oversight of corporate America. 526 Investors in mutual funds and public pension funds could therefore benefit twice, as both fund managers and corporate managers compete to improve their results.

As an ancillary matter, however, it is worth noting that even if all of the hurdles to the exercise of shareholder voice were removed, and even if public equity fund managers were permitted to share in the benefits from monitoring, there simply may not be a market for increased corporate governance. It may well be that most retail investors would prefer the existing low-risk, low-reward strategy of public equity funds and would reject any offering of high-risk, high-monitoring strategies. In this regard, efforts to deregulate shareholder activism have little downside risk. If there is no market for monitoring, nothing will change if the rules are altered. On the other hand, if there is an untapped potential to reduce agency costs through improved corporate governance—whether at the level of voice or control—it would presumably be fostered by efforts to enable that market. The beauty of any proposal to deregulate fund compensation is therefore that its primary function would not be to dictate any particular conduct but merely to create the preconditions for a deeper market for good corporate governance. Currently, public equity funds have only one viable model—low-cost diversification with little or no monitoring. Were they permitted to experiment with a high-cost, high-return model, we would soon discover whether additional active monitoring is indeed economically efficient.

525. See BREALEY & MYERS, supra note 309, at 181 ("Wise investors don’t take risks just for fun. They are playing with real money. Therefore, they require a . . . risk premium.").

526. See MEYER & MATHONET, supra note 182, at 27 (noting that "the ‘growth of private equity is a classic example of how organizational innovation, aided by regulatory and tax changes, can ignite activity in a particular market’" (quoting Stephen D. Prowse, The Economics of the Private Equity Market, ECON. REV. 21, Federal Reserve Bank of Dallas (1998))).
CONCLUSION

Policymakers should permit mutual fund and public pension fund managers to charge incentive-based compensation similar to that currently charged by private equity fund managers. By doing so, they would create direct incentives for public equity fund managers to adopt a strategy of active oversight. Monitoring would cease to be a distraction and an obstacle to cost-cutting and would instead become a primary means of competition. By bringing the vast resources of retail investors into the market for corporate governance, incentive pay would fundamentally alter the relationship of corporate managers and their shareholders. The pendulum would swing. Managers would become more accountable.

Admittedly, private equity funds are not without their critics. For example, both their growing wealth and newfound political clout have come under attack of late. In presidential politics, Republican hopeful Mitt Romney has been both extolled and criticized for his role as a founder of Bain Capital. Like corporations, investment funds have also had their share of scandal. And with a Democratic

527. See, e.g., Paul Krugman, Op-Ed, Gilded Once More, N.Y. TIMES, Apr. 27, 2007, at A27 (noting that the 2006 annual income of the twenty-five highest paid hedge fund managers was “more than it would cost to provide health care for a year to eight million children—the number of children in America who, unlike children in any other advanced country, don’t have health insurance”). The survey, which appeared in the April 2007 issue of Institutional Investor’s Alpha magazine, has been widely reported in the regular media. See Taub, supra note 9, at 41–42 (reporting that the top twenty-five hedge fund managers each earned over $240 million in 2006). To their credit, however, the managers’ philanthropy does appear to be increasing, although perhaps not as quickly as their wealth. See, e.g., Hedge Fundraising: The New Moneymen Give Some Back, ECONOMIST, June 2, 2007, at 80 (noting that “[h]edge-fund managers seem to be following the well-trodden charitable trail blazed by 19th-century industrialists such as Andrew Carnegie and modern-day billionaires like Bill Gates”); Jennifer Levitz, Hedge Funds Roil Charity Fund-Raising, WALL ST. J., Apr. 14, 2007, at B1 (reporting on an annual charity fund-raiser for Big Brothers Big Sisters of Massachusetts Bay that had traditionally netted approximately $200,000 but instead raised $1.8 million once several hedge fund managers joined the charity’s board).

528. See Alison Leigh Cowan, Wealthy Enclave Offers Windfall for Candidates, N.Y. TIMES, May 25, 2007, at A1 (reporting that, as a result of the concentration of private equity funds there, Greenwich, Connecticut had joined New York, Los Angeles and Silicon Valley as an important campaign fundraising stop for presidential hopefuls); Brody Mullins & Kara Scannell, Hedge Funds Coming of Age Politically, WALL ST. J., Apr. 19, 2007, at A6 (noting that political donations by executives at the twenty-five largest hedge funds had increased from $576,000 in 2000 to nearly $2.3 million in 2004).

529. See David D. Kirkpatrick, Romney Political Fortunes Tied to Riches He Gained in Business, N.Y. TIMES, June 4, 2007, at A1 (describing the political fallout from Romney’s previous career at Bain Capital). According to a ranking by Private Equity International, Bain Capital is now the nation’s eighth largest private equity fund, with $17.3 billion under management. PRIVATE EQUITY INTERNATIONAL, supra note 216, at 62.

530. See Vikas Bajaj & Julie Creswell, Bear Stearns Staves Off Collapse of 2 Hedge Funds, N.Y. TIMES, June 21, 2007, at C1 (detailing negotiations between lenders and two flailing hedge funds on the verge of having to sell mortgage securities in the open
Congress and the widely publicized IPO of Blackstone Group, federal policymakers have begun rethinking their laissez-faire approach to the regulation of private equity funds. Even Hollywood has joined

market); Julie Creswell & Vikas Bajaj, $3.2 Billion Move by Bear Stearns to Rescue Fund, N.Y. TIMES, June 23, 2007, at A1 (comparing the 2007 $3.2 billion bailout by Bear Stearns Companies investment bank to the more infamous $3.6 billion bailout of Long-Term Capital Management by over a dozen lenders in 1998); Julie Creswell, A New Genre of Wall St.: Bailout Blog, N.Y. TIMES, June 28, 2007, at C1 (noting that the SEC had initiated an inquiry into the losses at two Bear Stearns hedge funds); Kate Kelly & Serena Ng, Bear Stearns Bails Out Fund With Big Loan, WALL ST. J., June 23–24, 2007, at A1 (highlighting that the funds’ liquidation could have panicked an already nervous mortgage-bond market).

Interestingly, though, most of the scandals thus far have occurred among traditional hedge funds, rather than private equity funds. The best known was of course the collapse due to hubris of Long-Term Capital Management, which was immortalized in Roger Lowenstein’s superb treatment. See generally LOWENSTEIN, WHEN GENIUS FAILED, supra note 343 (chronicling the details of Long-Term Capital Management’s crash based on interviews with insiders at the firm and major investment banks). Meanwhile, Amaranth Advisors famously lost over $3 billion in a few short weeks in 2006. See Gretchen Morgenson & Jenny Anderson, A Hedge Fund’s Loss Rattles Nerves, N.Y. TIMES, Sept. 19, 2006, at C1 (attributing the fund’s decline to a fall in natural gas prices). The most notable pure fraud may have occurred when the principals of Bayou Group disappeared in 2005 with approximately $300 million of their investors’ funds. See Ian McDonald, Bayou Drained Accounts in ’04 of $161 Million, WALL ST. J., Sept. 1, 2005, at C1 (tracing Bayou’s transfers of funds to and among banks around the world); Ian McDonald, John R. Emshwiller & Fanthe Jeanne Dugan, Bayou Transfers Set Off Alarms, WALL ST. J., Sept. 12, 2005, at C1 (explaining that the fraud scheme operated by tricking low-level bank employees into accepting funds by confusing them with technical financial language); Gretchen Morgenson, Jenny Anderson, Geraldine Fabrikant & Riva D. Atlas, What Really Happened at Bayou, N.Y. TIMES, Sept. 17, 2005, at C1 (detailing the unraveling of a complex $300 million fraud scheme at the Bayou Group hedge fund firm).

531. For example, at the time of this writing, bills aimed at increasing the taxes on private equity funds had passed in both houses of Congress. See Jenny Anderson & Andrew Ross Sorkin, A Tax Gap Puts Private Equity Firms on Hot Seat, N.Y. TIMES, June 16, 2007, at C1 (noting that recent interest in changing the tax code was prompted by the increasing prominence and wealth of private equity firms); Jenny Anderson & Andrew Ross Sorkin, Tax Equity’s Battle Cry in New Bill, N.Y. TIMES, June 23, 2007, at C1 (announcing that the proposed democratic bill would tax private equity firms at the standard income tax rate of thirty-five percent rather than the fifteen-percent capital gains tax they currently enjoy); Sarah Lueck, Jesse Drucker & Brody Mullins, Congress Hunts for Tax Targets Among the Rich, WALL ST. J., June 22, 2007, at A1 (reporting that the Senate might introduce a series of multiple narrow tax reform bills rather than one broad bill like the one being considered by the House of Representatives); Henny Sender & Sarah Lueck, Tax Plan Adds to the Pressures on Buyout Firms, WALL ST. J., June 16–17, 2007, at A1 (reporting on a Senate bill to tax publicly traded private equity advisers as if they were corporations). For an academic study on the impact of such tax reform, see Michael S. Knoll, The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income, (U. Penn. Law Sch., Scholarship at Penn. Law, Paper No. 172, 2007), available at http://ssrn.com/abstract=892440. Regulators are also investigating whether private equity funds are involved in a disproportionate number of insider-trading and/or antitrust cases. PRIVATE EQUITY TERMS & CONDITIONS, supra note 196, at 50.
the act, casting Matt Damon as a morally dubious hedge fund manager in the Oscar-nominated movie *Syriana*.

And yet, despite their growing influence and the interest of Hollywood and the press, legal scholars have thus far paid scant attention to the role private equity funds play in America’s system of corporate governance. This is a mistake, however, as private equity funds have embraced corporate oversight as their primary investment objective. Not only do their actions benefit overall corporate governance by improving the performance of underperforming firms, but they also provide an important model for broader governance reform. \(^{534}\) Hostile takeovers failed as a monitoring device and institutional investor voice remains an unfulfilled promise. Public equity fund control, by contrast, has not even been considered.

In fact, institutional investor control may already be on the march. Acquisitions by private equity funds are rising as a percentage of total deal flow, such that fully twenty percent of global M&A activity, as measured by value, is now undertaken by private equity funds. \(^{535}\) Additionally, several prominent private equity advisers, most notably Blackstone Group and Kohlberg Kravis Roberts, have either sold subscriptions to the general public or announced that they will soon do so. \(^{536}\) This will enable such funds to partially tap the retail dollars

---


533. Three very worthwhile exceptions to this are Bratton, *supra* note 10, at 1375 (analyzing the results of hedge fund activism on the governance of 130 domestic firms); Brav, Jiang, Partnoy & Thomas, *supra* note 7, at 2 (measuring the value of hedge funds as corporate monitors by examining a sample of 888 events launched by 131 funds during the period 2001 through 2005); and Kahan & Rock, *supra* note 7, at 1022 (examining the nature of hedge fund activism and its role in corporate governance and regulatory reform). See also Hu & Black, *supra* note 10, at 811 (discussing the role of hedge funds in the practice of vote buying).

534. See Steven Kaplan, *Management Buyouts: Evidence on Taxes As a Source of Value*, 3 J. Fin. 611–32 (1989) (analyzing seventy-six management buyouts from publicly held companies from 1980 to 1986 and estimating the resulting tax benefits); Steve Kaplan, *Management Buyouts: Efficiency Gains or Value Transfers* 43–45 (University of Chicago Working Paper No. 244, 1988) (concluding from both pre- and post-buyout information that efficiency gains and taxes are the most important sources of value in management buyouts); see also Bruner, *supra* note 199, at 56 (summarizing the results of several studies that found increased value in leveraged transactions); Black, *Empirical Evidence, supra* note 10, at 924 (noting that existence of “substantial evidence suggesting that LBOs often led to improved corporate performance, at least up through about 1986”).


536. See Jenny Anderson & Michael J. de la Merced, *Kohlberg Kravis Plans to Go Public*, N.Y. Times, July 4, 2007, at C1 (explaining that upcoming tax legislation threatens private equity firms’ profits); Michael J. de la Merced & Andrew Ross
currently available only to public equity funds and to use them as an important additional source for the financing of corporate monitoring. Their aim—like that of the reforms considered in this Article—is convergence: joining retail dollars to the fight for improved corporate discipline.

There can be no guarantee of what would happen if public equity fund compensation were to be deregulated. However, there is reason to believe that the result would be increased corporate oversight by mutual funds and public pension funds. Risk and reward would be left to mediate between themselves, with different funds offering their investors different choices with respect to their preferred level of monitoring. Were that to occur, one might even imagine that some public equity funds might join private equity funds in competition to squeeze agency costs out of inefficient companies. The result would be a deeper and more active market for good corporate governance. Their fees deregulated, public equity funds might yet be capable of fulfilling their promise as the ideal corporate monitor.

Sorkin, Blackstone Rival Plans Own I.P.O., N.Y. TIMES, June 22, 2007, at C1 (reporting rumors that Kohlberg Kravis Roberts is considering a public offering of its own shares); Gregory Zuckerman & Henny Sender, Blackstone’s Green Day, WALL ST. J., June 22, 2007, at C1 (reporting on the first day of trading of the newly public company); see also Michael J. de la Merced & Jenny Anderson, Hedge Funds Continue Public Path, N.Y. TIMES, July 3, 2007, at C1 (reporting on the recent IPO of Och-Ziff Capital Management, a $26.8 billion hedge fund); Peter A. McKay & Joanna Slater, Blackstone IPO Rallies 13% On a Down Day, WALL ST. J., June 23–24, 2007, at B1 (noting the apparent initial success of the private equity adviser’s IPO).