# The Myth of the Ideal Investor

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## ABSTRACT

Critiques of specific investor behavior often assume an ideal investor against which all others should be compared. This ideal investor figures prominently in the heated debates over the impact of investor time horizons on firm value. In much of the commentary, the ideal is a long-term investor that actively monitors management, but the specifics are typically left vague. That is no coincidence. The various characteristics that we might wish for in such an investor cannot peacefully coexist in practice.

If the ideal investor remains illusory, which of the real-world investor types should we champion instead? The answer, I argue, is none. The corporate finance ecosystem evolves at such a rapid pace that interventions specifically designed to encourage particular types of investors are increasingly likely to be ineffective or even counterproductive: we are destined to place our bets on the wrong horse, time and again.

To illustrate the difficulty, this Article briefly sketches the evolution of three types of shareholders frequently advanced as exemplars based on their time horizons: major mutual fund groups, activist hedge funds, and private equity funds. Based on their behavior to date, there is little support for policies aimed either at favoring or penalizing such investors' participation in the capital markets generally, and corporate governance specifically.

## INTRODUCTION

The corporate governance literature remains deeply divided over the impact of investor time horizons on management agency costs and firm

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value. Long-term shareholders are often praised for their incentives to increase corporate value over the long term;[1] their willingness to take into account the interests of non-shareholder corporate stakeholders (such as creditors and employees) who may be instrumental to firms' long-term growth;[2] and their patience—the ability not to be distracted by a firm's short-term results, which may be due to chance rather than managerial performance.[3]

By contrast, proponents of short-term investing argue that long-term investors do a comparatively poor job of maximizing firm value.[4] Because long-term investors today are generally institutional, they may suffer from incentive problems that render them excessively passive vis-à-vis management.[5] Alternatively, they may aggressively advance particular agendas that are inconsistent with investor wealth maximization.[6] For such critics, the workhorses of the corporate governance world are activist hedge funds, which relentlessly pursue relatively short-term increases in firms' stock prices by appealing directly to management to make changes.

Not surprisingly, then, proposals abound for both regulatory and private-ordering fixes designed to favor or discourage investors with particular time horizons. From the long-termist camp, there are proposals to give long-term shareholders greater weight in voting[7] or to allow long-term shareholders privileged rights to make shareholder proposals or nominate directors.[8] Meanwhile, the short-termist camp would limit firms' ability to defend against activist hedge funds[9] and would prohibit dual-

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1. *See* Lynne L. Dallas & Jordan M. Barry, *Long-Term Shareholders and Time-Phased Voting*, 40 DEL. J. CORP. L. 541, 570–71 (2016) (summarizing the various arguments in favor of long-tenured shareholders).

2. *See generally* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (arguing that shareholders should not be given sole control of the corporation because non-shareholder stakeholders are also essential to firm value).

3. *See* Sunil Wahal & John J. McConnell, *Do Institutional Investors Exacerbate Managerial Myopia?*, 6 J. CORP. FIN. 307, 308–09 (1990) (defining investor impatience as pressuring management to underinvest in projects with long-term payoffs).

4. *See generally* Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015) (finding activist interventions tend to increase firm value overall).

5. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 889 (2013).

6. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796–97 (1993).

7. *See, e.g.*, David J. Berger, Steven Davidoff Solomon & Aaron J. Benjamin, *Tenure Voting and the U.S. Public Company*, 72 BUS. LAW. 295 (2017); Dallas & Barry, *supra* note 1, at 570.

8. *See, e.g.*, DEL. CODE ANN. tit. 8, § 112(1) (2017) (permitting Delaware corporations to condition a shareholder's right to include its board nominee(s) in the corporation's own proxy on a certain minimum duration of share ownership).

9. For example, one could prohibit the use of poison pills to penalize the acquisition of large share blocks even without the intent to acquire control.

class and other voting structures that can concentrate voting power in management.[10] Adding fuel to the fire, the debate over investor time horizons is often merely a cover for the perennial debate over whether shareholders or managers should have more control over the corporation: generally speaking, the short-termist camp maps nicely onto the set of shareholder-rights advocates, while the long-termist camp draws heavily from corporate managers, their advisors, and scholars in the managerialist camp.

Yet there is simply no consensus as to whether we should favor long-term investors over short-term investors, or vice versa.[11] While long-term investors appear to be winning in the court of public opinion,[12] the academic literature is simply divided.[13] This confused state of affairs is owed in part to the surprising difficulty of identifying the precise connection between (1) investors' time horizon, (2) the time horizon of firm projects, and (3) the time horizon over which firm value is maximized. From an efficiency standpoint, most would accept that the goal is to maximize long-term firm value,[14] defined as the discounted sum of all expected future cash flows of the firm. Yet, there is deep disagreement as to what project duration is likely to achieve that result, and what type of investor will most successfully induce management to adopt such projects.[15] Lay discussions frequently conflate the three distinct inquiries. Critiques of the ill-defined "short-termism" of the financial markets, for example, frequently imply without proof that short-term investors prompt firms to favor short-term projects, with the goal of

10. *See* Bebchuk et al., *supra* note 4, 1152–53 (criticizing proposals that diminish voting rights of short-term shareholders and tighten disclosure requirements of acquiring firms).

11. *See, e.g.*, Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1574 (2015). Others have argued that the debate should be reframed as the conflict between current and future investors, rather than between short-term and long-term investors. *See* Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1287 (1991); Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044 (2005).

12. Leaders of some of the largest U.S. investment fund groups have raised alarms over perceived short-termism in the markets. *See, e.g.*, Letter from Larry Fink, Chairman, Blackrock, Inc., to CEOs (Jan. 24, 2017), https://www.blackrock.com/corporate/en-gb/investor-relations/larry-fink-ceo-letter [https://perma.cc/4BUV-9Z9R]; Letter from F. William McNabb, III, Chairman & CEO, Vanguard Grp., to the Independent Leaders of the Boards of Directors of the Vanguard Funds' Largest Portfolio Holdings (Feb. 27, 2015), https://about.vanguard.com/vanguard-proxy-voting/CEO_Letter_03_02_ext.pdf [https://perma.cc/8VZM-6K2P].

13. *See infra* Part I.

14. *See* K.J. Martijn Cremers, Saura Masconale & Simone M. Sepe, *Commitment and Entrenchment in Corporate Governance*, 110 NW. U. L. REV. 727, 754–55 n.139 (2016).

15. *See infra* Part I.

maximizing firm value only over the short-term.[16] In fact, however, the connection between these three measures remains largely unresolved, both theoretically and empirically.

In light of this uncertainty, we lack a solid basis for the various policy proposals targeting investors with particular time horizons—notwithstanding the confidence and urgency with which they are typically advocated. Perhaps firms do best precisely when their investors display a wide range of time horizons. Because there is no ideal investor, the push-and-pull of investors with competing interests could plausibly produce the best outcomes, pitting the patience of long-term investors against the urgency of short-term investors.[17] Policies tied to specific investor time horizons pose a further problem, which is that they are necessarily bets on the actions of the real-world investors that tend to adopt that horizon. Privileging or penalizing specific investor time horizons necessarily means privileging or penalizing specific types of investors. Favoring long-term shareholders over short-term shareholders, for example, would amount to favoring mutual funds and pension funds over hedge funds.

This game is a risky one to play, given the speed with which the capital markets and capital-market participants now evolve. The current debate pays insufficient heed to the fact that the characteristics of any real-world investor type change over time and, arguably, at an accelerating rate.[18] This rapid change significantly lessens our ability to predict the social-welfare impact of encouraging or discouraging such investors. As a result, any corporate governance intervention—whether imposed by law or adopted through private ordering—that is designed to favor one type of investor over another is problematic and can in fact prove counterproductive.

This Article proceeds as follows: Part I briefly sets the scene for the investor time-horizon debate, offering a simple framework for situating

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16. *See* THE ASPEN INSTITUTE BUSINESS AND SOCIETY PROGRAM, OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (Sept. 9, 2009), https://assets.aspeninstitute.org/content/uploads/files/content/docs/pubs/overcome_short_state0909_0.pdf [https://perma.cc/5X5P-U5RE] (describing various harms associated with investor short-termism).

17. Relatedly, Michal Barzuza and Eric Talley posit a helpful symbiosis between the long-term bias of management and the short-term bias of some investors. *See* Michal Barzuza & Eric L. Talley, *Short-Termism and Long-Termism* (Va. Law and Econ., Research Paper No. 2, 2016; Univ. of Cal. Berkeley Pub. Law, Research Paper No. 2731814, 2016; Columbia Pub. Law, Research Paper No. 14-503, 2016; Colum. Law and Econ., Working Paper No. 526, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2731814.

18. *See* Jennifer G. Hill, *Images of the Shareholder—Shareholder Power and Shareholder Powerlessness*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 53 (Jennifer G. Hill & Randall S. Thomas eds., 2015) (arguing that legal doctrine and regulation lag behind the changing profile of shareholders over time due to the mobility of capital and innovation and globalization in the capital markets).

the most common claims and critiquing conventional accounts. Parts II through IV illustrate the difficulty of betting on investor time horizons by describing the evolution of three types of investors that have been variously championed (or reviled) based on their time horizons: mutual funds, activist hedge funds, and private equity funds. In each case, their investment practices and impact on firms and governance have changed repeatedly, often in unexpected ways, and popular and academic enthusiasm have waxed and waned accordingly. Part V concludes by highlighting the ironic role that each of these three investors has played in the ongoing decline in U.S. public companies. Because this decline is not only unintentional but ultimately harmful to their respective interests, we might well wonder at the wisdom of relying on any one of them to solve all of our corporate governance ills.

## I. The Short-Term versus Long-Term Debate

To make headway in the debates over "short-termism" and related policy proposals, one must first disentangle three inquiries that are frequently conflated: (1) firm value time horizons; (2) firm project time horizons; and (3) investor time horizons. These are addressed in turn.

### *A. Firm Value*

From the sole perspective of economic efficiency, there is broad (though certainly not unanimous) agreement that a firm's management should seek to maximize what we might refer to as *long-term firm value*.[19] A firm's long-term value is typically defined as the (discounted) sum of all cash flows expected to be generated by the firm for the benefit of investors over all future periods.[20] While the formula for calculating long-term firm value is simple, estimating it at any point in time is far less so, requiring difficult predictions as to both firm-specific and market-wide measures. Conveniently, however, if the capital markets are informationally efficient—by which we mean that securities prices immediately and perfectly reflect all available information—then a firm's

19. Cremers, Masconale & Sepe, *supra* note 14, at 754–55 n.139. While there is disagreement over whether the goal of maximizing long-term value should be incorporated into law or remain a norm, Delaware court opinions occasionally make explicit reference to it when discussing director fiduciary duties. *See, e.g.*, Virtus Cap. L.P. v. Eastman Chem. Co., C.A. No. 9808-VCL, 2015 WL 580553, at *16 n.5 (Del. Ch. Feb. 11, 2015). However, J.B. Heaton argues that Delaware law pays lip service to the maximization of long-term firm value, when in practice is calls for the maximization of firm longevity, which may well be in conflict. *See* J.B. Heaton, *The "Long-Term" in Corporate Law*, 72 BUS. LAW. 353 (2017).

20. *See* RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 82, 94 (11th ed. 2013).

current *market value* (which we may refer to as *short-term firm value*) should be precisely equal to its expected long-term value.[21] Indeed, the current price of a firm's shares should be no more and no less than the market's estimate of all future cash flows of the firm that will be available to be paid to shareholders—and likewise with the current price of the firm's debt obligations, if any. Management need only look to the aggregate market value of the firm's various outstanding securities to obtain the market's collective estimate of the firm's value.

Already we may precisely situate and critique the two competing views in this debate. First, as we have seen, it is theoretically possible that long-term and short-term firm value are but one and the same.[22] It is not only possible but also plausible in markets like those for U.S. large-cap stocks, which are highly competitive and information-rich and thus, more likely to be efficient. If that is the case, however, then concerns over investor "short-termism" are entirely misplaced: rather than decry management's and investors' focus on short-term value, we should *encourage* it because short-term value is the best estimate of long-term firm value. Stated differently, in an efficient market, anything that increases short-term value increases long-term value and vice versa; there is, therefore, no point in paying heed to anything other than the firm's current securities prices.

On the other hand, it is also plausible that short-term and long-term value *do not* perfectly overlap, but the case must be made in a precise way. In order to claim that the focus on short-term value is somehow problematic, one must necessarily identify one or more informational inefficiencies in the relevant financial market. The literature to date offers many potential candidates, including (1) investor cognitive biases;[23] (2) investor liquidity constraints;[24] (3) limits to arbitrage;[25] (4) agency costs

21. *See id.* at 328 (noting that in an efficient market, "every security trades at its fundamental value"). A more precise definition of market efficiency requires only that securities prices offer *unbiased* estimates of fundamental value. In other words, securities prices may deviate from fundamental value in an efficient market, but any such deviations will be randomly distributed.

22. *See, e.g.*, George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 122–28 (2010); Jonathan R. Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467, 481 (1988) (highlighting the "wholly false" distinction between present and future firm value).

23. *See, e.g.*, David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q. J. ECON. 443 (1997).

24. *See, e.g.*, Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 619 (2006).

25. *See, e.g.*, Andrei Shleifer & Robert W. Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35 (1997).

and cognitive biases in corporate management;[26] and (5) agency costs in investment managers.[27] This literature is too lengthy to survey here.[28] Suffice it to say that while certain inefficiencies in the capital markets have been well documented, the extent (if any) to which they create a material and exploitable wedge between short-term and long-term value remains largely unknown.

### *B. Firm Projects*

Discussions of investor time horizons are often paired with claims about the time horizon of firm projects. A common worry, for example, is that the "short-termism" of the capital markets results in firms shifting away from long-term projects and investments toward shorter-term projects. Under pressure from activists, for example, a firm might choose to jettison its research and development and use the savings to increase shareholder payout. Even assuming that U.S. firms are shifting toward shorter-term projects, however, we would need to know more before concluding that this shift is problematic. Recall that the ultimate goal is the maximization of firm *value* over the long term, not the length of firm projects or the life span of the firm itself. A long-term project is not preferable to a short-term project (or vice versa) in the abstract; what matters is how each is expected to contribute to firm value.[29]

The relevant inquiry is as follows. We can safely assume that for every firm, there is some mix of feasible projects that would maximize its expected long-term value, and that this mix may involve projects of varying time horizons. The relevant questions, then, include (1) what the value-maximizing (or "efficient") mix of short-term and long-term projects is for any firm; (2) whether firms tend to depart from this efficient mix; and (3) if so, why. Because the first and second questions are so difficult to answer directly, they are often approached indirectly, for example, by observing whether firms' investment mix changes over time or in response to particular shocks.[30]

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26. *See, e.g.*, Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q. J. ECON. 655 (1989) (providing a model in which management engages in value-decreasing behavior).

27. *See, e.g.*, Gilson & Gordon, *supra* note 5.

28. For an overview of the various explanations for why short-term and long-term value may diverge, see William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, U. PENN. L. REV. 653, 691–708 (2010).

29. As stated, this principle is correct from the perspective of the firm itself. From a social-welfare standpoint, however, it is likely that certain long-term projects, such as research in basic science, yield larger positive externalities for society than do short-term projects.

30. *See, e.g.*, Wahal & McConnell, *supra* note 3, at 320–23 (studying the effects of changes in institutional ownership on firm R&D expenditures).

Once again, available studies yield mixed results. The seemingly tautological question of whether short-term investors cause firms to switch to short-term projects is unresolved.[31] Yet even if short-term investors do so, is that necessarily harmful to long-term value? The answer is far from clear. Perhaps in an ideal world, long-term projects tend to contribute more to firm value than short-term projects, all else being equal. Yet in the real world of management agency costs, it may be that short-term projects generate more firm value because they enable investors to better monitor managers and measure their performance.[32] If that is the case, then *both* short-term and long-term investors should prefer short-term projects.[33] The puzzle remains.

### *C. Investor Time Horizons*

We now return to the inquiry with which we began, namely whether there is an optimal investor time horizon, and if so, whether we should adopt policies to promote it. The first point to be made is that the focus should be on the time horizon of *institutional* investors, rather than retail investors.[34] The last half-century has seen a seismic shift in investment channels, with the bulk of retail investors investing through financial institutions or investment funds.[35] As a result, investor holdings have not only become increasingly institutionalized but also increasingly concentrated.[36] We may therefore assume that institutional investors primarily determine both securities prices and governance outcomes in corporate America.

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31. For evidence that activist hedge funds (which are considered short-term investors) cause firms to adopt shorter-term projects, see, e.g., John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016); YVON ALLAIRE & FRANCOIS DAUPHIN, INST. FOR GOVERNANCE OF PUBLIC AND PRIVATE ORGS., HEDGE FUND ACTIVISM: PRELIMINARY RESULTS AND SOME NEW EMPIRICAL EVIDENCE (Apr. 1, 2015), http://www.shareholderforum.com/access/Library/20150401_Allaire.pdf [https://perma.cc/7B8M-3B6X]. For the contrary view, see Bebchuk et al., *supra* note 4.

32. *See* Richard T. Thakor, A Theory of Efficient Short-Termism 2–4 (Aug. 12, 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2821162.

33. *See* Barzuza & Talley, *supra* note 17, at 9 (modeling securities markets where (1) managers are overconfident, leading them to inefficiently favor long-term projects, and (2) investors are present-biased, leading them to inefficiently favor short-term projects).

34. "Retail investors" are comprised of individuals and households, whereas "institutional investors" include organizations like banks, insurance companies, pension funds, mutual funds, and other investment funds that tend to make large investments. *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1025–26 (2009).

35. *See generally* ROBERT C. CLARK, CORPORATE LAW (2d ed. 1986).

36. *See* Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. (forthcoming 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2872754.

What, then, do we know about institutional investors' time horizons and their effects on long-term firm value? First, the received wisdom about institutional investor time horizons is often inaccurate. Paradigmatic "short-term" investors, such as activist hedge funds, are not all that short-term.[37] By contrast, "long-term" investors, such as mutual funds, have mixed horizons, and by some measures they should be considered relatively short-term.[38] As for how such investors' time horizons affect firm value, here again, the easy answer is not necessarily the correct one. We are often told that short-term investors engage in tactics that boost short-term value at the expense of long-term value.[39] Yet we lack evidence that this is indeed the case.[40] In fact, it can be shown that both short-term and long-term investors have incentives to occasionally push firms to engage in value-decreasing behavior.[41] Without more convincing evidence, there is no a priori reason to favor one investor over the other.

To conclude this Part, the theoretical and empirical literatures are largely unresolved as to whether short-term or long-term investors are better for firm value. The remaining Parts argue that even if the evidence favored one time horizon or the other today, it would not follow that we should adopt policies promoting investors with that time horizon. There are no ideal investors, only real-world ones. Parts II through IV offer brief thoughts on three such real-world investor types that are closely associated with a particular time horizon: mutual funds (which are associated with long-term investment), activist hedge funds (short-term), and private equity funds (medium-term). In each case, we find that their behavior and their impact on firm value and governance have changed remarkably, even over short periods, making it risky to bet on any particular investor type

37. *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1731–32 (2008) (finding that the median holding period for activist hedge funds between 2001 and 2006 was approximately twenty months).

38. *See* Anne M. Tucker, *The Long & The Short: Portfolio Turnover Ratios & Mutual Fund Investment Time Horizons*, J. CORP. L. (forthcoming) (on file with author).

39. *See* Martin Lipton et al., *Taking Short-Termism Seriously: A Response to Charles Nathan*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Sept. 13, 2016), https://corpgov.law.harvard.edu/2016/09/13/taking-short-termism-seriously-a-response-to-charles-nathan/ [https://perma.cc/D3HS-G72R] (claiming that "short-termism and activism are significant contributors to diminished GDP and to economic decline").

40. *See* Mark J. Roe, *Corporate Short-Termism--In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 1005–06 (2013) (noting the dearth of evidence of short-termism in the financial markets). Furthermore, theoretical models in which short-term investors affect the behavior of managers do not necessarily imply discrepancies between short-term value and long-term value. *See, e.g.*, Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481 (2009) (claiming that short-term "transient" investing by institutional blockholders can increase firm value); Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148 (1990).

41. *See* Fried, *supra* note 11.

by altering the rules of corporate governance. The dynamics of the capital markets are such that we do not know (even in the relatively short-term) what the outcome would be.[42]

## II. LONG-TERM INVESTMENT: MUTUAL FUNDS

Direct retail investors, due to their short-term liquidity needs, their lack of sophistication, and their small, dispersed holdings, have long shouldered the blame for two evils in the capital markets: inefficient asset pricing and poor corporate governance. But direct retail investors are dwindling: institutional investors currently own close to 70% of the U.S. stock market,[43] up from a mere 6.1% in 1950.[44] Thus, the rise of institutional ownership—particularly by mutual funds—was welcomed in the early 1990s as a promising solution to the agency costs of corporate management,[45] especially after draconian regulatory barriers to shareholder communications were removed from the federal securities laws in 1992.[46] With retail investors pooling together into funds, corporate governance would be left in the hands of a much smaller number of fund managers, who would presumably have greater incentives and ability to be more active monitors and to maximize long-term firm value. This would be so even where individual retail investors entered and exited a fund in the very short term because the fund itself would maintain the vast majority of its assets invested in a broad array of firms and would do so for the foreseeable future. Combining relative sophistication and a long-term investment horizon, mutual fund managers ought to have been the counterweight to corporate management that shareholders needed.

Indeed, mutual fund complexes are often not only the longest tenured but also the *largest* shareholders of U.S. public companies.[47] With such

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42. *Cf.* Jennifer G. Hill, *Visions and Revisions of the Shareholder*, 48 AM. J. COMP. L. (2000) (tracing the many visions of the shareholder, which owe in part to changes in shareholder behavior over time).

43. Marshall E. Blume & Donald B. Keim, *Institutional Investors and Stock Market Liquidity: Trends and Relationships* (Wharton Sch. U. Pa., Working Paper, Aug. 21, 2012), http://finance.wharton.upenn.edu/~keim/research/ChangingInstitutionPreferences_21Aug2012.pdf [https://perma.cc/U4YG-6QZ6].

44. Gilson & Gordon, *supra* note 5, at 874.

45. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

46. *See* Mark Roe, *Free Speech for Shareholders?*, WALL ST. J., Dec. 18, 1991 (critiquing the pre-1992 regime under which communications among shareholders were severely restricted).

47. *See* Posner et al., *supra* note 36, at 5–6.

significant holdings, mutual fund complexes have the capacity to exercise immediate and dramatic interventions in the corporate governance of firms in their portfolios, such as by (1) removing directors, (2) vetoing mergers and other management proposals, (3) initiating their own shareholder proposals, (4) meeting with management, or (5) waging public relations campaigns.[48] Mutual funds' massive ownership stakes would thus seem to solve the problem of rational shareholder apathy first identified by Berle and Means and avoid shareholder collective action problems to boot.[49]

Yet the 1990s' burst of optimism surrounding mutual fund participation in corporate governance proved short-lived. The anticipated revolution in corporate governance led by mutual funds never fully materialized. Instead, mutual fund managers quickly came to be viewed as excessively passive, continually rubber-stamping corporate management and reluctant to advocate for major change.[50] Investment managers have incentives of their own, after all, and moving from direct shareholdings by retail investors to indirect holdings through investment funds added new and different agency costs to the corporate governance calculus.[51] Indeed, the new received wisdom became that mutual funds would rationally invest little time and expense into monitoring firms for at least three reasons.

First, mutual fund managers are compensated based on a fixed percentage of the assets in their funds, rather than on a share of profits, which substantially dampens their incentives to pursue value-increasing, but costly, interventions in governance.[52] Managers of index funds, whose inflows have begun vastly outpacing actively managed funds in recent years,[53] have even fewer incentives to intervene because they are judged solely on their ability to track the relevant market index. Seeking to "move" the index by expending costly resources on governance (which are borne solely by the managers and may not be passed on to the funds)

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48. But see *infra* note 56 for restrictions on mutual funds' active involvement in management.

49. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 71–82, 129–31 (rev. ed. 1967).

50. Gilson & Gordon, *supra* note 5, at 887 (finding that only 4.5% of all shareholder proposals between 2007 and 2009 were proposed by mutual funds).

51. *Id.* at 865.

52. *See, e.g.*, Rock, *supra* note 45, at 473–77.

53. *See, e.g.*, Michael C. Macchiarola & Daniel Prezioso, *Expanding Alternatives: From Structured Notes to Structured Funds*, 19 U. PA. J. BUS. L. 405, 444 (2017) ("[I]n calendar year 2015 alone, passive index mutual funds and ETFs brought in $365 billion of new money while actively managed funds suffered net outflows."); Patrick Keon, *Vanguard Group's Passively Managed Mutual Funds Dominate Net Inflows for 2016*, THOMSON REUTERS (Jan. 20, 2017), http://lipperalpha.financial.thomsonreuters.com/2017/01/vanguard-groups-passively-managed-mutual-funds-dominate-net-inflows-for-2016/ [https://perma.cc/DB78-JN5W].

is thus unlikely to be an optimal strategy for them.[54] Where index funds are concerned, moreover, the threat of exit is obviously not credible when negotiating with corporate management. Second, mutual fund managers are commonly affiliated with financial institutions that cater to large corporate clients, or seek to attract their retirement funds, presenting a conflict of interest with regard to their willingness to critique firm management.[55] Finally, large mutual fund managers that "seek to influence" management are subject to very heavy disclosure burdens, which places an upper bound on their involvement.[56]

Just as shareholder advocates had begun to give up on mutual funds, however, the landscape shifted yet again. Since 2004, mutual fund managers have been required to disclose how they vote their shares in publicly traded corporations.[57] Under public pressure to do so, mutual fund groups have, by two measures, significantly increased their involvement in corporate governance.[58] First, they have ceased voting consistently in line with corporate management, instead often following the recommendations of proxy advisory firms hired specifically for this purpose.[59] Second, they have occasionally supported campaigns by hedge fund activists.[60] Given the major mutual fund groups' shareholdings, an activist campaign's success is all but assured once it attracts the mutual fund groups' votes.[61] This, in turn, dramatically increases the incentives

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54. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1050–51 (2007).

55. *See id.* at 1054–56; Jennifer Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 101 (2009); *see also* James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 908 (2005) (noting that fund managers are often faced with conflicts regarding "gaining admission as one of the acceptable vendors of 401K plans for a portfolio company's employees and confronting a shareholder-friendly proposal (e.g., separating the position of CEO and board chair) that is opposed by that portfolio company's management").

56. Investment advisers that own or control 10% or more of a firm's shares and that seek to influence the control of the corporation are required to file Schedule 13D with the SEC, which calls for extensive disclosure. *See* 15 U.S.C. § 78p (2012).

57. 17 C.F.R. § 270.30b1-4 (2017).

58. Gilson & Gordon, *supra* note 5, at 887.

59. For detailed reviews of the relationship between mutual funds and proxy advisory firms, see Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869 (2010); James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1 (2010); Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359 (2014).

60. *See* Gilson & Gordon, *supra* note 5, at 887–88 (explaining that mutual funds tend to support activist campaigns that oppose management on anti-takeover measures like declassified boards and poison pills).

61. *Id.* at 886, 896.

for activists to wage campaigns in the first place and to spend more resources on them.[62]

Given their vast ownership stakes and their privileged position as long-term shareholders, should we seek to increase mutual funds' influence in corporate governance, whether through regulation or private ordering? Should long-term shareholders be given additional weight in shareholder voting, for example? Should we ease the remaining regulatory impediments to mutual funds' active involvement in governance? What we know of mutual funds today does not provide a sound basis for such policies.

First, despite the renewed vigor of mutual funds' interventions in governance, for the time being, their involvement remains muted and idiosyncratic, and their record in governance is mixed.[63] As discussed, their occasional interventions in governance often depend on the prior efforts of shareholder activists. Yet any policy that favors long-term investors over short-term investors will reduce the latter's ability to wage activist campaigns in the first place, thus potentially (and ironically) leading to *less* intervention by mutual funds.

Further, mutual fund complexes routinely engage proxy advisory firms for recommendations as to how they should vote their shares.[64] The delegation to proxy advisory firms is controversial, however. On the one hand, such firms specialize in governance issues and can devote significant time and resources to them. On the other, given that their clients cover the entire span of public companies, proxy advisory firms generally take a position on a specific governance issue across the board, rather than tailoring their recommendations to individual companies. For those who believe that corporate governance is far from a one-size-fits-all proposition,[65] this approach may be value-decreasing. Increasing the voting power of mutual funds would also worry those convinced by recent studies suggesting that cross-ownership by mutual funds leaves open the possibility for collusion and decreased competition among firms in their portfolios.[66]

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62. *See, e.g.*, Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 610 (2013) (finding that proxy fights by activist hedge funds cost approximately $10 million on average).

63. *See, e.g.*, K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67 (2016).

64. *See* James D. Cox et al., *Quieting the Shareholders' Voice: Empirical Evidence of Pervasive Bundling in Proxy Solicitations*, 89 S. CAL. L. REV. 1175, 1201 (2016) (noting the influence of proxy advisory firms in the shareholder voting process).

65. Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1818 (2008).

66. *See* Posner et al., *supra* note 36.

Finally, although mutual funds have a long history in the United States, they continue to evolve in ways that do not make for easy predictions with respect to corporate governance. In just the last two decades, mutual funds have experienced major shifts, such as the surge in indexing (at the expense of active investing);[67] the rise of alternative mutual funds (which make heavy use of derivative instruments and can even be short-biased);[68] and the increase in investments in large *private* companies, such as Uber.[69] Each of these developments potentially upends our understanding of mutual fund strategies and incentives.

More broadly, we do not truly know whether investors today are intervening too much or too little in governance.[70] Even if the answer were "too little," would greater involvement by mutual funds, in particular, be value-increasing?

## III. SHORT-TERM INVESTMENT: ACTIVIST HEDGE FUNDS

Complaints about "short-termism" in the financial markets are often directed at activist hedge funds, the proverbial thorn in corporate management's side. While activist shareholders have always existed in a loose sense, private investment funds specifically organized to affect decisions in public companies are a new phenomenon—little more than two decades old. Activist hedge funds acquire non-controlling stakes in firms' stock, and then seek to drive up the stock price by advocating for major changes in corporate operations (e.g., layoffs), strategy (e.g., acquisitions or spin-offs), capital structure (e.g., issuing more debt in order to buy back stock), and corporate governance (e.g., replacing board members or executives). The critique, at base, is that by increasing short-term value, the very actions that generate high returns for hedge funds have negative consequences for long-term value.[71] In other words, hedge funds

67. *See* Robin Wigglesworth, *ETFs Are Eating the US Stock Market*, FIN. TIMES (Jan. 24, 2017), https://www.ft.com/content/6dabad28-e19c-11e6-9645-c9357a75844a.

68. *See* Wulf A. Kaal, *Confluence of Mutual and Private Funds*, *in* ELGAR HANDBOOK ON MUTUAL FUNDS 3 (2016), https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2715083 (describing the rise of alternative mutual funds).

69. *See* Andrew Ross Sorkin, *Main Street Portfolios Are Investing in Unicorns*, N.Y. TIMES (May 11, 2015), http://www.nytimes.com/2015/05/12/business/dealbook/main-street-portfolios-are-investing-in-unicorns.html (describing the recent phenomenon of mutual funds investing in private tech companies).

70. For competing views on whether managers, shareholders, or other corporate stakeholders should control the corporations, see generally STEPHEN BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE (2008); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

71. *See, e.g.*, Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General*

can sometimes fool the market in the short run, but they leave companies with fewer productive assets for the long run.

Yet activist hedge funds have fierce defenders, particularly in the scholarly literature, where they are frequently viewed as the lone bright spot in an otherwise dismal corporate governance landscape for U.S. public companies.[72] Proponents point to large-scale studies finding, on average, positive abnormal returns to shareholders associated with the announcement of an activist campaign,[73] with some evidence of persistence after the campaign has concluded.[74] In other words, other shareholders appear to welcome activist hedge funds' interventions, which in turn suggests that they do yield benefits for shareholders. Should we therefore mold the law or develop private ordering solutions to promote hedge fund activism?

The answer is less than clear. These studies' conclusions are not universally accepted.[75] Separately, studies linking activist campaign announcements to a boost in share price suggest only that *shareholders* gain in expectation from activist campaigns—at least temporarily—but these studies do not speak conclusively to the effect on firm value as a whole. Recall that firm value is the aggregate of future cash flows available to *all* investors—shareholders and creditors alike. Yet the gains to shareholders from activist campaigns may be achieved, at least in part, at the expense of firms' creditors.[76] For example, an activist campaign that causes management to increase payout to shareholders may simultaneously lower the value of the firm's debt securities: with less cash

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*Corporation Law*, 50 WAKE FOREST L. REV. 761, 790–91 (2015) (arguing that "directors are increasingly vulnerable to pressure from activist investors . . . and that this pressure may logically lead to strategies that sacrifice long-term performance for short-term shareholder wealth").

72. *See* Bebchuk et al., *supra* note 4 (providing evidence that successful hedge fund activist campaigns lead to increases in firm value); Alon Brav et al., *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 REV. FIN. STUD. 2723, 2763–64 (2015) (providing evidence that activist hedge funds improve firm productivity).

73. *See* Brav et al., *supra* note 37, at 1730–31; April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 188 (2009).

74. *See* Bebchuk, et al., *supra* note 4.

75. *See, e.g.*, K.J. Martijn Cremers et al., Hedge Fund Activism and Long-Term Firm Value (Dec. 14, 2015) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2693231 (claiming that many of the positive shareholder returns associated with activist campaigns are merely the result of selection bias because activist funds target underperforming companies, and that activist campaigns actually result in lower returns as compared to matched peer companies).

76. *See* April Klein & Emanuel Zur, *The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders*, 24 REV. FIN. STUD. 1735, 1737 (2011) (finding that bondholder returns decline upon the announcement of an activist campaign targeting the firm); Jayanthi Sunder, Shyam V. Sunder & Wan Wongsunwai, *Debtholder Responses to Shareholder Activism: Evidence from Hedge Fund Interventions*, 27 REV. FIN. STUD. 3318, 3320–21 (2014) (finding that several types of activist campaigns result in widening loan spreads for the target firm).

on hand, the firm is more likely to experience financial distress and fail to make its debt payments.[77] This is critical for two reasons.

First, to the extent that activist hedge funds have succeeded thus far in extracting value from creditors, creditors should be expected to push back.[78] Creditors of large corporations today have already responded to the rise of hedge fund activism by adopting provisions, such as dead-hand proxy puts, to penalize firms where activist investors gain board seats over the objection of creditors.[79] While the Delaware courts have proven skeptical of such devices for the time being,[80] both the odds that activist campaigns will succeed and the gains when they do are likely to decline as creditors develop new ways to discourage activism.

Second, if creditors are in fact harmed by activist campaigns, then the proposition that hedge fund activists increase long-term firm value is subject to challenge, even if we accept the evidence that they tend to produce gains for shareholders on average. Once again, a firm's value is the value of the firm's equity *plus* the value of its debt.[81] Actions that increase share value by decreasing debt value therefore have an ambiguous effect on overall firm value. A one-time transfer of value from creditors to shareholders may give a large boost to share price but in turn raise the firm's cost of capital if it makes it much more difficult for the firm to raise debt capital in the future.[82] On the other hand, the most widely cited study, which examines activist campaigns between 2001 and 2006, finds that such campaigns are associated with positive shareholder returns *even in firms with no outstanding debt*,[83] which would in fact suggest that the

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77. *See* Coffee & Palia, *supra* note 31, at 603.

78. The current state of affairs is similar to the first wave of leveraged buyouts by private equity funds, in which shareholders seized considerable value from firms' existing creditors by increasing the firm's credit risk through asset substitution, increased leverage, and increased payout. *See generally* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979). For the seminal case involving the extraction of value from creditors in a leveraged buyout, see Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989), *vacated*, 906 F.2d 884 (2d Cir. 1990). Creditors responded to the widening threat of LBOs in the 1980s by tightening the covenants in their loan agreements and indentures to effectively require that they be paid off (or offered to be paid off) in the event of a leveraged buyout.

79. *See* Sean J. Griffith & Natalia Reisel, *Dead Hand Proxy Puts, Hedge Fund Activism, and the Cost of Capital*, 84 U. CHI. L. REV. 1027, 1030 (2017).

80. *Cf.* San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc., 983 A.2d 304, 307 (Del. Ch. 2009), *aff'd*, 981 A.2d 1173 (Del. 2009).

81. *See supra* notes 20–21 and accompanying text.

82. Of course, the current share price on the market should take into account the firm's expected future cost of capital, but the one-shot, immediate transfer of wealth from current creditors to shareholders may be large enough to offset the longer term negative impact on cost of capital from shareholders' perspective.

83. *See* Brav et al., *supra* note 37, at 1767 (finding increased shareholder returns even for firms with no long-term debt).

benefits of activism do not derive solely from wealth transfers between creditors and shareholders. Yet the answer to this question may well change as shareholders' and creditors' strategic game unfolds.

Finally, deep skeptics of market efficiency are unlikely to be convinced by the positive shareholder returns associated with activist campaigns, likely viewing the study designs as circular. Indeed, it is unsurprising that activist campaigns overall result in stock price increases—they would not wage them otherwise. For market efficiency critics, the real question is whether such short-term stock price increases actually reflect increases in long-term firm value—something that examining short-term stock price movements cannot answer for them.

More generally, there is substantial uncertainty over what returns hedge fund activism will yield in the future and what effect it will have on firm behavior. Even over their short history, activist funds and the markets in which they operate have changed significantly. The low-hanging fruit are gone: companies with obviously underperforming management and ready fixes to operations or strategy have been picked clean in prior waves of activism.[84] Competition among activist funds has already lowered their expected returns, and the pervasive threat of activism has succeeded in changing the behavior of corporate management *ex ante*,[85] even at firms that have not yet been targeted. While potentially a positive result for corporate governance, this preemptive effect reduces the opportunities for activist hedge funds to earn abnormal returns, leaving their future somewhat in doubt. Competition could also lead activist hedge funds to engage in riskier strategies or one-time value extractions from creditors that are far less likely to lead to increases in firm value. Finally, many firms remain immune to activist campaigns, whether because of their size or their ownership structure, placing a cap on activism's impact on governance.[86] For all these reasons, it appears premature to place bets on

84. *See generally* C.N.V. Krishnan et al., *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296 (2016) (noting the more competitive environment for hedge funds, but finding that funds with more established reputations, greater financial clout, and greater expertise continue to perform well).

85. *See* Jesse M. Fried & Charles C.Y. Wang, *Short-Termism and Capital Flows* 1 (Harvard Bus. Sch., Working Paper No. 17-062, 2017), http://www.hbs.edu/faculty/Publication%20Files/17-062_4b0ff13f-2654-475f-bd45-7b1f42bb936a.pdf [https://perma.cc/P4FG-6YPA] (noting that the costs and benefits of activist tactics "impact any firm that *might* be targeted by activist shareholders, not just those that are *actually* targeted").

86. *See generally* Frank Partnoy & Steven Davidoff Solomon, *Frank and Steven's Excellent Corporate-Raiding Adventure*, ATLANTIC (May 2017), https://www.theatlantic.com/magazine/archive/2017/05/frank-and-stevens-excellent-corporate-raiding-adventure/521436/ [https://perma.cc/2ES7-4KPZ] (concluding that smaller public companies are highly unlikely to face an activist campaign).

a class of investor that has been a material presence in the market for no more than two decades.[87]

## IV. MEDIUM-TERM INVESTMENT: PRIVATE EQUITY FUNDS

Ever since Michael Jensen predicted the "eclipse of the public corporation," private equity funds have been hailed by many as the ideal investor to control management agency costs and increase firm value.[88] In contrast to dispersed shareholders of public companies, private equity funds hold *controlling* stakes in mature businesses,[89] giving them clear incentives to exert effort to maximize corporate value.[90] Although private equity funds delegate the day-to-day conduct of corporate business to professional management,[91] just as public-company shareholders do, they engage actively and aggressively in governance. Private equity-owned corporations have smaller boards that meet more frequently than public-company boards;[92] managers viewed as underperforming are quickly replaced; and management is incentivized with the "carrot" of high-powered incentives and the "stick" of a highly-levered capital structure, which forces the firm to operate leanly and focus closely on cash flows.[93]

We may think of private equity funds as medium-term investors. Ironically, private equity funds are both praised and criticized for their time horizon. On the one hand, private equity funds typically have a term of ten years, which is likely to be substantially longer than the holding

87. Frank Partnoy, *U.S. Hedge Fund Activism*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 99 (Jennifer G. Hill & Randall S. Thomas eds., 2015) (noting that hedge fund activism became prominent within the past two decades).

88. Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989, at 61.

89. For purposes of this Article, "private equity funds" refer solely to leveraged-buyout funds, and do not include other related private investment funds, such as venture capital funds.

90. *See* James D. Cox & Randall S. Thomas, *Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation*, 95 N.C. L. REV. 19, 63 (2016) (noting that private equity firms have more incentives to monitor a corporation's risks and are better risk managers than public company boards).

91. *See* Daniel Ames, *The Relation Between Private Ownership of Equity and Executive Compensation*, 13 J. BUS. INQUIRY 81, 84 (2014) (studying a large sample of privately-owned firms with hired management).

92. *See* Francesca Cornelli & Ōguzhan Karakas, *Private Equity and Corporate Governance: Do LBOs Have More Effective Boards?*, *in* GLOBALIZATION OF ALTERNATIVE INVESTMENTS WORKING PAPERS VOLUME 1: THE GLOBAL ECONOMIC IMPACT OF PRIVATE EQUITY REPORT 2008 65, 72 (World Econ. Forum, 2008), https://www.chicagobooth.edu/pdf/WorldEconomicForumGlobalEconomicImpactOfPrivateEquity.pdf [https://perma.cc/HW3Z-B89B].

93. *See generally* Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219 (2009) (discussing how managers of private-equity-owned firms are compensated).

period for investments by hedge funds and most retail investors.[94] Thus, private equity funds have, in theory, both the time and the incentives to make major operational changes in their portfolio companies that increase long-term value. On the other hand, a private equity fund tends to hold portfolio companies for significantly less than the fund's term (5.5 years, on average[95]), because it takes time for the fund to identify and acquire target companies, and then ensure that they are sold well before the end of the fund's term.

More importantly, the manner in which private equity fund managers are compensated creates incentives for them to hold portfolio companies for as short a time as they can achieve an exit at a large gain. In the typical structure, the manager does not receive any share of the profit from fund distributions until the fund has surpassed an 8% "preferred return," which is an internal rate of return (IRR) on the capital invested by the fund's limited partners.[96] All else being equal, the longer that the fund retains investors' capital, the lower the fund's IRR will be, and thus the lower the manager's compensation. IRR figures are also the primary means used to measure and market private equity firms' performance, as advertised in their private placement memoranda. Thus, at least for portfolio companies that will be sold at a large gain, there is a strong incentive for the private equity fund to sell as quickly as possible—the "quick flip" often complained about in the press.

If the timeline is short enough, private equity firms can benefit as much or more from short-term swings in the capital markets (such as an unusually favorable window for IPOs) than from implementing long-term strategic plans. Indeed, evidence suggests that at least some of the returns generated by private equity funds are derived from mere market timing rather than operational or governance changes.[97]

Just how well do private equity funds do at maximizing firm value? By now the answer should come as no surprise: it is largely unclear. There is some evidence that private equity has generated small net gains in employment (albeit at the cost of more layoffs), innovation, and

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94. *See* DEBEVOISE & PLIMPTON LLP, PRIVATE EQUITY FUNDS: KEY BUSINESS, LEGAL AND TAX ISSUES 39 (2015), https://www.debevoise.com/~/media/files/insights/news/2015/pe_fundskey%20business_legal_tax_issues.pdf.

95. *See* Amy Or, *Average Private Equity Hold Times Drop to 5.5 Years*, WALL. ST. J. (June 10, 2015, 4:13 PM), https://blogs.wsj.com/privateequity/2015/06/10/average-private-equity-hold-times-drop-to-5-5-years/.

96. *See id.*

97. Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121, 136 (2009).

productivity, at least over certain periods.[98] While the thrust of the finance literature appears to take a positive view of private equity, there are considerable obstacles to measuring its effect empirically, most notably selection effects (i.e., the fact that private equity firms do not pick their portfolio companies randomly).[99]

Just as we saw with activist hedge funds, however, increasing competition among private equity funds has altered their behavior.[100] Whether rightly or wrongly, fund sponsors have recently been accused of shifting their attention away from the difficult task of increasing firm value toward the much easier approach of extracting value from their own funds and portfolio companies.[101] When given the choice between (1) taking a dividend of its portfolio company's available cash—even at the cost of putting it at high risk of financial distress—and (2) making risky, costly, and difficult operational changes that may not pay off for years, the former may occasionally be irresistibly tempting. This is particularly true given that private equity funds can simply choose to put their portfolio companies to creditors in bankruptcy, although established fund managers' reputational concerns should help constrain such behavior.[102]

Given fund sponsors' considerable financial sophistication and their option-like compensation, it should come as no surprise that their tactics change constantly in the hunt for returns. Recently, private equity funds have begun borrowing to fund the *equity* portion of their portfolio companies' purchase price, making their investment even more akin to an

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98. *See generally* Shai Bernstein et al., *Private Equity and Industry Performance*, 63 MGMT. SCI. 1198 (2017); Steven J. Davis et al., *Private Equity, Jobs, and Productivity*, 104 AM. ECON. REV. 3956 (2014); Josh Lerner, Morten Sorensen & Per Strömberg, *Private Equity and Long-Run Investment: The Case of Innovation*, 66 J. FIN. 445 (2011).

99. While the returns from private equity appear to have been favorable to investors thus far, the reliance on self-reporting and the opacity of fee and return calculations make any conclusions in this regard tentative. Most importantly, we are only interested in the returns to investors that have come from a true increase in portfolio company value rather than, say, market timing or extraction of value from other firm stakeholders.

100. *See* Gillian Tan, *Private Equity Follows the Money*, BLOOMBERG (Aug. 16, 2017), https://www.bloomberg.com/gadfly/articles/2017-08-16/advent-is-latest-private-equity-firm-following-the-money-into-debt (describing the private equity industry's surprising diversification away from the traditional leveraged buyout strategy).

101. In October 2015 and August 2016, the SEC brought actions against two of the largest private equity firms, Blackstone and Apollo, claiming that they charged more in fees from their funds than they were entitled to. Apollo Mgmt. V, L.P., File No. 3-17409 (Aug. 23, 2016), https://www.sec.gov/litigation/admin/2016/ia-4493.pdf [https://perma.cc/W533-YUQD]; Blackstone Mgmt. Partners L.L.C., File No. 3-16877 (Oct. 7, 2015), https://www.sec.gov/litigation/admin/2015/ia-4219.pdf [https://perma.cc/9JF4-S6ZG].

102. *See* Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115 (2014).

option and further altering their incentives.[103] Separately, the largest private equity firms now simultaneously manage funds with radically different investment strategies, in different asset classes, and sometimes with directly conflicting interests.[104] Consider, for example, a sponsor whose equity fund and credit fund are both invested in the same distressed portfolio company. The difficulty of pinning down private equity to a particular time horizon and investment strategy suggests considerable uncertainty for policies designed to subsidize or restrict its activities.

## CONCLUSION

Policy proposals to favor either long-term or short-term investors appear to have outpaced the theoretical and empirical literatures, which remain deeply divided as to which, if any, are more likely to help maximize firm value. Similarly, there is little basis for favoring the major investors that currently embody long-term, short-term, or medium-term investing, such as mutual funds, activist hedge funds, and private equity funds, respectively. Substantial uncertainty persists about the current role of each in corporate governance, and perhaps more importantly, we have every reason to believe that the nature, magnitude, and desirability of their involvement will change significantly over time.

This state of affairs is perhaps best illustrated by pointing out a glaring irony regarding mutual funds, activist hedge funds, and private equity funds: arguably, their greatest impact on corporate governance is not only unintentional but in many respects antithetical to their own business interests. Specifically, each of these three investors has contributed to the ongoing decline in the number of U.S. public companies.[105] While the causes of this decline are numerous and complex, there is reason to believe that each of these fund types shares some of the blame by materially reducing the incentives of U.S. firms to go and remain public.

How so? First, mutual funds have shifted their investments over the last two decades toward the largest public companies due to their increased

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103. *See* David Carey, *Buyout Firms are Magically—and Legally—Pumping Up Returns*, BLOOMBERG (Apr. 13, 2017), https://www.bloomberg.com/news/articles/2017-04-13/buyout-firms-are-magically-and-legally-pumping-up-returns.

104. *See* William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 51–53 (2009).

105. *See* Craig Doidge et al., *The U.S. Listing Gap*, 123 J. FIN. ECON. 464 (2017) (documenting the decline in exchange-listing U.S. firms); Xiaohui Gao et al., *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1663 (2013) (documenting the decline in initial public offerings by U.S. firms).

demand for the most liquid securities.[106] In turn, this shift likely contributed to the demise of the small company IPO.[107] With smaller firms increasingly shunning the public markets, the set of U.S. public companies is simply shrinking.

Second, certain firms may be avoiding the public markets in part to avoid hedge fund activists.[108] While activists' impact on firm value is subject to debate, founders and managers' distaste for activists is not. While some firms go public today with dual-class voting structures that help shield them from activists,[109] others are simply choosing to go or remain private, foregoing entirely the benefits of public company status, such as liquidity.

Finally, private equity funds also contribute to the decline in public companies. One explanation for this decline is simply that it has become so much easier for firms to remain private in recent decades.[110] This is partly due to the explosion of capital now available to private firms.[111] Private equity funds, among others, figure prominently in this story. They have been so successful at raising funds that they have helped lower the cost of equity capital dramatically for private firms, thereby inducing even some very large firms to remain private.

The painful irony for these three investor groups is that the decline in public companies, should it persist, is problematic for each of them. Fewer companies going public eventually means fewer investment opportunities for mutual funds, which are constrained in their ability to invest in private firms due to their statutorily-imposed liquidity requirements. Activist hedge funds currently only target public companies; their returns depend on being able to enter (buy) and exit (sell) a target's stock relatively quickly, a tactic that would not be feasible in illiquid private company stock. Finally, IPOs have historically been

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106. *See* Robert P. Bartlett, III, Paul Rose & Steven Davidoff Solomon, *What Happened in 1998? The Demise of the Small IPO and the Investing Preferences of Mutual Funds* (Ohio St. Pub. Law, Working Paper No. 328, 2017; Univ. of Cal. Berkeley Pub. Law, Research Paper No. 2718862, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2718862.

107. *See id.*

108. *See* Matt Levine, *Uber Is Raising More Money from Rich People*, BLOOMBERG (Jan. 15, 2016), http://www.bloombergview.com/articles/2016-01-15/uber-is-raising-more-money-from-rich-people (noting that private companies today have most of the advantages of public companies, without any of the disadvantages, including hedge fund activists).

109. *See* Kristin Lin, *The Big Number—Share of IPOs This Year with Dual-Class Stock Structures*, WALL ST. J. (Aug. 17, 2015), http://www.wsj.com/articles/the-big-number-1439865699 (reporting that the proportion of IPOs with dual-class structures increased from 1% in 2005 to approximately 14% in 2015).

110. *See* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 448, 466–72 (2017) (tracing the easing of regulatory burdens on the issuance and trading of private securities).

111. *See id.* at 467.

private equity funds' most profitable means of exiting their portfolio-company investments. As IPOs decline, it remains unclear whether private equity funds can make up the returns elsewhere.

It should give us pause that what will perhaps prove to be these three investors' longest lasting and most profound effect on corporate governance has not been the result of their direct interventions, but rather the indirect, unintended consequences of their behavior. Calls to give investors more weight in U.S. corporate governance based on their time horizons should, therefore, be answered with some skepticism. We have little means of predicting how such investors would respond when put in the driver's seat. After all, by contributing to the decline of public companies, mutual funds, activist hedge funds, and private equity funds may be quietly undermining their own business models. Who would have predicted that?