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Institutions and Entrepreneurs in American Corporate Finance

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Proponents of the "political model" of corporate finance claim that large-scale institutional investors could play a key role developing a solution to the "problem" of the "separation of ownership and control" in American corporate practice. As financial institutions grow larger, political model proponents argue, they could purchase larger stakes in operating companies and thereby acquire more leverage over management affairs. If legal obstacles were removed, institutions could use their special expertise in corporate governance to make management more efficient and accountable. This Article argues that the political model theory is deeply flawed. The primary function of institutional investors, the author contends, is to insulate their customers from risk. The author maintains that institutional investors cannot acquire large shares in fewer companies without significantly compromising diversification and thus increasing the riskiness of their portfolio. The author also observes that management reforms would have to be imposed on a significant number of the firms in an institution's portfolio if these changes were to have any measurable impact on returns. Since there are no sure-fire reforms, this sort of large-scale activism inevitably entails a great deal of risk and puts activist institutions at a decided disadvantage to their more passive competitors. The author considers

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three techniques that might be used to manage risks implicit in institutional activism—portfolio insurance, risk-capital reserves, and government guarantees—and concludes that all three are impractical. The author suggests that entrepreneurial firms may be better suited for an activist role since entrepreneurs, unlike institutional investors, are not in the business of providing financial guarantees to their customers. Rather, entrepreneurs deliberately take on the risk of uncertain ventures in order to achieve high returns.

INTRODUCTION

Institutional investors now own most of the stock issued by American corporations.¹ Adherents of the "political model" of corporate finance argue that these institutions could revolutionize the American system of corporate governance by using their influence as large shareholders.² Institutional investors, however, have traditionally

1. Institutional investors, which include pension funds, bank-managed trusts, mutual funds, insurance companies, and foundation and endowment funds, held over 53% of all publicly traded equity in U.S. companies in 1991. See C. BRANCATO & P. GAUGHAN, INSTITUTIONAL INVESTORS AND CAPITAL MARKETS: 1991 UPDATE, tbl. 10 (Colum. L. Sch. Institutional Investor Project, Sept. 12, 1991), cited in Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 827 n.27 (1992) [hereinafter Black, *Agents*]. It is likely that their share will continue to grow. Institutional investors owned over 60% of outstanding stock in more than one-third of the 1000 largest U.S. companies in 1991. See *id.* at 827 (citing BRANCATO & GAUGHAN, *supra*, tbl. 20). In Great Britain, institutions own an even greater share of the country's enterprises; the United States may follow this trend in the near future. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2007-17 (1994).

2. See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) [hereinafter Black, *Shareholder Passivity*]; Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991). Both of these articles begin with fairly ringing proclamations of a new way of looking at the ownership/control issue in corporate finance. The article perhaps most responsible for founding the political model is Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988); see also Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89 (1990); Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987); John Pound, *Proxy Voting and the SEC: Investor Protection Versus Market Efficiency*, 29 J. FIN. ECON. 241 (1991); Mark J. Roe, *The Modern Corporation and Private Pensions*, 41 UCLA L. REV. 75 (1993) [hereinafter Roe, *Private Pensions*]; Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991); Mark J. Roe, *Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry*, 93 COLUM. L. REV. 639 (1993) [hereinafter Roe, *1906 Pacification*]. Roe's analysis is collected and expanded in his book STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994) [hereinafter ROE, STRONG MANAGERS].

I borrow the term "political model" from John Pound. See John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003 (1993). Although I use the term to describe a family of views broader than Pound's, it is fair to label Pound as sympathetic to the arguments favoring institutional activism criticized in this Article. I do not mean to suggest that all the scholars cited above agree on everything, only that their views share family resemblances, that one can subscribe consistently to most of their views, and that most are susceptible to the objections I make in this Article.

been passive shareholders in the United States. Given their impressive size and great potential power, their passivity presents a puzzle. Why have institutions³ failed to exercise their potentially enormous influence?

The political model stresses that institutions labor under many complex restraints, ranging from state corporate and insurance laws to federal bankruptcy, securities, antitrust, and banking regulations.⁴ According to the political model, these laws have historically been the product of politics⁵ and not economic evolution,⁶ and because of these restrictions, the American public corporation has "strong managers and weak owners."⁷ Unlike their counterparts in other countries,⁸ political model scholars stress, American institutions have not been active corporate owners.⁹

Before the political model, scholars usually explained institutional passivity as the product of the high costs of coordinating shareholder action among dispersed investors and the lack of monitoring expertise

3. In this Article, I use "institutions" to mean large financial intermediary institutions such as pension funds, mutual funds, banks, and insurance companies, unless the context indicates otherwise. See *infra* Part II.

4. See, e.g., Black, *Shareholder Passivity*, *supra* note 2, at 530-60 (examining state corporate law, and federal proxy, disclosure, insider trading, controlling person liability and other restrictions on shareholder activism).

5. See ROE, *STRONG MANAGERS*, *supra* note 2, at 51-146 (arguing that history of legal restrictions on banks, insurers, mutual funds, and pension funds inhibits them from institutional activism).

6. See Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996).

7. See ROE, *STRONG MANAGERS*, *supra* note 2, at 21-25.

8. For the role of banks in German corporate finance, see ALFRED D. CHANDLER, JR., *SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM* 415-19 (1990). An excellent historical review is Richard H. Tilly, *Banking Institutions in Historical and Comparative Perspective: Germany, Great Britain and the United States in the Nineteenth and Early Twentieth Century*, 145 J. INSTITUTIONAL & THEORETICAL ECON. 189 (1989). For accounts of Japanese corporate finance, see MICHAEL L. GERLACH, *ALLIANCE CAPITALISM: THE SOCIAL ORGANIZATION OF JAPANESE BUSINESS* (1992); W. CARL KESTER, *JAPANESE TAKEOVERS: THE GLOBAL CONTEST FOR CORPORATE CONTROL* (1991); Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LITERATURE 1 (1990); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993); Takeo Hoshi et al., *The Role of Banks in Reducing the Costs of Financial Distress in Japan*, 27 J. FIN. ECON. 67, 73-74 (1990); Paul Sheard, *Japanese Corporate Finance and Behaviour: Recent Developments and the Impact of Deregulation*, in JAPANESE FINANCIAL MARKETS AND THE ROLE OF THE YEN 55 (Colin McKenzie & Michael Stutchbury eds., 1992); Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. ECON. BEHAV. & ORGANIZATION 399 (1989).

9. See ROE, *STRONG MANAGERS*, *supra* note 2, at 231-81 (policy recommendations flowing from political model); see also Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 74 (1995) ("Despite some protestations of agnosticism, the [political model] critics' tone makes it clear that they regard the American system of corporate governance as inferior" (footnotes omitted)).

by institutional investors.¹⁰ Political model proponents argue, however, that as financial institutions grow larger, they could purchase larger stakes in the ownership of operating companies, which would make coordination costs more manageable. Institutional investors may lack expertise regarding individual firms, but they have special expertise in corporate governance. If artificial legal and regulatory barriers were removed, the argument runs, institutions could and would own larger, and thus more influential, blocks of companies' shares. This consolidation of ownership would allow institutions to bring their expertise to bear on reforming corporate governance. An institution owning a substantial block of a firm's shares could discipline wayward corporate managers.¹¹

The political model, then, promises a large step towards the unification of ownership and control as the solution of the "master problem"¹² of American corporate law. This claim is obviously significant and initially compelling.¹³ The "problem" of the "separation of ownership and control" has been the primary theme of much corporate law scholarship since the New Deal.¹⁴ More recently, discussion of the economics of agency costs has dominated corporate law and finance scholarship.¹⁵ Reduction of this costly separation by strengthening the role of the corporate "owner" is an attractive prospect.¹⁶ Institutions command

10. See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 407 (1983). For a critical summary of the various explanations of institutional passivity that scholars have offered, see Helen Garten, *Institutional Investors and the New Financial Order*, 44 RUTGERS L. REV. 585, 612-32 (1992).

11. Black collects evidence of "systematic shortfalls in corporate performance" in Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 898-916 (1992).

12. See Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923 (1984). Romano is more a critic than a proponent of the political model. See, e.g., Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021 (1993); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993) [hereinafter Romano, *Pension Fund*]. For a different, forcefully argued view of the "separation" problem, see Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375 (1983). According to Demsetz, "[a] broader perspective on the problem of the optimum ownership structure makes the fears of Berle and Means meaningless." *Id.* at 377. Perhaps most interestingly, Demsetz suggests that profit-based incentives and monitoring are substitutes that should be allocated efficiently. See *id.* at 386; see also *infra* text accompanying notes 185-190.

13. For a favorable review of Professor Roe's recent book, cited in note 2, *supra*, see Gregory A. Mark, *Realms of Choice: Finance Capitalism and Corporate Governance*, 95 COLUM. L. REV. 969 (1995) (book review essay).

14. See, e.g., ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

15. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 9-11, 14-15, 38, 73-76, 113-17, 217-18 (1991).

16. For a comprehensive survey of capital structure theories based on agency costs, asymmetric information, product/input interactions, and corporate control considerations, see Milton Harris & Artur Raviv, *The Theory of Capital Structure*, 46 J. FIN. 297 (1991). For an excellent, non-

vast pools of capital. In the abstract, they seem poised to become strong owners. The work of political model scholars has been one of the most stimulating developments in recent corporate literature because it suggests a solution to the thorniest problem in American corporate law.

Unfortunately, the theory is deeply flawed. Institutions, after all, primarily exist to serve as financial intermediaries—pension funds, insurance companies, and banks.¹⁷ Customers entrust their money to intermediary institutions for specific financial purposes. To serve their customers' needs and to stay in business, intermediary institutions must manage risk efficiently.

Most intermediaries manage risk by maintaining a broadly diversified portfolio, the overall value of which is only minimally affected by changes in the fortunes of individual operating companies. An intermediary that cannot manage risk efficiently is likely to lose its risk-averse customers, and may be driven out of business by rivals that manage risk more efficiently.

The political model, however, requires intermediaries to perform a function—reforming the managements of operating companies—that would undermine their ability to manage risk. In order to obtain the necessary influence to reform a company, an intermediary would have to collect a large amount of that company's stock. But if an intermediary collects a large amount of one company's stock, it will no longer be sufficiently diversified. Unable to manage risk effectively, it will become less attractive to customers seeking to use intermediaries to manage risk in their own lives. Because intermediaries must manage risk efficiently to stay in business, they are unlikely to adopt the strong ownership role envisioned by the political model, whether the law permits it or not. Instead, these institutions should, and probably will, remain largely passive investors.

Corporate law scholars should not view this passivity as a bad thing. It is part and parcel of the fundamental function that financial intermediaries perform in a market economy—the management of risk. In this Article, I explain that institutional passivity is a direct product of the central risk-managing role that financial intermediaries perform. By examining the causal link between risk management and passivity, we can view efforts to reform corporate governance in a more realistic light.

Accounts of institutional passivity among financial intermediaries should begin by analyzing the particular nature of the business of financial intermediation. To be sure, the business is complex and diverse,

technical treatment, see PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 448-537 (1992).

17. See *supra* note 1.

but financial economists have described it in general terms. Financial intermediaries—depository banks, mutual funds, insurance companies, and pension funds—as Robert Merton and Zvi Bodie have explained,¹⁸ provide services to individuals.¹⁹ These individuals are best conceived of not as investors in these institutions, but rather as customers.²⁰ Like investors, these individual customers seek financial payouts in the event of a contingencies. Life insurance, for example, pays a benefit if the insured party dies. Unlike investors, however, customers want these payouts to be guaranteed, or as close to guaranteed as possible. Because these payouts are often contingent on events that might occur far in the future, markets for financial products and services of this sort are highly credit-sensitive. To be competitive, financial intermediaries must be able to assure their customers that their guarantees are sound.

Financial intermediaries provide this assurance to their customers by guaranteeing the contracted-for payouts. They must then take steps to eliminate, as nearly as possible, the risk that they will not have sufficient funds to make the promised payouts if and when they come due.²¹ If a financial institution were to practice the shareholder activism proposed by the political model, however, the costs of providing this assurance to customers would substantially increase. An institution which followed the political model would be at a competitive disadvantage to its more passive rivals. It would be less able to appeal to risk-averse customers and would face elimination from competition. Because of the inevitable problem with risk management, an intermediary would be unlikely to adopt a political model-style role even if it could.

The term “financial intermediary,” of course, covers much ground. Although not all of the business of all financial intermediaries consists of providing guarantees, this guaranteeing function is at the core of the business. Providing guarantees, however, is incompatible

18. See Robert C. Merton & Zvi Bodie, *On the Management of Financial Guarantees*, FIN. MGMT., Winter 1992, at 87, 88-89 [hereinafter Merton & Bodie, *Financial Guarantees*]; see also ROBERT C. MERTON, FINANCIAL INNOVATION AND THE MANAGEMENT AND REGULATION OF FINANCIAL INSTITUTIONS (Harv. Bus. Sch. Working Paper, 1994) [hereinafter MERTON, FINANCIAL INNOVATION]; ROBERT C. MERTON, OPERATION AND REGULATION IN FINANCIAL INTERMEDIATION: A FUNCTIONAL PERSPECTIVE (Harv. Bus. Sch. Working Paper, 1993) [hereinafter MERTON, OPERATION AND REGULATION]; ROBERT C. MERTON & ZVI BODIE, FINANCIAL INFRASTRUCTURE AND PUBLIC POLICY: A FUNCTIONAL PERSPECTIVE (Harv. Bus. Sch. Working Paper, 1995); ROBERT C. MERTON & ZVI BODIE, A CONCEPTUAL FRAMEWORK FOR ANALYZING THE FINANCIAL ENVIRONMENT (Harv. Bus. Sch. Working Paper, 1995); Robert C. Merton & Zvi Bodie, *Deposit Insurance Reform: A Functional Approach*, 38 CARNEGIE-ROCHESTER CONF. SERIES ON PUB. POL’Y 1 (1993) [hereinafter Merton & Bodie, *Deposit Insurance*].

19. By “individuals,” I mean both natural persons and firms.

20. See Merton & Bodie, *Financial Guarantees*, *supra* note 18, at 90.

21. Merton & Bodie identify three basic methods used by financial intermediaries to manage risk. See *id.*

with shareholder activism. This inconsistency warrants skepticism of the political model's assessment of the potential of institutional activism.

Institutions are not well suited to reducing managerial agency costs in firms. This does not mean that these costs should not, or cannot, be minimized.²² This task, however, is best left to entrepreneurial investors, who deliberately bear risks that financial intermediaries must avoid. Understanding the distinction between financial intermediary "institutions" and "entrepreneurs" is crucial to a complete picture of the political economy of corporate governance. "Institutions" typically provide guarantees to customers who need to manage the risk in their own lives. "Entrepreneurs," on the other hand, are persons or firms who deliberately take on risk in exchange for residual profits.

Ironically, the large size of institutions is what inspires political model scholars to see them as potentially strong owners. Institutions are probably only as large as they are, however, because their risk-management capability attracts large numbers of ubiquitous risk-averse customers. Institutions that adopted an entrepreneurial role would tend to lose these risk-averse customers and the size that gives them such promise as activist shareholders in the first place.

Entrepreneurs, as I use the term, can also perform intermediary functions. They may provide individuals seeking risky investments a vehicle for pooling their funds. These entrepreneurs are not primarily in the business of providing financial guarantees to customers. Instead, they are conduits through which investors share the risk of uncertain ventures. Indeed, some activist investment funds already implement, in effect, the political model, soliciting investors with the promise of achieving high returns from stock through increased monitoring of corporate management.²³ Legal reforms of the sort political model scholars suggest might make such funds larger and more numerous. Nevertheless, this is likely to remain a specialized entrepreneurial niche in a much larger market. The larger, customer-serving financial intermediaries are never likely to fulfill this function in a market economy,²⁴ nor should we want them to.²⁵

22. However, I do not mean to take the position that agency costs are currently "too high." See *infra* text accompanying note 125.

23. For example, the Lens Fund. See John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 858 (1994) (citing Susan Pullman, *Calpers Won't Invest in Activist's Fund*, WALL ST. J., June 22, 1993, at C1); *Meaningful Relationships*, ECONOMIST, June 26, 1993, at 82.

24. An account of whether Japan and Germany actually have financial systems organized around relatively activist financial institutions—and if so, how such institutions developed—is beyond the scope of this Article. However, I reject the view that the Japanese and German structures are superior to the more passive American and British institutional shareholders, and that the American form of corporate governance is the result of historical political interventions, rather than economic forces. Cf. ROE, *STRONG MANAGERS*, *supra* note 2, at 169-186, 263 (German and Japanese

Institutions and entrepreneurs have distinct but complementary functions in the political economy of corporate governance. Entrepreneurial reforms and innovations that improve corporate management will likely inspire imitation and propagate to many firms, while unprofitable governance innovations die out. Financial intermediaries, which hold well-diversified portfolios, will be virtually unaffected by unsuccessful innovations, but will benefit from changes that become standard

corporations do not follow the American model; U.S. law should be changed to allow competition among different organizational models). I think the American and British systems are mainly the result of economic evolution, driven by market forces, toward more efficient institutional arrangements. One might say the same of the Japanese and German systems, if one thinks that similarities between American and Japanese and German financial structures are much more significant than their differences. Professor Ramseyer seems to take this view. See J. Mark Ramseyer, *Columbian Cartel Launches Bid for Japanese Firms*, 102 YALE L.J. 2005 (1993). But it might also be the case that political forces prevented the development of passive American-style institutions in Japan and Germany, instead constructing their financial arrangements along more statist and authoritarian lines. If this is true, the increase in global competition might push German and Japanese structures toward more passive American-style behavior. Indeed, this may already be happening. Some commentators think the Japanese main bank system is in the throes of historical changes. See, e.g., Gerard Baker, *Survey of Japanese Industry*, FIN. TIMES, Sept. 25, 1995, at 30; *Decline of Main-Bank System a Watershed: Liberalization Leading to Changes in Ways Companies Raise Funds*, NIKKEI WKLY., April 1, 1996, at 6; *JFTC Finds Decrease in Keiretsu Among Six Largest Business Groups*, INT'L BUS. & FIN. DAILY (BNA), at d8 (Aug. 9, 1994), available in Westlaw, BNA-IBFD database; Kiyoshi Mori, *Industrial Sea Change: How Changes in Keiretsu Are Opening the Japanese Market*, BROOKINGS REV., Sept. 22, 1994, at 20; Jin Nakamura, *Economic Forum: Politician-Bureaucrat-Businessman Alliance Starts Falling Apart*, DAILY YOMIURI, Mar. 6, 1996, at 7; Sandra Sugawara, *Loosening Japan Inc.'s Lock on Loyalty: Strong Yen, Stronger Competition Shake Carmakers' Keiretsu—and Give U.S. Suppliers an 'In'*, WASH. POST, Mar. 10, 1996, at H-1. Professor John Coffee also makes the point that "the multilateral relationships between financial intermediaries and large corporations [like those found in Japan and Germany] appear highly unstable, particularly in a world moving toward international credit markets." John C. Coffee, Jr., *Comparative Corporate Governance*, N.Y.L.J., Mar. 26, 1992, at 5.

25. Macey and Miller have recently published an important criticism of the work of political model scholars. See Macey & Miller, *supra* note 9. Their main point is that commercial banks in Germany and Japan typically make their largest investments in operating firms in the form of fixed claim loans, not equity. Since they are primarily fixed claimants, commercial banks have the incentive to use their managerial power to make their portfolio firms pursue less than optimally risky strategies, since this maximizes the value of their loan portfolio, even as it reduces the value of equity. They suggest that German and Japanese banks have been doing this in collusion with firm managers, who are risk-averse for their own reasons, and who particularly desire protection from hostile takeovers. See *id.* at 77, 83-84, 87-89, 96-100. These criticisms are telling, and for my money are a plausible description of German and Japanese institutions. But even if commercial banks which invest in operating firms primarily in the form of fixed claims do not have the correct incentives to represent the interests of residual shareholder claimants, this argument is not very damaging to all versions of the political model. Roe, Black, and others, see *supra* note 2, have always argued that financial intermediaries generally, not commercial banks in particular, hold the promise to be activist monitors in a new paradigm of American corporate governance. Macey and Miller's criticisms seem not to lay a hand on the argument that pension funds, insurance companies, and other primarily equity investors would take on an activist role if given the chance. Even if Macey and Miller's account of German and Japanese institutions is correct, all political model advocates have to say is that activist equity intermediaries such as large pension funds would incorporate the virtues of the German and Japanese models, without the problems Macey and Miller point out. My criticisms, in contrast, are tied to a more general, if more stylized, model of financial intermediary institutions.

practice. At the same time, the diversified and passive nature of intermediaries allows them to insulate their customers from default risk and promotes efficiency by allowing customers to purchase guaranteed payoffs at lower cost.²⁶

In Part I of this Article, I explain in more detail Merton's distinction between customers and investors in the context of financial intermediaries. In Part II, I introduce the important theme of risk management through diversification, and argue that financial intermediaries, contrary to claims of the political model, are not overdiversified. In Part III, I explain why political model-style activism would increase the riskiness of institutional portfolios. Part IV reviews the three primary techniques available to institutional investors to manage risk: portfolio insurance, risk-capital reserves, and government guarantees. I argue that these techniques would become quite costly, if not impracticable, in the presence of institutional activism. Institutions that must compete with more passive rivals are therefore unlikely to become activist. Part V then makes the case that passive institutions and entrepreneurs nevertheless have a complementary relationship in American corporate finance. Entrepreneurial reforms can benefit institutional investors; when a successful reform is adopted by the broader market, diversified institutions benefit, but without compromising their risk-management needs. In Part VI, I turn briefly to some practical consequences of my arguments and suggest that one can rank the desirability of legal reforms proposed by political model proponents according to whether they would allow entrepreneurs to invest in improving firm managements, or whether they would merely extend opportunities to financial intermediaries that they are unlikely to want or accept. Part VII offers a brief conclusion.

I

THE FUNCTION OF FINANCIAL INTERMEDIARY INSTITUTIONS

Financial intermediaries will not undertake the shareholder activism prescribed by the political model because doing so would put them at a competitive disadvantage to passive institutions in providing services to their customers. Robert C. Merton developed the distinction, which I use in this Article, between "customers" and "investors" in the financial intermediary business.²⁷ Part I.A explains the distinction between

26. See *infra* Part I.A.

27. The exposition of the customer/investor distinction in this Article closely follows that in Merton's writings. See Merton & Bodie, *Financial Guarantees*, *supra* note 18, at 88-89. Merton gives the distinction more elaborate formal development in ROBERT C. MERTON, *CONTINUOUS-TIME FINANCE* 450-51, 463-67 (rev. ed 1992).

customers and investors. Part I.B explores the connection between the needs of customers and the size of financial intermediaries.

*A. Customers and Investors in the Financial
Intermediation Business*

The term "financial intermediary" describes a broad range of institutional investors, from banks and insurance companies to mutual funds. The main function of financial intermediaries, however, can be described in general terms. Robert Merton, probably the leading theorist of financial intermediation and risk management, along with Zvi Bodie and others, has developed a systematic account of the workings of financial intermediation. The distinction between intermediaries' *customers* and their *investors* is central to Merton's account.

This distinction is easy to make in a non-institutional setting, but one can easily lose sight of it in the financial intermediary business.²⁸ The person who buys an automobile from Ford is a customer, while the person who buys stock in the Ford corporation is an investor. Customers of a financial intermediary, as Merton explains, typically purchase promises of future services in return for present payments to the intermediary. For example, a customer pays insurance premiums and expects later payouts if a specific contingency, such as death or disability, occurs. The intermediary's promise to make this future payment usually involves specified amounts of money and is contingent on the occurrence of the relevant events and the passage of time. These promises to make future payments are liabilities of the financial intermediary. But loans to, or stock held by investors in, the intermediary firm are also liabilities; they represent obligations the firm has to its investors. Because both promises to customers and stock held by investors are found on the liability side of the firm's balance sheet, it is easy to mistakenly lump them together. Both customers and investors hold pieces of paper issued to them by the firm—an insurance policy and a stock certificate, for example.

In fact, however, customers and investors have very different relationships to the intermediary.²⁹ The identifying feature of customers, according to Merton, is their strict preference that the payoffs on their contracts be as insensitive as possible to the variable fortunes of the intermediary firm that issued them. A person buys life insurance because she wants her beneficiaries to receive a specified cash benefit upon her death. She will be much less likely to buy insurance from a particular intermediary if she doubts the firm will be solvent at the time of her

28. See Merton & Bodie, *Financial Guarantees*, *supra* note 18, at 89.

29. See *id.*

death.³⁰ Risk-averse customers will prefer a policy that pays for certain to a discounted policy that pays if the intermediary is solvent, even if the price of the latter policy is reduced by an actuarially fair amount.³¹

Investors have a dramatically different relationship with intermediaries. Unlike customers, investors expect the value of the liabilities the intermediary has issued to them, such as stock or subordinated bonds, to vary with the profits and losses of the issuing firm. While the intermediary's customers receive guarantees, the intermediary's investors are at least in part the guarantors. Investors contribute some or all of the risk capital that provides the cushion that assures that customers' liabilities will be honored.

Liabilities issued to financial intermediary customers are often substantial and come due only after many years. Customers of financial intermediaries are therefore much more concerned about the soundness of issuing firms than are customers of other sorts of firms.³² The financial stability of Chrysler corporation might be an issue to a mini-van purchaser; if the firm becomes insolvent, it might be unable to honor its warranty obligations, and repairs might be more difficult. But the creditworthiness of a bank, an insurance company, or a pension fund is the primary issue for its customers.³³ Any increase in the possibility of a future default by the intermediary on its contracts makes those contracts much less able to serve the risk management functions for which customers entered into them in the first place. When default becomes more likely, the intermediary's very purpose—providing guarantees to its customers—is frustrated.³⁴

30. See MERTON, OPERATION AND REGULATION, *supra* note 18, at 43. Merton notes that a formal example of this may be found in an economy with pure Arrow-Debreu securities (securities with specified payoffs for every possible future state of the world). A complete set of such securities that was also contingent on the solvency of their issuers would no longer be efficient. See Robert C. Merton, *On the Application of the Continuous-Time Theory of Finance to Financial Intermediation and Insurance*, 14 GENEVA PAPERS ON RISK & INS. 225, 252-53 (1989). This formal result has strong intuitive appeal.

I believe that many financial institutions and practices can be understood as partial or complete efforts to isolate particular risks so they can be sold or otherwise allocated to the parties who want to (or for other reasons should) bear them. This process can be intimately connected to justice and fairness concerns. See, e.g., Thomas A. Smith, *A Capital Markets Approach to Mass Tort Bankruptcy*, 104 YALE L.J. 367 (1994).

31. See Merton & Bodie, *Financial Guarantees*, *supra* note 18, at 89.

32. See MERTON, OPERATION AND REGULATION, *supra* note 18, at 4-5.

33. See *id.* at 5.

34. The buying and selling of contingent claims—stocks, bonds, insurance contracts, and the other products which intermediaries sell to customers and investors—may be thought of as wagers among persons concerning the future state of the world. For a formal treatment, see KENNETH J. ARROW, *The Role of Securities in the Optimal Allocation of Risk-Bearing*, in *ESSAYS IN THE THEORY OF RISK-BEARING* 121 (1971). For example, in a conventional two-person economy, each of the two risk-averse parties is made better off by such a trade. Robinson Crusoe agrees to give Friday a specified amount of his dry-weather crop if the coming growing season turns out to be sunny, and in exchange Friday agrees to give Crusoe a specified amount of his wet-weather crop if it turns out to

Not all financial intermediaries are principally in the business of servicing financial customers. In the most abstract terms, a "financial intermediary" is just a firm or person that transforms financial assets from one form into another.³⁵ Some financial intermediaries, such as some sorts of investment funds, do not, strictly speaking, have customers at all. Instead, they serve investors who pool their money through the intermediary and entrust intermediary agents to make profitable investments for them. But as Merton stresses,

[t]hat many of the important businesses run by financial intermediaries are considerably more "credit-sensitive" than most of those run by non-financial firms is a critical element that distinguishes the important management issues for an intermediary from those of a typical business firm. Thus, risk management is an activity of first-order importance to the efficient operation of an intermediary, but in general is not so for business firms. Similarly, acquiring or issuing guarantees of financial performance is an operating activity of first importance for intermediaries, but only a specialized transaction for most business firms.³⁶

The business of some financial intermediaries is therefore more credit-sensitive than that of others. Moreover, the distinction between serving customers and investors is functional, not institutional.³⁷ A large insurance company, for example, might be mainly in the business of selling term life policies, which are guaranteed contingent claims. In selling these policies, they serve customers. However, the same com-

be rainy. In the real world, insurance policies are contingent on accidents, and stock dividends are contingent on firm profits. Assuming people are risk-averse, exchanges such as these increase welfare. The customer buys this guarantee because, if she can take performance for granted, she can plan her productive activities accordingly, and specialize in those at which she is best. For example, Friday can concentrate his efforts on raising wet-weather crops, at which he is more skilled, if he knows to a certainty that Crusoe will deliver the goods if the weather turns out to be dry. If he believes that Crusoe is less than certain to perform, however, Friday will have to supplement his contract with Crusoe with other risk-management techniques, such as growing some of his own dry-weather crops, which by hypothesis he does less well than Crusoe.

In the same way, financial intermediaries allow customers to allocate their productive resources more efficiently by providing guarantees to them. It might be argued, as Merton observes, that insurance buyers ought to be indifferent to uncertainty in insurance contracts because they could, after all, diversify across insurance companies. If a customer bought \$10,000 worth of life insurance from each of 100 different companies, this would effectively create a one million dollar policy that was almost certain to pay off to some predictable extent in the event of death. Insurance customers, however, do not and would not want to do this, because it would be much costlier for each customer to engage in this kind of risk-management through diversification than it would be for an insurance company to *guarantee* to the customer that the policy will be paid, and then take the steps, through diversification, reserve maintenance, and reinsurance, for example, to manage the risk for customers. A central function of financial intermediaries is to provide such guarantees to customers who cannot efficiently "make them at home."

35. See MERTON, OPERATION AND REGULATION, *supra* note 18, at 1.

36. *Id.* at 5-6.

37. See Merton & Bodie, *Financial Guarantees*, *supra* note 18, at 89.

pany might also sell variable annuity policies that may be investments packaged as insurance policies mainly for tax reasons. In selling annuities, the company might provide an opportunity primarily for investors. Indeed, a single product may blur the line between customer and investor; a single individual may be both a customer and an investor. I might buy a contract that has a guaranteed component, and a component whose value depends upon the performance of the issuing intermediary. Conversely, some investors might actually be customers in disguise. The future pensioner with a defined contribution plan,³⁸ who has put the bulk of his retirement savings in the stock market, might look like he is taking a gamble by playing the market. He may view himself, however, as saving as a hedge against the expected costs of aging.

It might seem paradoxical to speak of an investment in the stock market as "guaranteed." As every mutual fund prospectus tells us, investment in the stock market involves risk. Here it is important to be clear about the function of financial intermediaries Merton develops and which I apply here. Intermediary customers, for various reasons, seek to manage risk in their own personal or institutional lives. Individuals save for retirement. Firms insure against unfavorable developments in markets to which their businesses are sensitive. In one way or another, almost everyone has risks they want to manage. Very often, the best way to manage risk is by acquiring some other risk that offsets the risk to which one's life or business is inevitably exposed. This is the practice of hedging. Thus, many retirement savers invest substantial portions of their savings in the stock market. We know that the equity market is relatively risky compared to other capital markets, such as those for government bonds. Does this mean that retirement savers investing in the stock market are not interested in financial guarantees? Not really. Retirement savers may be making a perhaps ill-advised attempt³⁹ to use stocks to hedge against inflation. Alternatively, they may be investing in the market to achieve some amount they believe is necessary to live comfortably during retirement. Even this saving strategy, however, is a kind of risk management that works by reserving capital against the depletion of human capital. A retirement saver who is willing to undertake stock market risk in order to build these reserves against the costs of old age is not evincing any willingness to take on other sorts of risk—such as risk arising from the credit-worthiness of his

38. For brief discussions of defined benefit and defined contribution pension plans, see JOHN DOWNES & JORDAN ELLIOT GOODMAN, *BARRON'S FINANCE & INVESTMENT HANDBOOK* 267 (4th ed. 1995).

39. See Zvi Bodie, *Shortfall Risk and Pension Fund Investment Policy*, in *INSTITUTIONAL INVESTING: CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY* (Arnold W. Sametz & James L. Bicksler, eds. 1991) 57, 64.

pension fund intermediary. As a first approximation, I claim that the pension saver with his funds invested in the stock market will want an assurance that, if the stock market doubles in value, his savings, to a near certainty, will double in value as well. To the extent he has no such assurance, the value of his savings as a hedge against the costs of aging is significantly diminished. As a general matter, financial customers are highly sensitive to the creditworthiness of intermediaries. They use intermediary products to take positions in underlying markets, such as the stock market, for their own risk management purposes; these products, for example, can act as a hedge against the cost of aging. Customers, typically, are quite unwilling to bear any risk that the intermediary itself will be unable to perform on its promises. Customers may take on risk under the contract, whatever it may be, but the contract serves its risk management purpose efficiently only if there is little uncertainty that the contract itself will be performed.

These complexities, while significant, should not obscure the main point: a core part of the financial intermediation business is the provision of guarantees that enable risk-averse customers to manage risk. This implies that risk management is crucially important to intermediary firms, which must credibly stand behind their guarantees if they want to keep their customers.⁴⁰

Merton and Bodie identify three main ways that financial intermediaries can provide adequate assurances to customers that they will indeed perform their promises.⁴¹ First, the intermediary's investors can provide a significant reserve of capital. If the firm's assets devoted to funding liabilities fall short in value, the reserve can be used to satisfy customer claims. This reserve of risk capital can take the form of equity or subordinated debt. Second, the firm can purchase a guarantee of these liabilities from a private third party. A put option, for example, allows an intermediary to establish a floor below which the price of its assets cannot fall. Even if its assets tumble significantly in value, it can exercise the option. Third, the government can guarantee customer liabilities, as with deposit insurance.⁴² When the government guarantees the value of customer liabilities, it usually imposes some regulatory requirements on the intermediary issuing the liabilities in order to limit the government's exposure to risk.⁴³

40. See Robert C. Merton & André F. Perold, *Theory of Risk Capital in Financial Firms*, J. APPLIED CORP. FIN., Fall 1993, at 16, 30 [hereinafter, Merton & Perold, *Theory*]. For an earlier version of this article, see Robert C. Merton & André F. Perold, *Management of Risk Capital in Financial Firms*, in FINANCIAL SERVICES: PERSPECTIVES AND CHALLENGES 215 (Samuel L. Hayes, III, ed., 1993).

41. See Merton & Bodie, *Financial Guarantees*, *supra* note 18, at 90.

42. See Merton & Bodie, *Deposit Insurance*, *supra* note 18.

43. See *id.*

*B. The Needs of Customers and the Size of
Intermediary Institutions*

This understanding of the financial intermediation business immediately casts doubt on the logic of the political model. At its root, the political model suggests revising the basic organization of the American public corporation. The traditional account of American corporate structure begins by examining how public corporations come into existence. In order to raise the large amounts of capital they require, corporations must sell many shares of stock. This process allows the capital to be raised, but it also leaves the corporation with numerous dispersed shareholders. This separation of ownership and control generates large agency costs.

The political model, on the other hand, argues that large financial intermediaries could serve as the conduit through which the savings of millions of dispersed households are collected and transformed into corporate capital and shareholder power. By pooling and investing the dispersed savings of their customers,⁴⁴ financial intermediaries could thus become large, influential shareholders, and could monitor firm managements and reduce agency costs. Superficially, it might seem that this process is already well underway in the United States; the majority of shares of operating companies are now owned by pension funds and other large institutional investors.⁴⁵

The logic of this story, however, and the promise of the political model are largely illusory. Financial intermediaries that are large enough to appear poised to unite ownership and control are so large for a reason: they provide financial services to the ubiquitous financial customer of relatively small wealth. These customers probably want their contracts insulated from the variable fortunes of their intermediary institutions. For reasons I explain later, shareholder activism would make such insulation impracticable. In other words, institutional size is the direct result of the function they serve, and their function makes them particularly unsuited for life as activist shareholders.

In his classic work *Continuous-Time Finance*, Merton remarks in passing that "as we all know, the vast bulk of a typical intermediary's liabilities are held by its customers."⁴⁶ Although it might be difficult to assemble data to support this observation, Merton's claim is plausible. Huge pension funds, for example, appear to be made up of the relatively small savings of many customers. Taken together, public and private pension funds own about one quarter of the total outstanding equity of U.S. public corporations, a stupendous amount worth trillions

44. See ROE, *STRONG MANAGERS*, *supra* note 2, at 21.

45. See *supra* note 1.

46. MERTON, *supra* note 27, at 451.

of dollars.⁴⁷ Yet a survey of the largest institutional managers of defined contribution and 401K plans reveals that the average value of a participant's account is a modest \$21,000.⁴⁸ Much of the capital raised by financial intermediaries—by taking deposits, selling insurance, or taking pension contributions—probably comes in similarly modest amounts, which become large only when multiplied by a very large number of customers.

"Customers," as defined by Merton, need not be modestly endowed financially, although modestly endowed customers do fit Merton's definition well. Some financial intermediary customers may be persons or entities of substantial wealth. To avoid confusion, this point is worth stressing now. An international bank that swaps a fixed rate obligation for a variable rate obligation,⁴⁹ and receives a guarantee on the performance of the swap obligation, is just as much a customer in Merton's view as a shoe salesperson who buys a term life insurance policy. In both cases, the intermediary provides a guarantee: it must pay the bank a variable amount depending on some agreed interest rate under the swap contract, or it must pay the shoe salesperson's family an agreed amount under the insurance contract if the salesperson dies. This allows both the bank and the salesperson to manage their own risks, and thus to allocate their respective productive resources more efficiently.

Yet while customers need not be modestly endowed financially, it seems likely that persons of limited wealth are much more likely to purchase financial products as customers than as investors. This deceptively simple point lies at the heart of the problem with the political model. The political model asks why large institutions such as pension funds, banks, and insurance companies do not function as activist shareholders. The answer, in simplest terms, is "because of where the money comes from." The great size of large institutions comes from the large numbers of small savers whose savings they pool. What these small savers lack in wealth, they make up for in numbers. Most crucially, small savers, with their savings and checking accounts, insurance policies, and pension plans, are probably best viewed as customers and not investors; they want guarantees on their contracts.

A large portion of the capital in institutions comes from business subject to explicit guarantees, such as term life insurance policies, de-

47. See BRANCATO & GAUGHAN, *supra* note 1; see also THE MONEY MARKET DIRECTORY OF PENSION FUNDS AND THEIR INVESTMENT MANAGERS (25th ed. 1995) [hereinafter MONEY MARKET DIRECTORY].

48. Figure rounded to the nearest thousand. See MONEY MARKET DIRECTORY, *supra* note 47.

49. For a description of the international interest rate swap market, see Wanda Cantrell, *Corralling the Interest Rate Risk*, MAGAZINE OF BANK MANAG., Feb. 1993, at 26.

financed benefit pension plans, and federally insured savings accounts.⁵⁰ When these products and services are sold, the intermediary explicitly provides a guarantee that the customer will be paid no less than a determinate amount of money at a certain date or upon a specific contingency. Persons with only limited wealth will demand that their institutions provide sound guarantees, because their small wealth exposes them to severe downside risk if institutions do not honor their sides of the bargain. Indeed, for most small savers the failure of a bank, the repudiation of a life or health insurance policy, or the insolvency of a pension plan spells real catastrophe. Customers who obtain these sorts of guaranteed contracts are different from investors who gamble money in the stock market, both in Merton's high theoretical sense and at gut level. Customers want, and need, their contracts to be performed, whereas investors hope for a profit, but are typically prepared to suffer a loss.

Most people probably purchase guarantees such as insurance policies and pension plans before they invest in the stock market or elsewhere. Typically, individuals purchase financial "luxuries" only after financial "necessities," such as insurance and retirement savings, are

50. Data on the wealth and financial holdings of small financial customers and investors is somewhat difficult to come by. However, the following information reinforces the inherently plausible claim that large capital pools come from very numerous small financial customers. Respecting pension funds, as of 1996, defined benefit plans, which employers typically use as a benefit more for lower paying than top paying jobs, contained approximately \$2.46 trillion in government, union, and corporate plans. Higher paying jobs often have defined contribution plans as a benefit. These plans contained an impressive, but much smaller, amount of about \$170 billion. See MONEY MARKET DIRECTORY, *supra* note 47, at xviii. This suggests that relatively small wealth contributors supply the vast majority of the pension fund capital that ultimately finds its way into the equity market. Respecting insurance companies, some insight into the financial objectives of insurance product buyers may be gleaned from the sort of products they buy. Products such as term life insurance and whole life insurance are usually understood to serve risk management purposes solely or, to the extent they serve as savings vehicles, to involve explicit or implicit guarantees. Products that pass investment risk through to buyers are more typically classified as variable products. For brief discussions of term life, whole life, and variable products, see DOWNES & GOODMAN, *supra* note 38, at 641, 673, 684. As of 1993, 75% of insurance product purchasers had incomes of under \$50,000 per year, and 87% under \$75,000. Variable and variable-universal life policies, which would seem to be those policies that arguably have investment motivations, amounted to only 10% of purchases in 1993 by type of policy. Size of policies purchased is suggestive: 92% of policies purchased were for an amount of \$100,000 or less. See AMERICAN COUNCIL OF LIFE INSURANCE, 1994 LIFE INSURANCE FACT BOOK 12-13 (1994). All these data point in the direction of relatively modestly endowed financial customers purchasing low default risk products for risk management purposes. However, even for buyers of variable products, there is no reason to assume that willingness to bear market risk evinces willingness to bear the risk that would be generated by institutional activism. Federally guaranteed banks and thrifts are another example of a huge capital pool that, notwithstanding its size, would be an inappropriate source of institutional activist investment power. According to data on the Federal Deposit Insurance Corporation World Wide Web "home page" (<http://www.fdic.gov/fdicsh.htm>), the insured deposit base of federally insured banks was nearly \$2 trillion, and that of savings associations, \$695 billion. Yet investing these funds so as to increase institutional investor influence would generate the risks discussed in this Article.

taken care of. Once they secure threshold guarantees, people then begin to invest, deliberately bearing risk for the sake of profit.⁵¹ Because most people are primarily concerned with financial necessities rather than financial luxuries, the financial intermediary business accumulates huge amounts of capital from these ubiquitous customers of limited means. But however many billions of dollars intermediaries accumulate, they must manage these funds consistently with the guarantees they have provided and on which their many risk-averse customers rely. The question is therefore not whether institutions—by which I mean financial intermediaries principally in the business of providing guarantees—have enough capital to own influential stakes in American operating companies. They do. The question rather is whether they can be influential, activist shareholders in the way political model scholars imagine, and at the same time remain faithful to the commitments that enabled them to accumulate such large masses of capital in the first place. The answer to that question is far less clear.

II

THE OVERDIVERSIFICATION MYTH

Risk management is a fundamental part of the financial intermediation business. Any inconsistency between risk management and institutional activism puts the workability of the political model in grave doubt. One fundamental means by which institutions manage risk is through diversification—building a portfolio consisting of relatively small ownership stakes in many different companies. Political model proponents suggest that financial intermediaries could hold bigger, more influential stakes in fewer operating companies, and thus increase their influence as shareholders over firm managements, without significantly compromising diversification. This suggestion is misguided. Very broad diversification by intermediaries serves important risk-management purposes.

A. Diversification and Large Institutional Investors

Institutional investors hold a huge amount of stock in U.S. corporations, but they normally spread their investments over a large number of firms. By spreading their capital so widely, they minimize their influence as shareholders. The California Public Employee Retirement

51. I use the terms "necessity" and "luxury" in the colloquial sense, not in any technical microeconomic sense. Merton has an extremely interesting and suggestive description of the relationship among intermediaries, capital markets, and financial product innovation he calls the "financial innovation spiral." See Robert C. Merton, *The Financial System and Economic Performance*, 4 J. FIN. SERVICES RES. 263 (1990); Robert C. Merton, *Financial Innovation and Economic Performance*, J. APPLIED CORP. FIN., Winter 1992, at 12.

System ("CalPERS"), for example, invests approximately forty billion dollars in 1200 different firms. Its largest stakes are normally no larger than about one percent of any given firm's equity.⁵² Diversification of this scope is not uncommon. In a 1992 survey by the journal *Institutional Investor*, nearly nineteen percent of pension fund managers responding reported that their funds held stock in more than one thousand firms.⁵³ Nearly another quarter reported holding stock in between 250 and 1000 different issuers.

Is this behavior irrational? According to political model proponents Black and Roe, institutions have no good economic reason for owning stock in so many different firms.⁵⁴ They imply that if the government lifted restraints against greater institutional ownership of corporations, institutions could concentrate their holdings, and exercise more influence over corporate management, without significantly compromising the benefits of diversification.⁵⁵ The claim that institutions are now overdiversified is a crucial part of the political model. However, if institutions do have good economic reasons for being as widely diversified as they are, independent of legal restrictions, then lifting legal restrictions would not necessarily prompt institutions to concentrate their equity holdings in fewer firms so they could exercise proportionately more influence as shareholders. Instead, they would remain widely diversified and would be relatively passive investors as a consequence. In this section I argue that regardless of legal restrictions institutions have compelling reasons to remain widely diversified.

B. Diversification Theory Basics

Diversification allows the investor to reduce the risk or variance of the returns on her portfolio. By buying stock in companies whose fortunes tend to vary (at least to some degree) independently of one another, the investor can design her portfolio to yield a return that equals that of the equity market as a whole.⁵⁶ Diversification works in part be-

52. See Michael Kinsman, *Quiet Clout: Giant CalPERS Pension Fund Takes Low-Key Approach*, SAN DIEGO UNION-TRIB., July 23, 1995 at I-1, I-7.

53. See *How Many Stocks Should a Pension Plan Hold?*, INSTITUTIONAL INVESTOR, Sept. 1992, at 171.

54. See Black, *Shareholder Passivity*, *supra* note 2, at 553-54; Roe, *Private Pensions*, *supra* note 2, at 97. Roe cites Lorie to the effect that "most diversification comes from the first fifteen or twenty different stocks." *Id.* at 97; see also *infra* text accompanying note 73. As I explain below, however, financial theorists generally, and Lorie in particular, do not mean to say that reducing beta risk is the be-all and end-all of diversification.

55. See Black, *Agents*, *supra* note 1, at 855.

56. Tests of the Capital Asset Pricing Model (or "CAPM") usually use a broad market index as a proxy for the entire capital market. This is problematic because the capital market is very diverse, and liquid public securities markets may not be a good proxy. See Richard Roll, *A Critique of the Asset Pricing Theory's Tests, Part I: On Past and Potential Testability of the Theory*, 4 J. FIN. ECON. 129 (1977). An excellent introduction for lawyers to the CAPM and other main topics of financial

cause risk factors that are *not* explicable in terms of overall market movements, but are instead associated with particular firms, tend to cancel each other out as the portfolio is diversified. Investors thus can "diversify away" firm-specific risk. When firm-specific risk is eliminated, what remains is called "beta" risk, or risk attributable to variance in the overall market. Diversification cannot eliminate "beta" risk, but it can reduce its level to that of the market as a whole. The more diversified the portfolio gets, the more its beta risk will approach that of the whole market, which by convention equals one.⁵⁷ The beta of a completely diversified portfolio would thus also equal one; that of a portfolio that was twice as risky as the market would be two, and so forth. The central empirical claim of the capital assets pricing model ("CAPM") is that the expected return of a portfolio is a function of its beta, namely, its riskiness compared to that of the market as a whole.⁵⁸

Investors are thus compensated by the market for bearing beta risk, but they are not compensated for bearing firm-specific risk, because they could diversify it away at little cost. So an investor that retains positive firm-specific risk receives no increased return on his portfolio for bearing that extra risk.⁵⁹ Through diversification, therefore, firm-specific risk can be reduced to practically zero without lowering the expected return of the portfolio.⁶⁰ Investors will prefer to do this, unless they think they can pick specific firms whose stock will offer returns greater than those anticipated by the market. Investors who do not believe they can outguess the market will want to reduce their firm-specific risk to as close to zero as possible. Thus, we can say that a perfectly diversified portfolio will have a beta of one and firm-specific risk of zero.⁶¹

Analysts have performed many empirical studies in attempts to determine how many different stocks would comprise a portfolio with an

theory is BERNARD S. BLACK & RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* chs. 2-7 (2d ed. 1995). Diversification could also be used to create returns different from the market as a whole, as in the pre-CAPM Markowitz approach. See HARRY M. MARKOWITZ, *PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS* (1959).

57. In the CAPM, the riskiness of a given portfolio compared to that of the market as a whole is referred to as its "beta." By convention, the beta of the market as a whole equals one. See, e.g., BLACK & GILSON, *supra* note 56, at 94-98; see also RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 134-36 (3d ed. 1988).

58. See BREALEY & MYERS, *supra* note 57, at 127-28.

59. See BLACK & GILSON, *supra* note 56, at 90; BREALEY & MYERS, *supra* note 57, at 133.

60. For reasons I elaborate later, see *infra* text accompanying notes 171-178, I think it is important to bear in mind that the "expected" return here is the return expected by the market. An entrepreneur might believe the market's expectations are wrong, and have expectations of her own. Later in this Article, I stress the Knightian theme that entrepreneurs make profits by identifying occasions where the market has mispriced assets.

61. See JEROME B. COHEN ET AL., *INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT* 759 (1977).

expected return equal, to one degree of precision or another, to that of the market as a whole—in other words, to get a beta of (close to) one. In fact, one can create such a portfolio by choosing a relatively small number of stocks at random.⁶² If one views diversification only as creating a portfolio with a beta of approximately one, holding 1000 different kinds of stock indeed appears to be gross overdiversification.

Concern over overdiversification of institutions and other investors has a relatively long history in financial economics. In an influential 1968 paper, John L. Evans and Stephen H. Archer concluded that only about ten stocks are necessary for a diversified portfolio.⁶³ Several finance textbooks later incorporated this result.⁶⁴ Judging by these results, it might seem that one could not only increase shareholder influence, but also save transaction costs, by constructing a portfolio with only fifty or a hundred stocks at most, instead of a thousand. According to Black, “[i]nstitutional voice requires institutions to hold larger percentage stakes and to be less diversified,” but this, he says, is a “minor cost.”⁶⁵ Many institutions, according to Black, “take diversification to ridiculous lengths.”⁶⁶

C. *The Costs of Imperfect Diversification*

The claim that institutions overdiversify is based on an overly narrow understanding of the benefits of diversification. As James H. Lorie has written, there is “too little appreciation of how much uncertainty or risk is created by even apparently small departures from perfect diversification.”⁶⁷ According to Lorie, excessive emphasis on the question of how many stocks are necessary to achieve a beta of one is responsible for this misunderstanding.⁶⁸ The difference between relatively small, imperfectly diversified portfolios and larger, perfectly diversified portfolios is greater than the “how-few-stocks-in-a-diversified-portfolio” approach suggests. Even small departures from perfect diversification create substantial amounts of risk.⁶⁹ Lorie has shown that a portfolio of

62. A brief review of studies may be found in Meir Statman, *How Many Stocks Make a Diversified Portfolio?*, 22 J. FIN. & QUANTITATIVE ANALYSIS 353, 353-54 (1987).

63. See John L. Evans & Stephen H. Archer, *Diversification and the Reduction of Dispersion: An Empirical Analysis*, 23 J. FIN. 761, 767 (1968).

64. See Statman, *supra* note 62, at 354; see also BLACK & GILSON, *supra* note 56, at 89, 91.

65. Black, *Agents*, *supra* note 1, at 834.

66. *Id.*

67. James H. Lorie, *Diversification: Old and New*, J. PORTFOLIO MGMT., Winter 1975, at 25, 28.

68. See *id.*

69. See *id.*; see also Roger B. Upson et al., *Portfolio Diversification Strategies*, FIN. ANALYSTS J., May/June 1975, at 86, 86-88 (discussing diversification and investor confidence in receiving the overall market rate of return). The simulation results in these studies were confirmed analytically in Edwin J. Elton & Martin J. Gruber, *Risk Reduction and Portfolio Size: An Analytical Solution*, 50 I. BUS. 415, 426 (1977).

fifty stocks of the Standard & Poor's 500 index produces returns that can easily differ from returns for the entire 500-stock index by as much as 4.5 percentage points per year. Portfolios of 100 stocks can differ by as much as three percentage points per year.⁷⁰ These are significant differences.⁷¹ As Lorie writes, "[i]nvestors who rely heavily on beta coefficients to predict returns and who do not understand the importance of scientific diversification are frequently surprised and not always pleasantly."⁷²

The central project of risk management is to avoid unpleasant surprises. This, rather than excessive zeal for diversification, is what accounts for very broad diversification by institutional investors. When institutions hold a thousand different types of stock in their portfolios, they are not simply engaged in the narrow project of equating the betas of their stock portfolios to nearly one (which they effectively accomplished with the first fifty or one hundred types of stock they purchased). They are, rather, trying to equate their firm-specific risk to zero. Even small amounts of firm-specific risk reduce the institution's confidence that the actual future value of its portfolio will equal that of the market portfolio.⁷³

1. *Costs of Underdiversification Under the Capital Assets Pricing Model*⁷⁴

Institutions must insulate their customers from default risk. In order to do so, the value of their portfolios must equal or exceed their liabilities to customers. Otherwise, any shortfall must be made up for by reserves or guarantees. It is plausible to assume that maintaining reserves and obtaining guarantees is costly, and that these transaction costs vary proportionally with the size of the reserves or guarantees. It follows that intermediaries, to be competitive, will maintain only such reserves or guarantees as are necessary to assure, to some high level of confidence, that they will be able to meet their obligations to customers.

Even a small amount of firm-specific risk in an institution's equity portfolios will reduce its confidence that its portfolio will perform ac-

70. See Lorie, *supra* note 67, at 28.

71. Langbein and Posner also rely on Lorie's analysis of diversification. See John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law: II*, 1977 AM. B. FOUND. RES. J. 1, 4 [hereinafter Langbein & Posner, *Market Funds II*]. Curiously, this important point about diversification seems to have been neglected in the legal literature about institutional investing. See also R. A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 113 (2d ed. 1983) (pointing out that a portfolio that is equally divided among 100 stocks still has a diversifiable risk of 3.6 percent a year).

72. Lorie, *supra* note 67, at 28.

73. See COHEN ET AL., *supra* note 61, at 759, for a discussion that puts this point in the general context of portfolio theory.

74. See *supra* text accompanying note 58.

according to predictions based on its riskiness relative to the market. If the institution holds part of its assets in the stock market, it presumably must have some estimate as to how it expects the stock market to perform in order to calculate how much insurance or reserves it must maintain in order to assure that its portfolio will not fall short of funding its obligations to customers. If the institution does not have confidence in its estimates of what its asset portfolio will be worth when liabilities come due, it will have to maintain larger reserves or guarantees in order to be highly confident that it will be able to meet its future liabilities. Anything that reduces confidence in predictions about future asset value is costly to financial intermediaries because it requires them to increase their reserves or guarantees in order to maintain the same level of assurance to their customers.

Yet this is precisely what reducing the diversification of an institutional portfolio would do. Lack of diversification increases firm-specific risk, and firm-specific risk makes portfolio performance relative to the market less predictable. Firm-specific risk therefore requires an institution to buy more insurance or increase its reserves in order to maintain its own confidence—and the confidence of its customers—in its continued solvency. We can assume that such precautions are costly. By maintaining broad diversification, institutions are not behaving irrationally or complying with irrational laws. Rather, they are avoiding less desirable alternatives: the maintenance of larger reserves or the purchase of more third-party guarantees. Diversification helps make these precautions unnecessary.

This argument assumes that financial intermediaries make predictions about what their stock portfolios will be worth at a future time based on their predictions of how the stock market will perform in the relevant time period. To the extent that this is true, underdiversification in and of itself is costly to institutional investors. Financial theory suggests, however, that stock market performance cannot reliably be predicted. The CAPM makes no promise that it can. Any argument which relies on the predictability of the value of institutional portfolios might therefore seem unpersuasive, because portfolio value depends at least in part on the stock market, and the stock market is not predictable. One might wonder: even if portfolio predictions based on these unreliable market predictions are made even less reliable by underdiversification, is that really so bad?

Leaving aside any difficulties caused by the unpredictability of portfolio value, the harm of underdiversification is nevertheless well-defined. CAPM tells investors that very broad diversification—much broader than the political model suggests—is a necessary part of an investment strategy that yields the maximum return for any given level of

risk the institution or other investor may choose. CAPM prescribes a standard formula for an efficient investment portfolio: if one wants a portfolio that is more or less risky and with correspondingly higher or lower expected returns than the market as a whole, one should diversify one's investment in risky assets and then combine that with risk-free securities (such as Treasury Bills), for less risk and return than the market, or borrow at the risk-free rate in order to buy more risky securities, for more risk and return than the market.⁷⁵ Political model scholars proceed as if their theory were consistent with these recommendations. But the political model requires a level of diversification too low to implement properly the standard CAPM investment strategy. The cost of adhering to the political model, then, is foregoing optimal returns on one's portfolio, no matter to what level of market risk one is exposed.

Under CAPM, the rational investor will not choose to bear firm-specific risk. (As I discuss in Part IV below, however, entrepreneurs specialize in bearing firm-specific risk.) But there is no reason to think that the mass of financial customers, whose modest savings collectively comprise in large part the huge capital pools of institutional investors, will typically have any interest in bearing the firm-specific risk institutions would generate with activism.

2. *Introducing the Moral Hazard Caused by Underdiversification*

Political model advocates might respond to this argument by conceding (as they should) that institutions would have to bear some increment of firm-specific risk in order to become activists. They might still argue that the firm-specific risk, while not compensated in market returns and thus technically not optimal in CAPM terms, would nevertheless be richly rewarded when activist monitoring yielded higher returns to shareholders. There are reasons to be skeptical of claims reporting such high returns on shareholder activism,⁷⁶ but whether activist monitoring increases firm value is of secondary importance. The point instead is that such activism generates significant risks for institutions and their customers. Managing these risks would be particularly costly for an institution that took up activism on the scale the political model suggests. Whether political model-style activism makes sense for institutions depends on whether the benefits of activism exceed its costs, but the costs of activism must be understood to include substantially increased risk-management expenses.

75. See JAMES H. LORIE & MARY T. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 198-210 (1973).

76. See *infra* Part III.B.1.

The magnitude of these costs and benefits is ultimately an empirical question.⁷⁷ There are, however, good reasons to doubt that the benefits of large-scale activism would exceed its costs for institutions. In any event, the comparison must be properly framed before it can be done properly. When underdiversification makes predictions of portfolio performance less reliable, institutions will be forced to increase their holdings of insurance or reserves to guarantee its liabilities to customers. An institution will face substantial costs whenever it reduces the diversification of its portfolio—thereby making its performance less predictable—whether it engages in shareholder activism or not.

One might argue that maintaining these reserves or guarantees would not directly entail any economic costs. For example, the portfolio insurance policies in the form of put options or liquid reserves in the form of cash, support the institution's guarantees to customers and are valuable financial assets in their own right.⁷⁸ An institution might be able to hold a less-diversified portfolio, but also hold a put option on that portfolio. With this combination, it might have a portfolio that on net would have approximately the same protection against risk, and the same returns, as the diversified portfolio. If the expected value and riskiness of this less-diversified, but insured, portfolio were approximately the same as those of the completely diversified portfolio, then the two portfolios should cost nearly the same. Each would be as effective as the other in providing the guarantees that intermediary customers want.

This story leaves out the problem of "moral hazard." A person who purchases insurance may, in some situations, obtain an incentive to behave less carefully. Perhaps she will even behave in ways that make her uninsurable at the premium charged, and perhaps at any premium.⁷⁹ If insurers sell insurance to buyers afflicted by moral hazards, they will rationally expect the hazard to cause problems, and charge higher pre-

77. Adopting the deregulatory agenda of the political model might be the best way to test the relative truth of the political model, and of my counter-hypothesis. If the political model is right, then deregulation ought to lead to large scale activism by giant institutions such as pension funds and insurance companies. Under my model, no surge in activism would occur. Instead, one should expect to see the rise of specialized entrepreneurial investors, which would be small compared to the large institutions invoked by the political model. These entrepreneurs would be better candidates to enter the corporate-reform business. Some recent events suggest this may already be happening. See *infra* Part V.D.

78. See Merton & Perold, *Theory*, *supra* note 40, at 18-26. The moral hazard and adverse selection problems I describe in Parts III and IV of this Article will create deadweight or economic costs for the insured institutional investor. Institutions will not be able to purchase insurance at actuarially fair values.

79. See generally MILGROM & ROBERTS, *supra* note 16, at 167-70 (discussing the concept of moral hazard).

miums or impose higher deductibles or other terms.⁸⁰ If they cannot control costs by these means, rational insurers will exit the market.

In the case of the activist institution, insurance against an underdiversified portfolio turning out to be less valuable than a diversified portfolio will be more expensive than it would be for a passive institution. The activist institution, by definition, can influence by its actions the value of its insured assets. While portfolio value might theoretically increase due to institutional monitoring, there is also a risk that this value will decrease. Potentially activist institutions will therefore have to pay more for portfolio insurance than will passive institutions. This suggests that an institution credibly committed to passivity could buy a less diversified portfolio and portfolio insurance for less than could the activist institution. If diversification acts as its own credible commitment to passivity, then underdiversification signals possible activism. It therefore makes sense that where the diversified portfolio and the underdiversified-but-insured portfolio are financial equivalents, institutions would choose to be passive and diversified, as it is probably the cheapest way to avoid the extra insurance costs, unless the gains from shareholder activism are so large that they would overwhelm all of these costs together.

Raising additional reserves and buying insurance could be a more efficient way to fund financial guarantees than a diversified portfolio; but only if a relatively underdiversified institution could credibly commit itself to shareholder passivity and thus keep insurance costs relatively low. It makes little sense to pursue such an elaborate strategy given the fact that institutions can achieve near-perfect diversification at a relatively low cost. Broad diversification kills two birds with one stone. It both eliminates firm-specific risk, and eliminates moral hazards that would make portfolio insurance more costly. Broad diversification is probably the cheapest and easiest way for an institution credibly to commit itself to shareholder passivity and to fund the guarantees that customers require.

Political model advocates might concede that activist institutions would face extra insurance costs. They might nevertheless contend that they would garner extra returns as well, because their activist monitoring would increase the returns from the assets in their portfolios. The extra returns, political model advocates might claim, could be more than enough to cover the extra insurance costs. This claim is difficult to refute, but it is equally difficult to credit. If it were true, it would mean that institutional managers possess monitoring and other techniques so powerful that applying them would increase asset values without incurring so much risk that the cost of portfolio insurance would not eat up any gains in asset value. Not only would institutional monitoring have

80. See *id.* at 185-90.

to increase the returns of portfolios beyond what their market risk would predict under the CAPM, but it would do so by such an amount as to more than cover inevitably significant extra insurance costs.

This implicit claim of the political model is troubling. First, what we know of institutions' ability to pick portfolios that will outperform the market suggests institutions lack the firm-specific knowledge that would seem important to reforming corporate governance. Even if institutions could reform corporate governance based on their general knowledge, it is implausible to argue they could do so without incurring commensurate risks. As I explain in more detail below, this risk, like firm-specific risk, makes portfolio returns less predictable and less than optimal under CAPM. This does not mean, of course, that no investors would want to bear these risks in return for the profits that undertaking to reform corporate managements might yield. After all, entrepreneurs such as T. Boone Pickens and Carl Icahn have made fortunes restructuring corporations and their managements and bearing the commensurate risks. What is implausible is to suggest that the financial customer of institutions would be willing to undertake these risks when they buy the insurance policies, open the bank accounts, and contribute to the pension plans that collectively make up the enormous pool of capital political model proponents see as the foundation of their new paradigm of corporate governance. Typical financial customers would demand that their bank accounts, insurance policies, and pension plans be insulated from the real risk that plans to reform corporate managements would, in spite of the best intentions, fail to achieve their hoped for results, but instead cause losses. In the following Parts, I explain the nature of the risk institutional activism would generate, and why institutions would find it difficult to insulate their customers from this risk.

III

THE RISKS OF INSTITUTIONAL ACTIVISM

The argument above assumes that institutional activism would create risks for institutions. In this Part, I explain the origins of these risks. These risks not only provide reasons to be skeptical of the political model; they help to explain the phenomenon of institutional passivity. In this Part, I examine both what I term "systematic" shareholder activism and "relational investing." In the intermediary context, both styles of activism would generate risk that would make providing guarantees to customers especially costly. These increased costs would make it difficult for activist institutions to compete successfully with passive rivals.

Below, I distinguish first between "systematic" and "asystematic" activism. Then I briefly review portfolio insurance and explain the moral hazard and adverse selection problems that would make insuring the portfolios of institutional activists costly. Finally, I argue that relational investing, although not systematic activism in my sense of the term, would give rise to similar problems.

A. Systematic and Asystematic Shareholder Activism

Proponents of the political model want institutional investors to actively monitor the managers of firms. Of what would this monitoring consist? Discussing this question explicitly, Black observes that institutional investors have no expertise specific to the firms in which they invest.⁸¹ For example, institutions will probably not know better than automobile company managers whether consumers want sport-utility vehicles or large sedans, or whether the company should build its new plant in Ohio or South Carolina. Black argues, however, that institutional investors do have special expertise *as shareholders*.⁸² They should therefore be able to monitor and influence aspects of the "structure and process" of corporate management that affect the value of equity.⁸³ Corporate policies relating to tender offers, proxy contests, shareholder voting, and executive compensation all fall into this category. Corporate law and finance scholars have also identified laws and practices that they believe reduce share value, such as state anti-takeover laws, poison pills, and other anti-takeover devices.⁸⁴ Some scholars, moreover, have stressed the need for the election of professional directors by institutions

81. See Black, *Agents*, *supra* note 1, at 834-35.

82. This is a recurrent theme in the political model literature. See, e.g., *id.* at 836; see also Ronald J. Gilson, *Executive Compensation and Corporate Governance: An Academic Perspective*, in 24TH ANNUAL INSTITUTE ON SECURITIES REGULATION, at 647, 677-78 (PLI Corp. Law & Practice Course Handbook Series No. B-792, 1992) (suggesting that institutions should develop the expertise necessary to evaluate executive compensation plans and that this expertise would have "scale economies" because it would not be applied to just a single firm); John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1445 (1994).

83. See Black, *Agents*, *supra* note 1, at 836.

84. Black identifies six areas where he thinks institutional oversight can clearly add value. These areas involve "clear problems" with "reasonably straightforward solutions." Black, *supra* note 11, at 899. Put in propositional form, these six solutions are as follows: (1) firms should have more independent directors; (2) institutional oversight should discourage corporate diversification; (3) institutions should encourage good takeovers and discourage bad ones; (4) institutions should roll back pro-incumbent governance rules; (5) institutions should discourage firms from overspending, although not through the simplistic approach of high leverage; and (6) institutions should control non-performance based overpayment of executives and morale-eroding disparities between CEO and line worker compensation. See *id.* at 899-917. But see *infra* text accompanying notes 185-189.

and the separation of the offices of chairman of the board and chief executive officer, as means of enhancing shareholder welfare.⁸⁵

I refer to the effort to impose rules, standards, or policies on the managements of some significant portion of the firms in an institutional shareholder's portfolio as systematic activism. Systematic activism may be thought of as an attempt to revise the "form contract" that effectively defines the relationship of the institutional shareholder and the firms represented in that shareholder's portfolio.⁸⁶ Systematic activism is typically based on what an institution, as a general matter, believes to be good for shareholder (or social) welfare. Activism is systematic only if an institution applies, or might apply, the proposed policy to some significant portion of the firms in which it invests.⁸⁷

Short of systematic activism, institutions may make the occasional attempt to influence management. An institutional investor might think, for example, that a particular acquisition was ill-advised and take steps to oppose it, even if it had no general policy regarding acquisitions. Institutions could, in theory, intervene in firm management on many different matters, but do so according to no predictable plan or policy. This I term "asystematic activism."⁸⁸ I discuss separately below⁸⁹ the

85. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); see also Marlene Givant Star, *Pension Funds Defy Sears' Management*, PENSIONS & INVESTMENTS, May 17, 1993, at 103; Richard W. Stevenson, *Balancing the Power at the Corporate Top*, *British Style*, N.Y. TIMES, Nov. 15, 1992, §3, at 4.

86. See generally Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

87. A categorization of shareholder proposals prepared by the Investor Responsibility Research Center usefully summarizes some of the contours of institutional activism:

<i>Proposal Type</i>	<i>Number of proposals</i>	<i>Average vote (%)</i>
Redeem or vote on poison pill	12	53.7
Confidential voting	13	39.9
Targeted share placements	2	36.0
Vote on future golden parachutes	4	30.7
Repeal classified board	39	35.8
Restrict director compensation	6	29.1
Provide for cumulative voting	35	25.1
Separate CEO & chairman	6	20.1
Independent nominating committee	6	16.0
Restrict executive comp.	37	14.2
Majority of independent directors	3	12.8
Minimum stock ownership	6	12.6
Disclose executive compensation	15	9.8
Board diversity	3	7.7
Shareholder advisory committees	2	6.0

Reprinted in William L. Cary & Melvin A. Eisenberg, *Cases and Materials on Corporations* 249 (7th ed. unabr. 1995).

88. Many forms of activism will fall somewhere between systematic and asystematic activism. CalPERS, for example, targets portfolio firms which it believes are poorly managed. If it uses some systematic method to make this determination, the resulting changes will tend towards systematic activism. Once CalPERS has identified these firms, however, it seems to decide on a case-by-case basis what action it will push upon the firm's management. For example, CalPERS sponsored a

investment strategy of "relational investing," which involves an institution acquiring a significant stake in a particular target firm and then actively participating in that firm's management.

B. Some Examples of Systematic Activism

Systematic activism can take many different forms. In this section, I briefly discuss some non-governance examples of systematic activism in order to introduce some risk-related aspects of this subject. In Part III.C, I will examine some corporate governance-related examples of systematic activism.

1. South African Divestment

A good example of systematic shareholder activism (though prompted by political rather than economic concerns) was the stance of several pension and other funds that they would hold no stock in firms that did business in South Africa.⁹⁰ In their study of the divestment by institutions of South Africa-related stocks, Grossman and Sharpe found that a hypothetical "South Africa free" portfolio performed significantly better than a nondivested portfolio.⁹¹

The main cause of this difference was not directly related to South Africa. Rather, the exclusion of stock in companies that invested in South Africa biased the portfolio toward stock in small-capitalization companies, because so many large-capitalization companies invested there. For reasons that are unclear, small-capitalization stocks outperformed otherwise similar large-capitalization stocks over the relevant time period.⁹² The "South Africa free" portfolio, weighted toward small-capitalization stocks, therefore performed better in the period studied than the portfolio not similarly weighted.⁹³

resolution calling for the board of Boise Cascade to be de-staggered, but it avoided the backroom conspiracy that purportedly forced James D. Robinson to resign as chairman of American Express. See Kinsman, *supra* note 52, at 1-7. Often CalPERS merely asks management to formulate a plan to improve their firm. Moreover, it apparently selects merely ten or so of the approximately 1200 firms in which it invests to focus its activism, or less than 1% of its portfolio in terms of number of firms. See *id.* It would be surprising indeed if *anything* CalPERS could do with respect to 1% of its portfolio would significantly change its expected returns.

89. See *infra* Part III.D.3.

90. See Andrew Rudd, *Divestment of South African Equities: How Risky?*, J. PORTFOLIO MGMT., Spring 1979; at 5; Wayne H. Wagner et al., *South African Divestment: The Investment Issues*, FIN. ANALYSTS J., Nov./Dec. 1984, at 14.

91. See Blake R. Grossman & William F. Sharpe, *Financial Implications of South African Divestment*, FIN. ANALYSTS J., July/Aug. 1986, at 15.

92. For discussions of the small firm effect, see Richard Roll, *A Possible Explanation of the Small Firm Effect*, 36 J. FIN. 879 (1981) and G. William Schwert, *Size and Stock Returns, and Other Empirical Regularities*, 12 J. FIN. ECON. 3 (1983).

93. See Grossman & Sharpe, *supra* note 91, at 25.

This does not mean that "South Africa free" portfolios would always outperform nondivested portfolios. Roberta Romano found that between 1985 and 1989, "South Africa free" funds performed worse than nondivested funds.⁹⁴ This most likely occurred because the small stock premium for this period was negative.⁹⁵ Fund managers engaging in systematic activism regarding South Africa would have thus paid a penalty for their activism in one period, and earned a bonus in another.

For our purposes, this example makes the important point that systematic activism, such as divestment from South Africa, may affect portfolio returns in unanticipated ways. Depending on the period in question, a divested portfolio might have either outperformed or underperformed the market. Even if institutions anticipated this small-stock effect (and I am aware of no evidence that they did), they would not have been able to predict whether the effect would be positive or negative. The effect is not well enough understood to admit of confident prediction.

South African divestment is not unique in its ability to create unanticipated effects. Institutional investors will often be unable to anticipate the effect of systematic activism on portfolio returns. Because the effects of systematic activism can be significant and difficult to anticipate, activism should properly be regarded as risky. Systematic activism can affect returns directly, by imposing corporate policies that themselves make portfolios worth more or less. They can also have an indirect effect, as in the South Africa example, by introducing a bias into portfolio selection. Such a bias will make the biased portfolio perform differently from the market as a whole, and in unpredictable ways.

2. "Economically Targeted" Investments

Another example of systematic activism is the making of so-called "economically targeted investments" ("ETIs"), at least if the scale of the ETIs is large enough measurably to affect the returns of the total portfolio. Despite the name, ETIs are investments made on political, not economic, grounds.⁹⁶ CalPERS, for example, has invested \$100 million in California companies with annual revenues of \$250 million, and entered a partnership to build residential housing in California. Public pension funds of Colorado, Iowa, Minnesota, Missouri, New York, Texas, Vermont, and Wisconsin all have earmarked pension funds for

94. See Romano, *Pension Fund*, *supra* note 12, at 829.

95. See *id.*

96. See generally Julie Bennett, *Pension Funds Hit New Targets; Retirement Funds Are Making Economic Development a Goal*, 61 PLANNING 4 (1995) (description and history of ETI concept).

local job creation.⁹⁷ Forty-six of the 119 largest pension funds in the U.S. invest in ETIs.⁹⁸

ETIs appear to introduce a bias into portfolio selection that has a systematic effect on portfolio performance. Mitchell and Hsin have reported that the investment returns on public-sector pension plans in states with ETI requirements were one percent lower than in states without such requirements.⁹⁹ More importantly in this context is that this practice, if it involves a significant portion of the institution's portfolio, will increase risk because it reduces the geographical or political diversification of the institution's portfolio.

3. *The "New American Workplace"*

The "New American Workplace" policy which has been promoted by the Federal Department of Labor and apparently espoused by CalPERS, provides another example of (at least potentially) systematic institutional activism. Under this policy, the Labor Department is encouraging institutional investors to push the managements of their portfolio companies to adopt policies in favor with the U.S. Labor Department, such as worker training. Labor Secretary Robert Reich urged state pension fund managers to take workplace policies into account in making investment decisions.¹⁰⁰ Testifying before the Securities and Exchange Commission, he suggested that the SEC find ways to encourage companies to disclose workplace practices to shareholders.¹⁰¹ The Labor Department has lavishly praised CalPERS for incorporating a review of workplace policies in its investment reviews.¹⁰²

A systematic rule adopted by an intermediary to encourage portfolio firms to spend more on worker training could introduce bias into its portfolio. It might be, for example, that high-technology firms spend more on worker training than do "low-tech" firms. Depending on the circumstances, weighting institutional portfolio selection toward high-technology firms could be either beneficial or costly. It would, however, certainly expose the portfolio to greater risk by reducing diversification and concentrating investment excessively on one sector of the economy. Or, the policy could simply be wrong, and its systematic application could cause significant losses because it leads to excessive in-

97. *See id.*

98. *See id.*

99. *See* Olivia Mitchell & Ping Lung Hsin, PUBLIC PENSION GOVERNANCE AND PERFORMANCE 5, 15-16 (Pension Research Council Working Paper Series 94-1, 1994).

100. *See Employment Practices: Reich Encourages States to Eye Workplace Practices When Investing*, DAILY LAB. REP. (BNA), at 31 d7 (Feb. 15, 1995), available in Westlaw, BNA-DLR database.

101. *See id.*

102. *See, e.g., Investments: Pension Funds Should View Themselves as Long-Term Company Owners*, Berg Says, 21 Pens. & Benefits Rep. (BNA) 2315 (Dec. 12, 1994).

vestment in worker training. Since neither the Labor Department nor CalPERS really knows how much worker training expenditure is optimal, pressing this policy on portfolio firms would be risky.

All of the above examples—South African divestment, ETIs, and worker-training policies—have a political flavor. The uncertainties that these policies introduce to portfolio performance, however, come not from their specific political content, but from their systematic application to the institution's portfolio. The bias toward small-capitalization stocks in the South African divestment example was caused by the elimination from the portfolio of all stocks issued by firms doing business there. Applying divestment systematically meant that many large-capitalization firms would be eliminated from portfolios and that a bias toward small-capitalization firms would thus be created. This, in turn, resulted in portfolio performance that departed from that of the overall market in unpredictable ways. "Economically targeted" and worker training investment policies could produce similar results, the former by biasing investments geographically or politically, and the latter by biasing investments toward particular industries or in favor of large expenditures on unproven programs.

The same logic applies to systematic activism on corporate governance issues. Corporate law scholars usually debate whether some proposed change in corporate governance would be good or bad for shareholders. I argue in the next section that whether particular changes are good or bad for shareholders is secondary. More important is the incontestable fact that implementing these changes would have uncertain effects. Consequently, they must be appreciated as risky.

C. Systematic Activism, Corporate Governance Issues, and Risk

The connection between systematic activism on corporate governance issues and risk may be illustrated with a simple hypothetical. Suppose a law professor invents some new institutional device or practice that she believes will help the top managements of firms reduce agency costs. Suppose that legislatures enact political model-style reforms, and that a large institutional investor then purchases a substantial percentage of the stock of each of the firms in its portfolio. It learns of the professor's proposal and is persuaded that it will enhance shareholder value. The institutional investor, using its influence as a large shareholder, then persuades each firm in its portfolio to adopt the innovation. Because the institution promotes the new policy with *all* of its portfolio firms, this is a case of systematic activism.

Consider now the possible effects of the policy change. Suppose the institution is a major fund with \$100 billion in equity, and the change increases the value of the institution's equity by one percent.

The institution gains an impressive one billion dollars from the change. What is important to note here is that a very large payoff is achieved because the change is imposed across the board; it affects the value of stock in not just one or a few portfolio firms, but in all of the equity in the fund's portfolio. Through systematic activism, the institution sought to implement a new or revised term in the form contract between the institution and its portfolio firms.¹⁰³ All firms in that institution's portfolio would follow the new policy—they would have a set amount of independent directors, would eschew certain forbidden transactions, or whatever the new policy provided.

Reaping large gains usually requires large risks, however, and systematic activism is no exception. If the innovation turns out to be a mistake, and thus harmful to shareholders, all of the institution's portfolio firms will lose value. The institution's losses may be just as large as the gains for which it hoped. To the extent it makes innovations that are ex ante not certain to increase shareholder welfare—and very few innovations are—systematic institutional activism will necessarily generate risk for the institutional investor. Moreover, because systematic activism theoretically affects the value of all or a substantial portion of the equity in an institution's portfolio, both potential gains and losses from such activism are potentially large.

This risk to which systematic activism on corporate governance issues exposes portfolios is similar to political risk. Investors face political risk when they hold significant assets in any one country; the assets may change in value because of legal or political changes in that country.¹⁰⁴ A foreign government might decide, for example, to impose new taxes that would affect the value of all assets subject to its jurisdiction. Large financial intermediaries often diversify internationally to minimize this sort of risk.¹⁰⁵

If an institution subjects all firms in its portfolio to any one principle or policy, it generates risk similar to that of owning a portfolio that is entirely subject to a single political jurisdiction. A rule change, whether it emanates from a foreign government or from the institutional

103. Black argues that institutions would have economies of scale respecting activism. See Black, *Shareholder Passivity*, *supra* note 2, at 581-84; Black, *Agents*, *supra* note 1, at 818. If this is true, it must necessarily be true that at least some of the proposed changes would be applied across a number of firms.

104. See generally DAVID M. RADDOK, *ASSESSING CORPORATE POLITICAL RISK* (1986).

105. See generally Cheol S. Eun & Sangdal Shim, *International Transmission of Stock Market Movements*, 24 J. FIN. & QUANTITATIVE ANALYSIS 241 (1989); Philippe Jorion, *Asset Allocation with Hedged and Unhedged Foreign Stocks and Bonds*, J. PORTFOLIO MGMT., Summer 1989, at 49; Haim Levy & Zvi Lerman, *The Benefits of International Diversification in Bonds*, FIN. ANALYSTS J., Sept./Oct. 1988, at 56. One of the main risks international diversification attempts to control is currency risk. See Cheol S. Eun & Bruce G. Resnick, *Exchange Rate Uncertainty, Forward Contracts, and International Portfolio Selection*, 43 J. FIN. 197 (1988).

investor itself, will often have an unpredictable effect on the value of assets subject to the change. This increase in risk materializes, moreover, as soon as the institutional shareholder acquires, by reducing diversification or otherwise, the power to impose new rules on its portfolio firms. It need not actually exercise that power, any more than a particular country must actually change governments or pass new laws in order to make assets located there subject to political risk.

D. Replies to Possible Objections

The claim that systematic institutional activism will generate large risks for institutions might provoke various objections. I address some of these objections in the subsections that follow. First, political model proponents could claim that the results of corporate governance reforms would not be significantly uncertain. Second, proponents might argue that reforms would not be systematic in the sense I mean. Third, advocates might also recommend "relational investing." I discuss the consequences of relational investing on risk management separately because it seems to be gaining popularity among political model proponents.¹⁰⁶

1. Results of Corporate Governance Reform Not Significantly Uncertain

First, it might be argued that the reforms the political model suggests shareholders should seek would only increase, and never decrease, the share value of portfolio firms. But unless systematic institutional activism confines itself to proposals certain to increase shareholder value, which are bound to be rare, it must generate significant risks for institutions.

Few of the theories on which corporate-governance-reform proposals are based are actually so certainly true that institutions may implement them systematically—applying them to a substantial portion of the equity in their portfolios—without incurring substantial risk. This may be true even of some theories with wide academic support. A theory that has attained academic acceptance may have been in truth subjected to only cursory scrutiny. Moreover, new theories of corporate governance may inspire activism even before the academic verdict is in. The history of economic thought provides numerous examples of theo-

106. See Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 988 (1994) ("This season's candidate for shareholders' champion is the 'relational investor.'"); see also Louis Lowenstein, Opening Remarks at Conference on Relational Investing, sponsored by The Institutional Investor Project and the Center for Law and Economics, Columbia University School of Law 2-19 (May 6, 1993) (transcript on file with author).

ries once confidently, even dogmatically, followed, then later rejected.¹⁰⁷ Even a small probability that an economic theory is false subjects assets managed according to that theory to substantial risk.

One recent debate over the proper structure of corporate management debate is instructive. Some institutional activists have recently called for the separation of the offices of chairman of the board and chief executive officer. In 1992, institutional investors succeeded, in a much publicized boardroom change, in ousting Robert Stemple as Chairman and CEO of General Motors and replacing him with two men, John Smith as the new CEO, and John Smale, the former CEO of Procter & Gamble Co., as the new chairman.¹⁰⁸ The change was much lauded in the press.¹⁰⁹ Apparently inspired by the event, Securities and Exchange Commissioner Mary Shapiro argued that the United States might learn from the British policy of separating the two posts.¹¹⁰ Prominent lawyers urged corporations to adopt the reform.¹¹¹

Yet recent research by Brickley, Coles, and Jarrell suggests that splitting the posts of chairman and CEO might not have the anticipated effect. According to the research, firms that separated their top posts earned no significant extra market return on average between 1984 and 1991.¹¹² Moreover, markets reacted negatively to the introduction of dual leadership.¹¹³ According to Coles, divided leadership can have costs that outweigh its apparent benefits. CEOs have "specialized knowledge of the opportunities and challenges facing the firm," according to Coles.¹¹⁴ Bringing in an outside CEO forces the other executives to spend time briefing the new officer; even after briefing, the new CEO may still have inadequate firm-specific knowledge. Divided leadership can also

107. See REUVEN BRENNER, *LABYRINTHS OF PROSPERITY: ECONOMIC FOLLIES, DEMOCRATIC REMEDIES* (1994). For an unflattering view of the overselling of various contemporary economic ideas, see PAUL KRUGMAN, *PEDDLING PROSPERITY: ECONOMIC SENSE AND NONSENSE IN THE AGE OF DIMINISHED EXPECTATIONS* 3-18 (1994).

108. See Linda Grant, *GM Shuffle May Be Watershed in Reining in CEOs Leadership*, L.A. TIMES, Apr. 13, 1992, at D1; Robert J. McCartney, *GM Shift May Signal Surge of Outside Director Activism*, WASH. POST, Apr. 8, 1992, at C1.

109. See, e.g., Linda Grant, *Setting a New Agenda for Directors*, L.A. TIMES, Nov. 1, 1992, at D1 ("[A]n influential group of corporate-governance experts and shareholder activists is demanding a shake-up in corporate oversight that would retire the *good-ole-boy network of passive, rubber-stamp directors* in favor of *committed and involved stewards of corporate affairs*." (emphasis added)).

110. See *Outside Chairmen Aren't Worth the Cost*, INVESTOR'S BUS. DAILY, July 26, 1995, at A4.

111. See John Close, *Directors Under The Hot Lights*, AM. LAW., June 1994, at 85 ("The separation of the offices of chairman and CEO is a favorite rallying cry.").

112. See *Outside Chairman Aren't Worth the Cost*, *supra* note 110; see also James A. Brickley et al., *Corporate Leadership Structure: On the Separation of the Positions of CEO and Chairman of the Board*, Bradley Policy Research Center, Financial Research & Policy Studies Working Paper Series (Nov. 29, 1994) (on file with author).

113. See *id.*

114. *Id.*

lead to power conflicts.¹¹⁵ Recently, perhaps deciding that they had made a mistake, General Motors reversed course, decided that "one head was better than two," and reunited the offices.¹¹⁶

These mixed reviews suggest that if institutional investors had had more influence over corporate boards than they actually did, they might have pushed harder for systematic separation of the offices of CEO and Chairman, which might have resulted in substantial losses for their portfolios. The riskiness of activism increases where institutions promote corporate governance reforms on the basis of inadequate evidence. Institutional activists probably overestimate their ability to predict the consequences of their actions. Both the inherent complexity of economic institutions and the overconfidence of political actors belie any claim that institutional activism would, or could, be limited to proposals that were certain to enhance shareholder welfare.

2. Case-By-Case (or "British-Style") Activism and Risk Management

It might be argued that institutions could be active without engaging in systematic activism as I have defined it. Instead, institutions could engage in informal, discrete, *asystematic* activism, each instance of which would be tailored to the circumstances of the particular firms in which the institution invests. According to Professors Coffee and Black, British institutional investors take this approach.¹¹⁷ Top institutional representatives meet on an informal case-by-case basis with top managers of underperforming firms to express their concerns.¹¹⁸

The problem with this sort of activism is not that it generates the same risks as systematic activism; it does not. Rather, the difficulty is that expected returns are much smaller.

When an asystematic institutional activist finds a firm in its portfolio that it believes is underperforming due to poor management, or making especially ill-advised management decisions, it sends institutional representatives to parley with the corporate managers. The representatives apply varying degrees of pressure to the managers, trying to convince them to improve management or change their decisions.

Before responding directly to this objection, it may be worth noting that an institutional investor may not know when a portfolio firm is undervalued specifically because of poor management. Case-by-case ac-

115. See *id.*

116. See Robert L. Simison & Rebecca Blumenstein, *GM Decides One Head Is Better Than Two*, WALL ST. J., Dec. 5, 1995, at B1.

117. See Black & Coffee, *supra* note 1, at 2055.

118. See *id.* at 2054 ("Whenever possible, the [British] institutions prefer to operate in the shadows. The prevailing view, even among activist managers, is that 'secrecy and trust are essential.'" (footnote omitted)).

tivism proceeds on two assumptions: first, that the institution can distinguish good management from bad; second, that it can determine how much any given firm's stock should be worth given the quality of its managers. Of course, the market makes a daily assessment of a firm's management, as reflected in share price. An institution engaged in asystematic activism would in essence be judging whether the market's assessment is correct or incorrect. If the market's assessment is correct, and the firm is worth less than it could be due to poor management, the institution could pursue managerial reforms and cause the share price to go up. If the market's assessment is incorrect, however, the institution would be better served to buy more of the firm's stock, because the share price will go up when the market learns of its misjudgment.

Moreover, if an institution can detect undervaluation due to bad management, it presumably also can detect market undervaluation due to other causes. The managements of a fast-food franchise corporation, an auto company, and a pharmaceutical firm, for example, have only the most general managerial principles in common. The ability to evaluate the "managements" of such diverse firms suggests sophisticated analytical powers that would be highly relevant to evaluating other aspects of the performance of specific businesses as well. If institutions can reliably identify portfolio firms which are underperforming due to bad management, they should, one would think, also have the ability to detect firms which are underperforming for other reasons.

Yet one of the best-established findings of financial economics is that institutional investors have shown no ability whatever to systematically identify firms that the market has undervalued.¹¹⁹ Institutions that engage in active "stock picking," presumably using the same skills an institution would use to locate portfolio firms which were underperforming due to poor managers, do no better on average than passive institutions that "hold the market."¹²⁰ Because institutional investors typically do not improve returns by picking stocks, there is reason to doubt they could improve returns by evaluating management performance and then improving it. In the main, their ability to distinguish good management from bad is questionable.

More importantly, even granting the questionable assumption that institutions are good judges of managerial quality, an asystematic, case-

119. For a classic summary of the evidence, see LORIE & HAMILTON, *supra* note 75, ch. 4; see also John C. Bogle & Jan M. Twardowski, *Individual Investment Performance Compared: Banks, Investment Counselors, Insurance Companies and Mutual Funds*, FIN. ANALYSTS J., Jan.-Feb. 1980, at 33; Richard A. Ippolito, *Efficiency with Costly Information: A Study of Mutual Fund Performance, 1965-1984*, 104 Q.J. ECON. 1 (1989); cf. John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RES. J. 1, 14-18 (arguing that it is unnecessary and unprofitable for trustees to do any stock picking).

120. See Langbein & Posner, *supra* note 119, at 14-18.

by-case approach to activism is unlikely to increase expected returns on institutional portfolios. The CAPM holds that expected returns from a portfolio vary with the market risk to which the portfolio is exposed. In a broadly diversified portfolio, the performance of one portfolio firm will have nearly no effect on the expected returns of the entire portfolio, because the portfolio is made up of holdings in many firms. Most institutions are very broadly diversified, and so it is extremely unlikely that reforming the management of one or a few portfolio firms will have any measurable effect on the whole portfolio. Changes in firm-specific returns are unlikely to affect overall portfolio returns.

Even if institutions actually improve the managements of the particular firms they target, they should not expect to increase returns on their portfolios, so long as they target only a small part of their portfolios.¹²¹ CalPERS, for example, apparently focuses its activism on less than one percent of total number of firms in its equity portfolio.¹²² It is difficult to see how anything it could do with respect to that proportionally tiny part of its portfolio could appreciably affect its expected return.¹²³ The result of "British style" activism would probably be similar. Occasional intervention with firms on a case-by-case basis is one drop in a very large ocean. Systematic activism, where an institution imposes a managerial change on all or most firms in its portfolio, would increase firm-specific risk, and might also increase portfolio returns if the change turned out to be positive. As I have explained above, however, this strategy is risky.

One way to give some teeth to asystematic activism would be to monitor actively only a few firms, but also increase the institution's investment in those firms, so that any increase in firm-specific returns was not diversified away. This is the strategy of "relational investing," which I discuss in the next section. As I will explain, it has consequences for risk management similar to those of systematic activism. As with any activist strategy, relational investing will increase risk-

121. Public funds such as CalPERS may indulge in more activism because the taxpayers, rather than a private sponsoring corporation, ultimately bear the increased risk. See Romano, *Pension Fund*, *supra* note 12, at 811-12; see also John H. Langbein, *The Conundrum of Fiduciary Investing Under ERISA*, in *PROXY VOTING OF PENSION PLAN EQUITY SECURITIES* 128 (Dan M. McGill ed., 1989). CalPERS has also directed its attention to passive index investing, arguing that it may not be consistent with pension fund manager's fiduciary duties. See *Indexing Fingered*, *ECONOMIST*, Apr. 30, 1994, at 84, 87 (citing CalPERS, *AN OUNCE OF PREVENTION: MEETING THE FIDUCIARY DUTY TO MONITOR AN INDEX FUND THROUGH RELATIONSHIP INVESTING* (1994)).

122. See Kinsman, *supra* note 52, at I-7.

123. Thus CalPERS-style activism might be viewed as a form of "on-the-job consumption" for CalPERS officials, analogous to the corporate jets and other perquisites consumed by corporate managers. Ironically, curtailment of such perquisites is one of CalPERS' missions as an activist investor. Cf. Demsetz, *supra* note 12, at 379 (on-the-job consumption may be a form of executive compensation).

management costs, and increased costs will ultimately put relational investors at a disadvantage to passive institutions.

3. *Relational Investing and Risk Management*

Corporate governance reformers have recently focused attention on "relational investing": the practice of owning a large equity stake in a firm and participating actively and over the long term in its management. Some political model proponents think relational investing could reduce the high agency costs they attribute to excessively autonomous management and overly passive investors.¹²⁴ In this section I explain that relational investing raises an institutional risk-management problem similar to that raised by systematic activism. It is therefore an inappropriate strategy for institutions.

The reasons for the problem with relational investing are straightforward. Under the CAPM, we know that the expected firm-specific return from a very broadly diversified portfolio is (close to) zero. This is because firm-specific factors that cause firms to enjoy higher or lower returns, which are not attributable to overall market movements, will cancel each other out in a widely diversified portfolio. A broadly diversified institution is very likely to find that its efforts to improve the managements of particular firms make no measurable difference in overall returns to its portfolio.¹²⁵ This should not surprise us. Efforts to

124. See, e.g., Black & Coffee, *supra* note 1, at 2055-59; Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985 (1993). For an effort to define "relational investing" and categorize different types of it, see Ian Ayers & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033 (1994).

125. For example, one study suggests that so far CALPERS' shareholder activism has produced no measurable improvements in returns to its overall portfolio. See Romano, *Pension Fund*, *supra* note 12, at 830. Romano notes that "[l]ittle can be concluded" from "the failure to find a relation between activism and fund performance" in her study. *Id.* But if activism is concentrated, CalPERS-style, on a tiny percentage of portfolio firms, it would be surprising if it did have any measurable effect. One cannot change the flavor of food by adding two or three grains of salt. Two studies, one by Wilshire Associates and the other by the Gordon Group, have purported to find that institutional activism increased returns on activist stakes in targeted companies. Gordon Group, *Active Investing in the U.S. Equity Market: Past Performance and Future Prospects* (1993); Steven Nesbitt, Wilshire Associates, *Long Term Rewards from Corporate Governance* (Nov. 1993). See *Reluctant Owners*, ECONOMIST, Jan. 29, 1994, at 16 (asserting that reports produced by paid consultants should be viewed with some skepticism.)

A recent academic study, Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227 (1996), does find that during the period between 1987 and 1993, CalPERS invested \$3.5 million in activism, on which it received a return of almost \$19 million. By my calculations, this is about three times the rate of return on the S&P 500 during the same period. I find Michael Smith's conclusions unpersuasive, however. First, they are based on event studies with worryingly long event windows. The increases in activism-target stock prices yielding the high returns occurred over event windows which had a mean length of 21 days. See *id.* at 242. Smith's analysis of the data over more conventional and shorter event windows of two days produced no significant cumulative abnormal returns attributable to CalPERS activism. See *id.* at 243. Equally

improve firm-specific returns are likely to be lost in the random variation of firm-specific returns around their expected value of zero.

The proponent of relational investing might argue that relational investing is rational if the gains brought about by participation in the firm's management exceed the costs of monitoring and participating in a firm's management.¹²⁶ An advocate might argue that it obviously makes sense for a relational investor to spend one million dollars in monitoring costs for an expected return of more than one million dollars. This seems accurate regardless of whether the change affects the expected return of the portfolio or not.¹²⁷ But this approach is wrong, or at least incomplete.¹²⁸ The relevant cost for the institutional investor is not simply the outlay for activism expenses, but the opportunity cost of the investment in activism. Relational investment supporters must claim that one million dollars spent on activism will yield greater returns than putting the same one million dollars into the S&P 500 or some similar passive investment. Moreover, the returns to activism must presumably be not only greater, but quite significantly greater than the market return, for they must compensate the relational investor for its exposure to firm-specific risk, which the passive diversified institution does not have to bear. Yet even otherwise-sophisticated assessments of returns to relational investors neglect these basic points—that the relevant cost is opportunity cost, and that returns must be judged in light of risk.¹²⁹

When relational investors intervene in the managements of particular firms, they presumably do so because they expect net gains from the intervention. These gains, however, will come only at the cost of bearing additional firm-specific risk. For example, suppose a relational investor convinces a particular firm to adopt a new policy regarding executive compensation. There is always the risk that the policy is a

troubling is the estimate of how much CalPERS spends on activism. For amounts spent by CalPERS on activism, Smith uses a frequently cited, but in my view unreliable, figure—only \$500,000 per year. This figure apparently traces to a Wilshire Associates report. See Paul Sweeny, *How CalPERS Can Ruin a CEO's Day*, GLOBAL FIN., Feb. 1993, at 35. The figure is implausibly low, and was produced by consultants to CalPERS with little incentive to find these costs to be high. It has not, to my knowledge, been independently audited. The real costs of CalPERS' activism might be greater if measured independently.

Studies cited by Black to the effect that concentrated shareholdings by investors are correlated with higher returns may support the conclusion that entrepreneurial involvement in firms increases returns, but not necessarily that relational investing by pension funds and similar institutions increases returns. See Black, *supra* note 11, at 917-24.

126. See, e.g., Jill E. Fisch, *Relationship Investing: Will it Happen? Will it Work?*, 55 OHIO ST. L.J. 1009 (1994).

127. Advocates of relational investing stress that various techniques might reduce relational investors' monitoring costs and therefore make this strategy cost-effective. See Gilson & Kraakman, *supra* note 85 (arguing that institutional investors should elect professional directors to represent their interests on corporate boards).

128. See, e.g., Smith, *supra* note 125, at 251.

129. See, e.g., *id.*

mistake; policies applied to particular firms are no more probably correct than are policies applied to whole portfolios. Executives might seem to be paid too much, but the relational investor might simply be ignorant of good reasons for the apparently high level of compensation. High salaries might be the prizes that provide incentives for lower-level executives, or they might compensate for risks peculiar to the firm or industry.¹³⁰ If the proposed reform turns out to be a mistake, the value of the institution's relational investment will decline. If the institutional investor does not know *ex ante* for certain that the policy is not a mistake, imposing it on a particular firm in which it holds a large stake will be risky.

In a very broadly diversified portfolio, the riskiness of the intervention into the management of a particular firm will not matter, as I mention above, because any increase or decrease in the firm-specific risks or returns of a particular firm will probably be diversified away, "washed out" by variation in the firm-specific returns from the many other firms in the portfolio.

Indeed, it might be this very opportunity to intervene in the managements of leading U.S. corporations—to be a "player," without risking any major detrimental effect on the diversified institution's overall returns—that makes CalPERS-style activism so irresistible to directors of public pension funds. Fund managers such as CalPERS officials Dale Hanson, DeWitt Bowman, and Jose Arau could "[gain] power in boardrooms around the world"¹³¹ while the results of their actions remained thoroughly hedged by the broad diversification of the fund they represented. For such officials, it must seem nearly a no-lose proposition. Exercising this unaccountable power might be termed "recreational activism."

But now consider the relational investor which wants its overall portfolio return to be measurably affected by the policy change it wishes to impress on a particular portfolio firm. To make any appreciable difference, the relational investor must have a large enough stake in the particular firm, so that changes in firm-specific returns are not diversified away. To do so, however, the relational investor must bear significant firm-specific risk, including the risk that the proposed policy change may reduce shareholder wealth.

Relational investors, at least under one definition of the term, tend not to be broadly diversified. Rather, they invest some significant por-

130. See Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841 (1981).

131. Sweeny, *supra* note 125, at 35.

tion of their total portfolio in particular portfolio firms.¹³² These relational investors do not have firm-specific risk that approaches zero. Instead, they maintain, by institutional standards, underdiversified portfolios. Consequently, their returns will depart unpredictably from market returns. An institution that wishes to increase its firm-specific risk, however, will have to obtain some form of insurance against this risk. As noted above, obtaining such insurance would create moral hazard problems. Customers will have the same problems explained in Part II above: institutional relational investors would face insurance and reserve maintenance costs which their passive rivals can avoid.

This is a simple point, but it is still important. If institutional relational investors want positive firm-specific returns, they must bear firm-specific risk. They will not be able to diversify this risk away. As soon as they bear this risk, however, they must take steps to insulate their customers from it, and this will be costly. Institutional relational investors could probably take some steps regarding particular firms that would increase their firm-specific returns from those firms, but expose them to very little risk. Institutional investors can presumably push for the removal of officers who are embezzling corporate funds or who have become mentally incompetent with very little risk. More importantly, advocating the removal of poison pills and anti-takeover laws that completely insulate managers from the corporate control market might be an example of a reform supported so overwhelmingly by the evidence as to be virtually risk-free. Such risk-free opportunities for gain, however, are notoriously scarce. To the extent that any really do exist in the area of corporate governance reform, institutions would probably exhaust them quickly and face more difficult choices of undertaking relational investment strategies that promise returns but also involve substantial risks.

To the extent that relational investment affects expected portfolio returns, it will generate risks. Institutional customers will insist on being insulated from these risks. Relational investors will find it at least as difficult to insulate their customers from these firm-specific risks as from the risks created by systematic activism, if not more so. Both systematic activism and relational investing would expose institutional portfolios to risk that would be costly to manage yet difficult to pass through to customers, who could take their business to passive institutional rivals.

The moral hazard problems that arise with systematic activism are present in equal measure with relational investing. If institutions turned to risk-capital reserves to insulate their customers, the reserves would have to be very deep to assure customers that their guarantees would not

132. See LOUIS LOWENSTEIN, *SENSE AND NONSENSE IN CORPORATE FINANCE* 211-17 (1991) (description of DuPonts and Warren Buffet as relational investors).

be exposed to the intractable risks of activism. Institutions that provide guaranteed financial products to customers, therefore, will probably be at a competitive disadvantage to their passive rivals if they engage in relational investing to any degree that affects the expected returns of their portfolios. The prospect of competitive disadvantage suggests that as long as institutional arrangements are subject to competitive markets, financial intermediaries are unlikely to become systematic activists or relational investors on the scale imagined by political model advocates. (This does not mean, of course, that institutions will not engage in the type of "risk-free" activism described above, allowing their officers to enjoy the perquisites of an activist role without actually significantly increasing the risk exposure of the institutional portfolio.)

IV

RISK-MANAGEMENT PROBLEMS UNDER THE POLITICAL MODEL

In Parts II and III above, I argue that political model-style activism would increase the riskiness of institutional portfolios in several ways. First, it would require institutions to hold less diversified portfolios, which would reduce the confidence institutions could have in their predictions of portfolio performance. This would make planning less reliable and require greater expenditures on reserves or insurance to protect customers against increased risk. Second, this underdiversification would create an additional risk, analogous to political risk. By investing in only a few firms, an activist institution would be similar to a corporation holding its assets in too few countries; if a country changed governments or altered its laws, the value of the corporation's assets could be dramatically altered. With systematic activism the principle is the same but changes would emanate from the institution itself, rather than from a foreign government. Third, neither asystematic activism nor relational investing holds much promise for institutions. Asystematic activism is unlikely to have much of an effect on portfolio value, and relational investing would generate profound firm-specific risks both from underdiversification and the chance that the institution was promoting an unwise policy. These risks would be quite costly for institutions to manage.

Given that the political model-style activism increases risk, activist institutions would have to find ways to manage the additional risk. In this Part, I discuss various risk-management techniques. I evaluate the practicality of managing risk through portfolio insurance, the maintenance of risk-capital reserves, government guarantees and, finally, what I call "experimental" activism. Institutional activism would pose significant obstacles to all these risk-management strategies.

A. Portfolio Insurance

In recent years, portfolio insurance has become an important risk-management tool for financial intermediaries. In this Part, I explain how portfolio insurance works, and how the moral hazard and adverse selection problems caused by institutional activism would make portfolio insurance costly for activist institutions.

1. How Portfolio Insurance Works

Classic portfolio theory advises investors to adjust the riskiness of their portfolios by diversifying risky assets and combining them with risk-free assets (or borrowing at the risk-free rate) to achieve the optimal level of risk exposure for a given rate of return.¹³³ But the value of such a portfolio still varies with that of the market. The value of even a perfectly diversified portfolio could still decline greatly if the whole market declined greatly. To protect against the risk of decline in overall market value, an investor could substitute risk-free assets (such as U.S. Treasury bills) for some of the equity in her portfolio. This strategy, however, has an opportunity cost: if the market surges upward, the investor will not get the benefit of the increase. No static combination of liquidity and diversification can simultaneously insulate the investor from losses due to market declines and allow participation in gains due to market increases. This is what portfolio insurance adds to risk management; it allows investors to construct a portfolio that participates in up-side gains but not down-side losses.¹³⁴

Financial economists invented portfolio insurance in the 1970s.¹³⁵ Portfolio insurance proved very appealing to institutions. It became practical when economists realized, first, that an "insurance policy" for a stock portfolio would be the equivalent of holding a put option on that portfolio. A put option allows the holder of the option to sell some underlying asset to the option seller at a set price on or before a specific time.¹³⁶ With a put option, an investor can in effect sell her stock at the exercise price of the option, even if its market price falls below the exercise price. Portfolio insurance in concept is nothing but a put option on a whole stock portfolio. Economists reasoned, second, that put options

133. See MERTON, *FINANCIAL INNOVATION*, *supra* note 18, at 17.

134. See *id.*

135. See Hayne E. Leland & Mark Rubinstein, *The Evolution of Portfolio Insurance*, in *PORTFOLIO INSURANCE: A GUIDE TO DYNAMIC HEDGING* 3 (Donald L. Luskin ed., 1988). For a good popular account, see PETER L. BERNSTEIN, *CAPITAL IDEAS: THE IMPROBABLE ORIGINS OF MODERN WALL STREET* 269-94 (1992).

136. The transactions are described as taking place directly between an option seller and buyer for convenience. In the real world, contracts are completed through an intermediary clearing house and settled in cash. See REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS VI-26 to 28 (1988) [hereinafter *MARKET MECHANISMS*].

on portfolios, which were then unavailable, could be simulated through "dynamic hedging" (which I explain further below).

A simple example illustrates how an investor can use a put option to insure the value of a portfolio. Suppose the investor buys a put option that gives her the right to sell her portfolio to the option seller at an exercise price of one million dollars. With the option, the most she can lose if the market value of her portfolio declines is the difference between the value of the portfolio when she bought the option and the exercise price of one million dollars. If the stock portfolio was worth \$1.2 million when she bought the put option, but then declines so that it is worth only \$500,000, the investor can "put" her portfolio to the option seller—make the seller buy the portfolio—for the exercise price of one million dollars. The put option thus limits the portfolio owner's loss to \$200,000, much less than the \$700,000 loss she would have suffered without the option.

This insurance is not free, of course. The "insurance premium" is the cost of buying the put option. The "deductible" of the insurance policy is the difference between the value of the portfolio at the time of option purchase and the exercise price.¹³⁷ As with other insurance, the greater the deductible (the further the option is "out of the money"), the less expensive the option will be, all other things equal; a lower deductible means a more expensive purchase price.¹³⁸

Portfolio insurance techniques have become more sophisticated as financial derivative markets have matured.¹³⁹ When economists Leland and Rubenstein invented portfolio insurance, there was no liquid market, as there is today, for put options on portfolios of stock.¹⁴⁰ They invented "dynamic hedging" to simulate the effect of holding a put option on a stock portfolio. The basis for dynamic hedging was their insight that if, as the Black-Scholes option pricing model demonstrated, the payoff of an option was identical to that of a portfolio containing a particular combination of the risky asset underlying the option and a riskless asset

137. For an introduction to options, see James B. Bittman, *Fundamentals of Options*, in *OPTIONS: ESSENTIAL CONCEPTS AND TRADING STRATEGIES* 29 (The Options Institute ed., 1990). For the basics of stock index options, see *MARKET MECHANISMS*, *supra* note 136, at VI-19.

138. See *MARKET MECHANISMS*, *supra* note 136, at VI-26.

139. A derivative is simply a security whose value is a function of the value of some other "underlying" security. For an overview of the growth of new derivative financial instruments, see John D. Finnerty, *An Overview of Corporate Securities Innovation*, *J. APPLIED CORP. FIN.*, Winter 1992, at 23. Merton has a theory of the dynamics of institutional change in financial markets and institutions. "[A]s products like futures, options, swaps, and securitized loans become standardized and move from intermediaries to markets, the proliferation of new trading markets in those instruments makes feasible the creation of new custom-designed financial products that improve 'market completeness.'" SCOTT P. MASON ET AL., *CASES IN FINANCIAL ENGINEERING: APPLIED STUDIES OF FINANCIAL INNOVATION* 19 (1995).

140. See Leland & Rubinstein, *supra* note 135, at 3-4.

such as cash, then the converse must also be true.¹⁴¹ That is to say, the payoff of holding the particular combination of the underlying risky asset (stock) and the riskless asset (cash) would be the equivalent of holding an option on that risky asset. Thus holding a particular combination of stock and cash allowed the portfolio manager to simulate holding a put option on a given stock portfolio.

In simplified terms, a portfolio manager engaged in dynamic hedging decides on a floor below which she will not permit the value of the equity portfolio to fall. This floor is the exercise price of the synthetic put option. If, and as, the market value of the risky assets in the portfolio declines, the manager gradually sells stock for cash. By the time the market value of the risky portfolio reaches the floor, it has been converted entirely into cash, and can fall no further in value. If, and as, the market value of the portfolio increases, the manager can use up cash to buy stock. At a given market level then, the portfolio will be fully converted to stock. The investor would then fully benefit from any increase in the market value of the stock above that point. This strategy requires complicated trading; it also calls for sophisticated quantitative analysis in order to figure out exactly what combinations of risky and riskless assets are required to simulate options under the Black-Scholes model.

With the development of stock index options and futures, portfolio insurance has become easier to implement.¹⁴² Index options, for example, now allow fund managers to take positions on well-known indexes such as the Standard & Poor's 500. The increase in the popularity of portfolio insurance is evidenced by the emergence of intermediary clearinghouses, which have become increasingly important risk-management institutions in the global economy.¹⁴³ Sellers and buyers who wish to manage risk may sell or purchase options and futures through the clearinghouse.

2. Institutional Activism and Portfolio Insurance

Institutional activism on the scale imagined by the political model would make it very hard for institutions to obtain portfolio insurance. First, an activist institution would have to maintain portfolios less diversified than the market as a whole. This would prevent those institutions

141. *Id.* at 4. Michael R. Granito, *The Intellectual Origins of Portfolio Insurance*, in PORTFOLIO INSURANCE: A GUIDE TO DYNAMIC HEDGING, *supra* note 135, at 197, puts this innovation in its theoretical context.

142. For an interesting and thorough account of the development and functioning of options and futures, see Lewis D. Solomon & Howard B. Dicker, *The Crash of 1987: A Legal and Public Policy Analysis*, 57 FORDHAM L. REV. 191 (1988).

143. Interestingly, financial options exchanges guarantee the performance of contracts traded on their exchanges. See MERTON, OPERATION & REGULATION, *supra* note 18, at 42.

from using options on indexes such as the S&P 500 as portfolio insurance. The institutions could still buy put options on the individual stocks in their underdiversified portfolios, but as insurance this would be more expensive and less effective. Second, the portfolios of activist institutions would be less liquid than those of their passive rivals. This would interfere with the practice of dynamic hedging, which requires the ability to convert stock to cash and vice versa, or to engage in equivalent transactions on the futures market, in accord with prescribed formulas. Third, and most importantly, institutional activism would create a moral hazard problem. Portfolio insurers—put option sellers—would likely respond to this hazard by charging activist institutions more for the insurance, or refusing to sell insurance to those institutions at all. Fourth, institutional attempts to avoid the moral hazard problem through dynamic hedging would be thwarted by an interesting version of the adverse selection problem.

a. Index Options and Institutional Activism

Index options and futures play an important role in portfolio insurance. But when an institution reduces diversification in order to play a more activist role, it becomes less assured that the performance of the risky portion of its portfolio will equal that of the market. If the institution is not "holding the market," an index put option will not insure its assets very accurately. Instead, the institution will have to obtain portfolio insurance through a series of individual options on the securities that make up its portfolio. Index options provide far more efficient portfolio insurance than options on the individual assets in the portfolio.¹⁴⁴ The pattern of returns and the cost of an option on a portfolio of assets are fundamentally different from those of a portfolio of options on the same underlying assets.¹⁴⁵ Any institution unable to insure its portfolio through index options would have to embrace costlier options in order to provide assurance to its customers. Underdiversification and activism increase risk-management costs.

144. The history of the Chicago Board Options Exchange illustrates how index options tend to replace options on individual securities. As Gammill and Perold relate, the trading volume of the OEX, a stock index option based on the S&P 100, exceeded the combined volume of options traded on individual stocks within two years of its introduction in 1983, and this combined volume declined and remained below its 1982 level. See James F. Gammill, Jr. & André F. Perold, *The Changing Character of Stock Market Liquidity*, J. PORTFOLIO MGMT., Spring 1989, at 13, 15.

145. See Robert C. Merton et al., *The Returns and Risk of Alternative Call Option Portfolio Investment Strategies*, 51 J. BUS. 183, 214-27 (1978); Robert C. Merton et al., *The Returns and Risks of Alternative Put-Option Portfolio Investment Strategies*, 55 J. BUS. 1, 41-42 (1982).

b. Dynamic Hedging and Institutional Activism

An activist institution would have to hold bigger blocks of stock for longer periods of time in firms it wished to influence.¹⁴⁶ But when an institution holds such large blocks of stock, it will find it more difficult to manage risk through dynamic hedging. First, if firm managers know that, in keeping with the practice of dynamic hedging, institutions may liquidate their investment in the firm at any time, managers may be more likely to resist institutional influence. Second, changes that institutions press on management may also affect share price only over the long term, if stock market prices do not accurately reflect long-term firm value, as political model proponents sometimes assume. Institutions are less likely to press for such long-term changes if they know they may be forced to sell their stock sooner because of a risk-management strategy. Third, larger blocks of stock are difficult to liquidate, as required by dynamic hedging, without depressing the market price. As I discuss below, this happens in part because it can be difficult to convince the market that the sale is an "informationless trade"—that is, a trade purely based on a predetermined trading rule designed to create portfolio insurance or raise cash for current obligations, rather than based on inside information that the stock may be overvalued.¹⁴⁷ By choosing activism, the ability of an institution to engage in dynamic hedging, one of its most promising risk-management strategies, would be severely compromised. Holding the market and insuring with index options or their equivalent avoids this problem.¹⁴⁸

c. Moral Hazard and Institutional Activism

As explained above,¹⁴⁹ insurers expose themselves to loss due to moral hazard when they insure persons for whom the insurance creates incentives to behave in ways that make them uninsurable, at least at the premium charged, and perhaps at any premium. If insurers sell insurance to buyers afflicted by moral hazards, they will rationally charge higher premiums, impose higher deductibles, or insist on other terms to control the hazard.¹⁵⁰ If a rational insurer cannot correct for the hazard with these steps, it will exit the market.

Systematic institutional activism would make equity portfolios subject to increased risk and create a moral hazard for portfolio insurers. Suppose that an institution owns an influential stake in a firm's eq-

146. See John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1318 (1991).

147. See MERTON, *FINANCIAL INNOVATION*, *supra* note 18, at 18.

148. See *id.*

149. See *supra* text accompanying notes 79-80.

150. See MILGROM & ROBERTS, *supra* note 16, at 185-90.

uity and wants to insure its investment in that firm. The institution obtains insurance, and thus does not bear any downside risk—beyond the deductible of the insurance policy—of losses in stock value due to misguided attempts to reform the firm's management. It still stands to benefit, however, from any gains in stock price due to successful intervention in management.

When an institution can participate in gains, but not the losses, that result from the policies it imposes, it has perverse incentives. It might, for example, pursue particularly risky changes that no uninsured institution would approve. These changes might subject a firm in the institution's portfolio, or even its whole portfolio, to substantial risk. The institutional investor would be no worse off than before since its position, by hypothesis, is fully insured.

This logic applies to both relational investors and systematic activists, who seek insurance for their entire stock portfolios.¹⁵¹ Systematic activism increases the riskiness of portfolios, making them less insurable because of moral hazard. Insurers will anticipate this moral hazard and adjust insurance costs accordingly.¹⁵² They may increase premiums, increase deductibles, impose other terms to control moral hazards, or refuse to insure at all.

151. I anticipate an objection here. It is probably true that diversified shareholders of a hypothetical XYZ Corporation should be indifferent to whatever steps the institutional monitor decides to take that makes the returns to XYZ stock riskier, so long as those changes increase the net present value of the stock. My point here, however, is that institutional activists under the political model are supposed to apply changes to firms in their portfolios across the board. So even if the (other) diversified shareholders in each of those portfolio firms would be indifferent to these changes, the customers of the financial intermediary monitor firm would not be. If the monitor is applying policy changes to all or a significant part of its portfolio—engaging, that is, in systematic activism—it increases the riskiness of its portfolio, and insuring against *this* increase in risk is subject to moral hazard, because the institution can increase this riskiness at will. It is important to bear in mind that we are discussing the insurance of *portfolios* here; insuring positions in individual stock is discussed here only for purposes of analogy. I have discussed "relational investing" above. See *supra* Part III.D.3. A relational institutional investor would increase the riskiness of the returns of a particular stock with activism, but the relational investor would be holding so much of that particular stock in its portfolio that increasing the riskiness of the stock's returns would also increase the riskiness of the portfolio.

152. It might be argued that insurers will not be able to appreciate fully the risks caused by systematic activism and relational investing. I do assume that insurance markets are efficient and that insurance prices would adjust accordingly. However, if insurance markets are not efficient, then financial intermediary activists might be able to get portfolio insurance at below-efficient market rates. At the extreme, the excessive risk-taking brought on by the illusion of insurer liquidity can lead to a collapse when the relevant market discovers this misestimation of risk. Arguably, something of this sort might have happened in October of 1987. By one account, portfolio insurers overestimated the liquidity of the stock index futures market, assuming they could hedge their equity positions by selling stock index futures. When no buyers could be found in the futures market, however, institutions found themselves with stock positions they never would have taken had they known they could not really insure against their downside risk. See *MARKET MECHANISMS*, *supra* note 136, at 55-56. My point is merely that a market failure in the insurance market would not make the problem go away. The problem would merely reappear elsewhere, possibly in a more alarming form.

It is possible that the benefits from institutional activism would be so great that institutions would bear these substantial cost increases or forego portfolio insurance entirely. An alternative story, however, is more plausible: institutions might choose to remain passive shareholders and insure their portfolios at lower rates.

Any attempt at activism will signal an increase in risk to insurers, and insurers will respond (unless the market is anonymous) by charging higher prices for insurance. Insurers might even insist that institutions guarantee their passivity contractually. For example, an institution could adopt a charter amendment or other contractual device mandating wide diversification. It might agree to buy only non-voting stock, to assign its votes by proxy to another party, or to execute a shareholder's agreement prohibiting it from attempting to influence corporate management. The least costly way for an institution to assure insurers of its passivity would be to remain highly diversified.

Institutional investors will always need insurance or some equivalent mechanism to assure customers of their creditworthiness. Even if political model reforms were adopted, therefore, the need for insurance will be one powerful incentive for institutions to remain highly diversified and passive. It is unlikely that removal of legal barriers would result in institutional activism of the sort the political model would seem to predict.¹⁵³ The moral hazard problem caused by activism is one major reason why.

d. Adverse Selection Problem

Faced with increased insurance costs because of the moral hazard problem described above, an activist institution might try dynamic hedging as a form of self-insurance on its portfolio. To engage in dynamic hedging, an investor must maintain a certain ratio of risky securities—stock, most commonly—and a riskless asset—cash or certain types of bonds. The ratio of the two depends on the price of the stock. If implemented smoothly, dynamic hedging produces returns identical to those of an insured portfolio. Such a strategy, however, would give rise to an interesting kind of adverse selection problem.

In the typical adverse selection problem, insurers cannot adequately distinguish between good and bad insurance risks. The problem has two primary sources: potential insurance buyers may be unable to signal credibly that they are good insurance risks, and insurers normally lack reliable substitute risk-detection mechanisms. To guard against

153. Coffee also argues that institutional passivity is not caused by regulation, but has "extra-legal" causes. However, my account is quite different from that of Coffee. See Coffee, *supra* note 146, at 1317-28.

mistakes, insurers have to charge higher premiums or not sell insurance at all.

Activist institutional investors would face a similar problem. Self-insurance through dynamic hedging would require institutions to adjust continuously the amount of stock and cash in their portfolios, selling stock for cash and buying stock with cash, depending on the changing value of the stock. But when activist institutions involved in corporate governance sold or bought stock in their own portfolio firms, as dynamic hedging requires, the market would not perceive the transactions as informationless trades. Rather, the market would infer from sales that the institutional investor believed the stock was overvalued for some reason that was not yet public knowledge.¹⁵⁴ As a result, prospective buyers would discount their bids. By the same token, the market would infer from an institutional buy order that the stock was undervalued, possibly because of inside information about undisclosed increases in the true value of the stock. To compensate, sellers would increase their asking prices. Unless an activist institution could signal convincingly that its trades were merely informationless portfolio-insurance transactions, it would have to bear transaction costs in the form of excessively low sell prices and high buy prices.¹⁵⁵

These increased transactions costs—taking the form, in effect, of higher insurance premiums—are an example of adverse selection costs. By contrast, a passive institution could match its portfolio to the market and implement portfolio insurance by selling and buying securities representing whole indexes, such as the S&P 500. Since the passive institution obviously has no inside information on the future operations of a broad market index, such selling and buying would not signal the possession of inside information. Compared to passive institutions, activists would have to pay larger insurance premiums, even if they insured through dynamic hedging, and would be at a competitive disadvantage to their passive rivals.

154. If activist institutions had no special access to information, selling might still have this effect, since potential buyers would worry whether the sale was intended to hedge against the risk of some risky governance action the seller was planning. That is, information about the intentions of the influential shareholder is always salient. For example, when relational investor Warren Buffett reduced his stake in the Salomon Brothers investment bank, its stock tumbled. See *Salomon Posts \$268 Million Gain In 3rd Quarter; Buffett Cuts Stake*, ASIAN WALL ST. J., Oct. 20, 1995, at 24.

155. An example of this phenomenon is the decrease in stock price that accompanies the issuing of equity to raise capital, which tends to signal that the issuing corporation thinks equity is overvalued. See Kenneth A. Froot et al., *A Framework for Risk Management*, HARV. BUS. REV. Nov.-Dec. 1994 at 91, 94 (citing Paul Asquith & David Mullins, *Equity Issues and Offering Dilution*, 15 J. FIN. ECON. 61 (1986)).

B. Risk-Capital Reserves

After insurance, the second main way that institutions can protect their customers against default risk is by raising risk capital from investors. This creates a reserve to cover any shortfall between the value of the institution's portfolio and its liabilities to customers.¹⁵⁶ But as corporate law scholars are well aware, raising equity capital generates substantial agency costs. Investors in financial intermediaries usually enjoy limited liability. Because their exposure in the event of a loss is limited, and they have the residual claim to any surplus remaining after customer liabilities are satisfied, investors have incentives similar to those of financial intermediary decision-makers afflicted by moral hazard. They are likely to expose the portfolio to excessive risk because their share of surplus will probably be greater than their share of any shortfall.

Sophisticated creditors in a similar quandary could limit their exposure by imposing strenuous financial covenants on borrowers that give lenders considerable control over managerial risk-taking activity. Financial intermediary customers are typically not this sophisticated, however, and may have greater trouble keeping close tabs on intermediary managers. Even so, they may still understand that investors lack adequate incentives to assure that the institution's guarantees to customers will always be honored. To safeguard their money, the customers may implement various monitoring mechanisms and regulatory strategies.¹⁵⁷ But even if monitoring worked well—which is by no means certain—intermediary activism would still create the difficult risk-management problems described above. Broad diversification by financial intermediary institutions seems to be a natural solution to the conflict of incentives between financial customers and the investors who provide institutions with risk capital.

Of course, monitoring does not always work well. Monitors of activist institutions will face the difficult task of assuring customers that the institution's risk-capital reserves are deep enough so that customers will be insulated from activism-related shortfalls in portfolio value. It is quite unclear exactly how or even if this difficult task can be accomplished.

For an equity cushion to insulate customers from risk successfully, the cushion must be at all times at least equal to, and preferably greater than, the potential shortfall. In a world where asset values and risk ex-

156. See Merton & Bodie, *Financial Guarantees*, *supra* note 18, at 90.

157. Monitoring mechanisms familiar to corporate lawyers include decision-making formalities, fiduciary duties, derivative law suits, shareholder voting procedures and the corporate-control market. See generally MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 172-577 (1995). Another approach, used historically by banks, is the relaxation of limited liability. See Macey & Miller, *supra* note 9.

posures are constantly changing, maintaining such a cushion is a formidable task even where risks are relatively quantifiable.¹⁵⁸ For activist institutions, however, risk exposure would not be quantifiable, because the firm-specific and quasi-political risk created by activism is intractable. Nobody has a clear idea in advance how large the gains or losses from an activist strategy might be. Nor is there a theory that predicts the magnitude of these potential gains and losses, as, for example, CAPM does for portfolios with various exposures to market risk. If reserves were sufficiently huge, risk-averse customers would presumably be assured that their default risk was minimal. But maintaining these reserves—and paying investors the sizable returns they would demand for insuring institutional forays into corporate governance—would be expensive. Rival passive institutions would not face these expenses because they would not be generating this sort of risk in their portfolios.

C. Government Guarantees

The third main way to assure customers against default risk is through government guarantees. Some financial intermediaries, such as pension plans and banks, currently do enjoy government guarantees.¹⁵⁹ The problems to which shareholder activism by government-insured institutions would give rise are sufficiently alarming that even zealous reformers should hesitate. On the one hand, government insurance causes an obvious moral hazard problem. If the institutional investor does not bear all of the down-side risk of the activism, then it will have the incentive to engage in excessive activism. This moral hazard may already account for the otherwise puzzling fact that currently the most active institutional shareholders are those of public employees, such as CalPERS, which may be viewed as enjoying at least a *de facto* government guarantee.

One might argue that governments could control this moral hazard problem by regulating the activism of government-insured institutions. If federal or state governments ultimately bear the risk of shortfalls due to misguided shareholder activism in pension plans, then presumably governments may legitimately take steps to control those risks.

If government were to insure the value of activist institutional portfolios, therefore, it should also regulate the parameters of that activism, a course that is fraught with difficulties. This sort of regulation would

158. For an example of some of the complexities involved in accounting for the net risk exposure of complex financial positions, see JANE B. ADAMS & CORLISS J. MONTESI, FINANCIAL ACCOUNTING SERIES SPECIAL REPORT, MAJOR ISSUES RELATED TO HEDGE ACCOUNTING (1995).

159. Indeed, the *Economist* reported in 1990 that federal insurance and loan guarantee commitments involved more than five trillion dollars, then almost twice the national debt and five times yearly federal spending. *Government Waste: Where's Nanny?*, *ECONOMIST*, Jan. 6, 1990, at 31, cited in MILGROM & ROBERTS, *supra* note 16, at 177.

inject the politics of the regulatory process directly into the business of corporate governance. Politics has already found its way into debates over corporate governance, as the history of anti-takeover legislation¹⁶⁰ and the political pressures on state pension fund managers illustrate.¹⁶¹ Nevertheless, any attempt to develop regulations on what institutions may and may not do to reform corporate governance would almost certainly involve the promotion of many special interests. Indeed, regulators might ultimately be captured by the interests of corporate managers, whose discretion reform efforts were intended to cabin.

The moral hazards caused by government guarantees could be eliminated by removing government insurance. If this were to be done, institutions would probably revert to a largely passive role respecting corporate governance. It may be the presence of *de facto* or *de jure* government insurance that prompts much current institutional activism in the first place.

D. Experimental Activism

A final possibility for managing the risks of institutional activism would be to engage in activism only on an experimental basis. The problem institutions face is, after all, one of knowledge: financial institutions do not know, with any certainty, what the consequences of their activism will be. If they did, systematic activism would not be unacceptably risky. It might be argued that institutions could solve this problem by undertaking systematic activism on an experimental basis only.¹⁶² (Exploring this possibility also serves to introduce this Article's account, developed in the next part, of the role of entrepreneurs in reforming corporate governance.¹⁶³)

Experimentation is often used as a risk-management tool. Consider, for example, the use of experimental trials in pharmaceutical research. A new drug might significantly improve the health of a given patient population; on the other hand, the drug is untested and might actually cause a net harm to their health. One could simply administer the new drug to the entire patient population, but this probably would entail unacceptably high risk.

160. See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

161. See Romano, *Pension Fund*, *supra* note 12, at 799-809.

162. Black seems to have something like this in mind. See Black, *Agents*, *supra* note 1, at 866. Black seems to be primarily concerned with the risks to the macroeconomy of concentrated institutional power, such as the possibility that money managers would follow fads or starve new ventures of capital. See *id.* at 866-67. These risks are not my principal concerns. Rather, I am concerned with the activism-related risks institutions would inevitably incur, and the problems of insulating their customers from risk.

163. See *infra* Part V.

The excessive risk in giving an untested drug to the whole population of potential patients is analogous to the excessive risk of systematic activism by institutional investors. To reduce risk, medical researchers assemble samples of patients which are sufficiently large to yield statistically valid results about the effects of the drug, but which are still much smaller than the whole population of patients to whom the drug will eventually be prescribed if it proves safe and effective.¹⁶⁴

Medical research presents a relatively familiar example, but experimentation is used in many other contexts to manage risk. Manufacturers facing large risks in the introduction of new products, for example, engage in market testing.¹⁶⁵ Experimentation works to manage the risk of innovation for two reasons in particular. First, risk is contained by experimenting on a group which is much smaller than the entire population but which is still sufficiently large, and possessed of other necessary features, to make it a valid sample of the whole population. Second, risk-bearing costs are reduced by allowing less risk-averse persons to volunteer to bear the risk.

An institution might in theory apply an analogous approach to systematic activism, at least with respect to the first type of risk management. It could isolate a statistically valid sample from its portfolio firms and then apply the experimental policy to the sample and measure its effect on share value. If the change was beneficial, the institutional investor could impose it on the entire portfolio. If not, the change could be modified or abandoned. Risk would be reduced because application of the activist policy would be limited to a small part of the institution's portfolio.

This "experimental" institutional activism would probably be impractical for several reasons. First, although the corporation can be thought of as a private contract among investors, managers, creditors, workers, and others, in reality many of the terms of the contract are determined by state and federal lawmakers. The activist institution will simply be unable to alter many salient corporate contract terms, such as those defined by federal securities or Delaware corporate law, for only a few of its portfolio firms at the same time. Even if the institution tries to change the terms of the contract by changing the law—as it might do through lobbying—it can only succeed in changing the law applied to

164. For a critical account of drug regulation, see generally HENRY G. GRABOWSKI & JOHN M. VERNON, *THE REGULATION OF PHARMACEUTICALS: BALANCING THE BENEFITS AND RISKS* (1983).

165. For an example of the market testing of a financial product, see Scott Hensley, *Marine Midland Is Reviving a CD with Yield Linked to Stock Market*, AM. BANKER, Dec. 19, 1995, at 6. Another recent example of a product test is interactive television. See *Oracle Systems Corp.*, INVESTOR'S BUS. DAILY, Dec. 6, 1995, at A4. Product testing methodology has been standard in marketing, but is difficult to apply to research and development intensive industries. See Chris O. Clugston, *High-Tech Demands Own New-Product Plans*, ELECTRONIC NEWS, Dec. 4, 1995, at 33.

all firms subject to that law. For example, an institution might decide that its shares in a particular Delaware corporation would be worth more if Delaware's anti-takeover law were repealed. But if the law is repealed, it cannot be repealed for just one firm. Many firms, probably including a significant subset of the institution's portfolio, would be affected by the repeal. (This problem could be avoided, however, where state or federal laws allow corporations to "opt in" or "opt out" of their terms.¹⁶⁶)

All laws cannot be contracted around.¹⁶⁷ Risk reduction by experimental activism will thus be difficult or impossible with respect to the large class of mandatory "contractual" terms which are set by federal and influential state laws. Changing these terms for only a small sample of the portfolio will be very costly, if not impossible.¹⁶⁸

Second, the logistical difficulties of experimenting scientifically with managerial reform would be daunting. As a general matter the size of the sample necessary for statistical validity varies inversely with the size of the effect to be measured.¹⁶⁹ Many managerial changes would be relatively small, even if they would have quite significant monetary results were they applied to a whole portfolio. To measure relatively small changes, institutions would have to construct fairly large samples. In order to manage risk, the sample should still be just a small part of the total portfolio. Where large samples are required, however, it obviously would be harder to limit the sample to a small portion of the portfolio. A sample that is too large would expose the entire portfolio to risk.

Moreover, institutions would still have to remain widely diversified to protect themselves from the risks of experimental activism. But a widely diversified institution is much less likely to hold a sufficient stake in any one corporation—let alone a sample of them large enough to generate statistically meaningful results—to control or influence its management. Moreover, mere influence might be insufficient to induce all the various firms in the sample to adopt substantially the same policy. If each firm adopts a variation on one policy, the differences between the various policies may render the sample useless. Furthermore, the sample, to be valid, would have to be diversified, for it is supposed to be a sample of a diversified portfolio. In order to implement the ex-

166. See generally John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988).

167. See generally John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Easterbrook & Fischel, *supra* note 86; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989).

168. Of course, if an institution were so widely diversified that Delaware or U.S. corporations constituted only a small part of its portfolio, it would not be in this position. This would nevertheless be difficult even for a large institution given the size of the U.S. economy.

169. See RICHARD F. MORTON & J. RICHARD HEBEL, *A STUDY GUIDE TO EPIDEMIOLOGY AND BIOSTATISTICS* 75 (1979).

perimental activism strategy, a fund must be large enough to be able to influence strongly or control a set of operating companies large enough to be a valid sample. At the same time, in order to manage risk, that sample can only be a small part of the institution's entire portfolio. An institution that could do both would have to be gigantic indeed, probably much bigger even than today's large pension and mutual funds.

Finally, if the changes will affect share value only over a significant time period, all these factors would have to be controlled over an extended time. This would be difficult, especially given a large sample, and the results would be still more difficult to measure.¹⁷⁰ Experimental shareholder activism is simply not practical. Nevertheless, this thought experiment highlights the problem institutions face—how to control the risk associated with taking an activist role.

E. Summary

In this Part, I have argued that the risk-inanagement techniques intermediaries normally use to manage risk—insurance, reserves, and government guarantees—are likely to be prohibitively expensive or impractical for an activist institution. Similarly, risk management by experimental activism seems possible in theory but unlikely to work in practice. Risk management is central to the business of institutional investors, and large-scale activism would undermine this critical role institutions play in American corporate finance. In the next Part, I attempt to define the institutional role more clearly by contrasting institutions with the proper agents of corporate reform—entrepreneurial investors.

V

THE ENTREPRENEURIAL ROLE IN AMERICAN CORPORATE FINANCE

If financial intermediary institutions are not well-suited to pioneer reforms in American corporate governance, who is? In this Part, I argue that the task of reforming corporate governance is "entrepreneurial" in nature. Entrepreneurs must be understood as distinct from institutions; the two perform distinct functions in the political economy of corporate governance. I elaborate this distinction between institutions and entrepreneurs, relying on economist Frank Knight's influential conception of the entrepreneur.¹⁷¹ I then argue that passivity allows institutions to

170. See BLACK & GILSON, *supra* note 56, at 203.

171. While I make use of Knight's insightful conception of the entrepreneurial function, I do not mean to commit myself wholesale to Knight's views on all issues in the theory of the firm, especially his treatment of ownership and control in the corporation. The Knight discussion might be liable to the accusation of "Whig history"—that is, finding contemporary theories partially realized in

take a wait-and-see stance toward corporate governance innovations and reforms. By passively allowing reforms to prove themselves in markets, institutions can participate in gains and avoid losses from corporate governance reforms. In the political economy of corporate governance, institutions and entrepreneurs have complementary roles.

A. Knight's View of the Entrepreneurial Function

To distinguish between the functions that entrepreneurs and institutions perform in corporate governance, we must first clearly define what an "entrepreneur" is. In his great work *Risk, Uncertainty and Profit*, Frank Knight defined the entrepreneurial function in terms that suggest contemporary concepts of risk management.¹⁷² Knight stressed that events that are individually unpredictable can become predictable in large numbers through "consolidation" or pooling.¹⁷³ Insurers rely on life-expectancy statistics in order to set their premiums, even though how long any individual will actually live is uncertain. Pooling does not so much eliminate ignorance of the future as make ignorance less relevant. The insurer does not need to know how long any particular individuals will live, as long as it can make a reliable prediction of the probable average life expectancy of the pool of individuals it insures. From this the insurer can determine what its costs are likely to be and calculate its minimum asking price for its products.

Not all ignorance about the future is manageable in this way. After pooling has reduced much uncertainty about the future into more tractable "risk," a residuum of uncertainty may remain, because inherent limitations of human judgment prevent human actors from categorizing all possible outcomes into classes of events that are susceptible to pooling or to any other form of risk management.¹⁷⁴

historical sources—which critics level at some interpreters of Knight. See Richard N. Langlois & Metin M. Cosgel, *Frank Knight on Risk, Uncertainty, and the Firm: A New Interpretation*, 31 *ECON. INQUIRY* 456, 457 (1993). I am not trying to offer a faithful interpretation of Knight, but rather to formulate a Knightian perspective on more recent approaches to financial theory, such as the CAPM.

172. See FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* 273-90 (photo. reprint 1964) (1921). All citations are to the reprint of the 1921 edition published by the University of Chicago Press in 1964.

173. See *id.* at 231-33.

174. Knight's account of the limitations of human judgment and knowledge is much more ambitious than Herbert Simon's similar notion of bounded rationality. Compare *id.* at 197-232, with Herbert A. Simon, *A Formal Theory of the Employment Relationship*, 19 *ECONOMETRICA* 293 (1951). The disdain some commentators have expressed towards "Knight's extended Austrian-style disquisitions on the foundations of human knowledge and conduct and the like" is mere philistinism. See Stephen F. LeRoy & Larry D. Singell, Jr., *Knight on Risk and Uncertainty*, 95 *J. POL. ECON.* 394, 402 (1987). Langlois and Cosgel offer an illuminating summary of Knight's conception of the limited nature of human knowledge. See Langlois & Cosgel, *supra* note 171, at 458-60. Knight's argument, they say, is that

[w]hen the categories of knowledge themselves are unknown, they cannot form the basis of interpersonal agreement and market exchange. In situations of risk, categories—like

One of the distinct functions of the entrepreneur, Knight argued, is to bear this residual uncertainty in return for the claim to the profits of the enterprise. Typically, those who undertake to bear this uncertainty also insist on control of the enterprise.¹⁷⁵ Entrepreneurs "assume the risk" of a venture, according to Knight, "insur[ing]" the "doubtful and the timid" investors by guaranteeing to them "a specified income in return for an assignment of the actual results."¹⁷⁶ This residual profit (the actual results of the business minus the guaranteed returns) is what the entrepreneur claims—and only this, strictly speaking, is "profit," in Knight's view.¹⁷⁷ If the costs and returns of an enterprise are predictable (assuming markets are perfectly competitive), investors will be able to bargain for a more reliable share of the final returns of the business, and no profit will be left for the entrepreneur.

Entrepreneurs can only make profits, therefore, where the market rate of providing some factor—capital or labor, for example—misestimates what the marginal contribution of the factor will actually be to the enterprise. Of course, the entrepreneur usually does not know for certain that a factor will produce more than it costs. He must use his powers of judgment.¹⁷⁸ By doing so, he goes beyond the mere bearing of "risk," which factor providers bear in exchange for a contractible return or "rent" priced by the market. The entrepreneur bears "uncertainty" in return for the profits of the enterprise.

Knight's analytical tools are useful in addressing questions of corporate governance. First, consider the institutional investor from a Knightian perspective, as compared to that of contemporary corporate law scholarship. Contemporary legal scholars, following Berle and Means, often characterize "the shareholders" of the corporation as its "owners." In (an admittedly simplified version¹⁷⁹ of) Knight's view, the owner of an enterprise is the party or parties who bear the residual uncertainty of its returns. By uncertainty, Knight meant the sort of risk that could not be priced by the market without the attachment of a residual claim—that is, a claim to whatever was left over after those with fixed claims were paid. It is natural enough to think of "shareholders"

"house burns down" or "house doesn't burn down"—can be shared and agreed upon interpersonally. This allows markets (in the narrow sense of simple contracts mediated by price) to function well enough. But when the categories are unknown, the parsimonious information mechanism of the market is not up to the task. In such situations . . . firms supersede markets.

Id. at 460.

175. See KNIGHT, *supra* note 172, at 270-71.

176. *Id.* at 269-70.

177. See *id.* at 271.

178. See *id.* at 258-59.

179. See Langlois & Cosgel, *supra* note 171, at 463-64.

as holding these residual claims, for are not shares of stock, after all, the residual claims to the returns of the corporation?

Here, in my view, is one place where the conventional analysis tends to go astray. It is true that shares represent residual claims, but whether the shareholder is really a residual claimant, or, more to the point, whether we should expect the shareholder to act like one, depends on her net position in the corporation. Suppose, for example, a shareholder in XYZ corporation has sold call options with an exercise price of \$1 above the current market price on all her XYZ shares. Is this shareholder still a "residual claimant"? She does not care whether the firm increases its per share value beyond the exercise price of the option. She has sold the claim to that value to someone else. Similarly, the shareholder who has purchased a put option on those shares will care about losses in firm value that would reduce the value of firm shares down to the exercise price of the put, but beyond that would be indifferent. It would be a mistake to call these investors residual claimants in the sense that "shareholders" are. These investors own shares, but their net position is not like that of the archetypal Berle and Means shareholder.

The highly diversified institutional shareholder, however, is in just as synthetic a position as the hedged investors described above. The institutional investor, if it is nearly perfectly diversified, will and should be indifferent to certain value-increasing actions managers of their portfolio firms could take. It will be just as indifferent as the call-option-selling shareholder would be to any actions managers could take to increase the underlying shares' value beyond the call option's exercise price. To drive home this point, it is useful to think of the diversified institution as holding a single, great synthetic instrument—its portfolio—which yields a variable return. This return is a function of its risk, as measured by its beta, or the relative risk of the portfolio compared to the market itself. Shares of stock are just the components out of which this giant synthetic security is constructed. The return on this synthetic instrument is determined by how much capital is exposed to a particular amount of market risk. The holder of this instrument is no more an archetypal Berle and Means shareholder than the hedged shareholders above.

From the Knightian perspective, the diversified shareholder, by diversifying, has effectively given up claims to the firm-specific returns managers could create by taking certain risks. As Knight would predict, such a shareholder has also given up control over these decisions as

well.¹⁸⁰ In return, the diversified shareholder receives a more predictable level of return on its portfolio. In a general sense, this fits Knight's "guarantee model," under which some investors forego some residual claims to the firm's profits in return for more certain returns on their capital. I develop this Knightian gloss on the Capital Assets Pricing Model further in the next section.

*B. The Capital Assets Pricing Model Through a
Knightian Lens*

Under the CAPM, returns on capital assets are disaggregated into returns attributable to overall market movements and those attributable to firm-specific factors. This distinction between market risk and firm-specific risk corresponds usefully, I believe, to Knight's distinction between "risk" borne by mere capitalists and the "uncertainty" borne by entrepreneurs.¹⁸¹ The market risk of a capital asset, like Knightian risk, is relatively knowable. The capital market provides a rate that is the price for bearing this relatively tractable quantity of risk. Diversified investors who take on this much risk, and no more, resemble Knightian capital providers who receive rents set by the market for contributing capital subject to a given level of risk. To the extent institutional investors eliminate firm-specific risk through diversification, they are mere providers of capital who in return receive market-determined rents, but they are not entrepreneurs in the Knightian sense.

According to the CAPM, however, investors are not compensated in expected market returns for any firm-specific risk they may bear. An investor who bears firm-specific risk bears a risk that the market cannot price. Finance textbooks usually explain this by saying that since firm-specific risk can be virtually eliminated at very low cost by diversification, investors do not need to be paid to bear this risk, and so they are not.¹⁸²

This explanation is potentially misleading. Not every investor in a firm can shed all firm-specific risk at a low cost. Some factor providers to the firm may have to bear some firm-specific risk, and they are not going to do it for nothing. Moreover, bearing firm-specific risk can be extremely profitable. Increases in firm value caused by firm-specific factors will cause firm share prices to increase. If the investor has diver-

180. Is Knight suggesting that stockholders would increasingly, through mechanisms such as voting trusts, find intermediaries to represent their controlling interests, as bondholders could do through indenture trustees? See, e.g., KNIGHT, *supra* note 172, at 301 & n.1.

181. I concede that the match is not perfect. For one thing, Knight seems to conflate the rate of return a capital provider would receive on a risky investment and the rate of return another capital provider (for example, those Merton calls customers) would receive for a risk-free or "guaranteed" investment. See *id.* at 310.

182. See Lorie, *supra* note 67, at 26.

sified away his exposure to firm-specific risk, this increase in value will probably be offset by decreases in the value of other portfolio firms due to different but equally firm-specific factors. Put another way, pooling firm-specific risk reduces it and its expected return to nearly zero. By not pooling firm-specific risk, the entrepreneur gets the possibility of positive (or negative) firm-specific returns.

Gains from the bearing of firm-specific risk are not rents, in the Knightian sense, but profits. Profit in this context can be conceived of as the amount by which the stock's value exceeds that predicted by changes in overall market factors—or, put another way, changes in value attributable to firm-specific factors.¹⁸³ Only those investors who are less than fully diversified can expect to receive these profits. The firm-specific risk isolated by the CAPM may therefore be seen as an instance of Knightian entrepreneurial uncertainty, and those who bear this firm-specific risk or uncertainty are entrepreneurs.

Viewing the CAPM through the Knightian lens is not just an intellectual exercise. As I suggested earlier,¹⁸⁴ the sheer size and potential power of present-day institutional investors impresses political model scholars. Institutions seem to them to be sleeping giants; if awakened, they could increase the value of firms in their portfolios by improving their managements. But this vision, I argue, is largely illusory. These institutions are broadly diversified. They have eliminated almost all firm-specific risk from their portfolios, and have done so for the good reasons explained above. One is more likely to find the willingness to bear uncertainty and exercise control among those who deliberately expose themselves to significant firm-specific risk.

One class of such investors would appear to be firm managers, whose human capital investments in the firms they manage are often irreversibly specialized.¹⁸⁵ Firm managers, rather than nominal shareholder “owners,” enjoy actual control of most public corporations. Managers bear much more firm-specific, or entrepreneurial, risk. Indeed, the managerially consumed perquisites that so many critics have decried¹⁸⁶ may simply be for the most part the proper level of compensation for managers as firm-specific risk bearers.¹⁸⁷ Managers are not the only firm-specific risk bearers, of course.¹⁸⁸ As Knight suggests, nearly

183. “Loss” by this definition would be a decrease in the price of the stock beyond that predicted by its beta.

184. See *supra* text accompanying notes 1-9.

185. Cf. Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978) (arguing that an increase in specialized appropriable rents results in a move towards vertical integration).

186. See, e.g., BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO* (1990).

187. See *id.* at 379.

188. Knight would agree with this assertion. See KNIGHT, *supra* note 172, at 300.

all returns on capital investments are some combination of interest and profit.¹⁸⁹ The point here is merely that of all the firm's various constituencies—managers, creditors, workers, and even firm-dependent communities—the firm's diversified shareholders have perhaps the least exposure to firm-specific risk. The robustness of managerial compensation schemes, various relational contracts with workers, financial covenants and similar provisions for creditors, and even occasional understandings with communities, all of which contain elements of control, should not be surprising. Nor should the relative passivity of institutional shareholders be disappointing.

C. Relational Investors, Progress in Corporate Governance, and Institutional Risk Management

In the last few years, some advocates of corporate governance reform have found great promise in the idea of relational investing.¹⁹⁰ As explained earlier, relational investors buy large stakes in target companies as long-term investments and then take an active role in firm management.¹⁹¹ Observers often cite Warren Buffett and his Berkshire-Hathaway firm as an example of a relational investor.¹⁹² To the extent that relational investors possess entrepreneurial knowledge and ability, they can make innovations and reforms that might improve the efficiency of corporate governance structures and policies.

This point is almost trivially true, but it suggests a less obvious observation. To the extent that relational investors are entrepreneurs who generate and successfully apply new knowledge about economic organizations and how they work, their innovations will be imitated. One example of this process of dissemination can be found in one of the great breakthroughs in American business history: the pioneering, development, and spread of the multi-divisional (or "M-form") corporate organization associated with the DuPonts' relational investment in General Motors.¹⁹³ Of course, innovations that are failures, or produce profits only in a particular firm, will tend not to spread through imitation.

The passive and diversified institutional investor can free-ride on external benefits created by new, entrepreneurially created knowledge about corporate governance and organization. As entrepreneurs make beneficial innovations standard practice, the overall value of diversified

189. See *id.* at 304.

190. See, e.g., Rock, *supra* note 106; Lowenstein, *supra* note 106.

191. See *supra* Section III.D.3.

192. See, e.g., Ayers & Cramton, *supra* note 124, at 1040.

193. See ALFRED D. CHANDLER, JR., *STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF THE INDUSTRIAL ENTERPRISE* 52-162, 324-80 (1962) [hereinafter CHANDLER, *STRATEGY AND STRUCTURE*]; ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 415-83 (1977) [hereinafter CHANDLER, *VISIBLE HAND*].

portfolios will increase, and institutional investors will benefit. But they will do so without exposing their portfolios to the firm-specific risk that entrepreneurs must bear when they pioneer innovations. The diversified institution may rely on market processes to filter out innovations that decrease value. But as more and more firms adopt innovations that have proven their worth in previous trials, more of the firms in the institution's portfolio will incorporate the innovation. As the new practice becomes standard, diversified shareholders will benefit, even though their exposure to firm-specific risk has been minimal. Diversified institutions can thus simultaneously enjoy exposure to the potential gains from corporate governance innovation and protection against potential losses, benefits analogous to those of portfolio insurance. This suggests that passivity and diversification are advantageous risk-management strategies for institutions where corporate governance innovations are concerned.

D. Institutional Risk and the Payoff from Entrepreneurial Activism

Because they are widely diversified, institutional investors enjoy a kind of natural immunity against entrepreneurial mistakes. At the same time, they stand to gain from entrepreneurial successes. This effect follows from the nature of entrepreneurial reform; entrepreneurs who make mistakes in their corporate governance reforms will tend to exit the business quickly, because their exposure to firm-specific losses is large. Mistakes may be disastrous for the entrepreneurs who make them, but they will affect only one or a few firms in a diversified institution's portfolio, leaving its overall return nearly unaffected. Entrepreneurial successes, on the other hand, will tend to be imitated, as the entrepreneur or his rivals apply the same idea (or modifications of it adapted to new firm-specific contexts) to other firms. Only successful ideas are likely to spread to enough firms to affect measurably the returns to diversified investors.

This process will occur only over fairly long periods of time. Because of the work of Alfred Chandler and the inspiration it provided to Oliver Williamson, among others, the proliferation of the multi-divisional (or "M-form") corporation is probably the best documented example of an innovation in corporate form spreading widely through the economy. As Chandler has described, the multi-divisional form was a daring entrepreneurial departure when it was first used by the DuPonts and then more systematically at General Motors.¹⁹⁴ The M-form, which allowed greater specialization and centralization of management,¹⁹⁵

194. CHANDLER, *STRATEGY AND STRUCTURE*, *supra* note 193, at 114-62.

195. *See id.* at 309-14. The division of tasks within the firm into entrepreneurial tasks to be accomplished by the central office and routine tasks for regular operations is a major theme in

proved to be successful at General Motors and other pioneer firms. Other industries eventually imitated the practice, adopting it where it promised to work. Though not without critics, between the 1920s and the 1950s, the M-form gradually became the standard form for large public corporations in the United States.¹⁹⁶

Passive, diversified shareholders of public corporations did not pioneer this transformation, but they did benefit from it. Because they came later to the benefits, diversified investors did not reap the same rewards as the pioneers. Nevertheless, their rewards were substantial and did not involve taking the same risks. As the new managerial "technology" improved efficiency throughout the market generally, passive investors' portfolios increased in value with little exposure to entrepreneurial risk.

Most managerial reform requires that the reformer have firm-specific knowledge and bear firm-specific risk. Entrepreneurs, who have this knowledge and are willing to bear these risks, are best suited for this role. Institutions, on the other hand, generally cannot afford the dangers of leading reform. Their customers demand security. Institutions must manage risk in a way that protects their customers against a shortfall and should not bear the firm-specific risk that institutionally led reform would create. Although they will benefit over time from the benefits created by entrepreneurial risk-taking, institutions are best suited to a passive role.

VI

SETTING PRIORITIES FOR CORPORATE GOVERNANCE REFORM

So far in this Article, I have argued that institutions remain passive shareholders not because of legal restrictions on their activities, but because they must employ this risk-management strategy in order to remain competitive in their markets. Reformers should not lose sight of the distinctive function institutions play in the financial market when evaluating various corporate law reform proposals. Because large institutions tend to be passive whether or not laws restrict them, lifting bars on institutional activism should not be a high reform priority. On the

Chandler's account of the development of the multi-divisional corporate form. See, e.g., *id.* at 311-12. This Article makes a somewhat analogous distinction between entrepreneurial and more routine and passive institutional functions. The salience of this distinction can be traced at least to Knight, although he is not listed as a source in either *Strategy and Structure* or *The Visible Hand*. It is possible that Knight's vision of economics was influenced by the developments Chandler describes, which were very much in progress at the time *Risk, Uncertainty and Profit* was published. Chandler was also well aware of Oliver Williamson's work, see CHANDLER, *VISIBLE HAND*, *supra* note 193, at 5, and Knight is the first antecedent that Williamson names in *The Economic Institutions of Capitalism*. See OLIVER WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 2 (1985).

196. See CHANDLER, *VISIBLE HAND*, *supra* note 193, at 482-83.

other hand, because entrepreneurs can reform and monitor firm management in ways institutions will not, reforming laws that inhibit these entrepreneurial investments in firms should be a high priority of reformers.

In this section, I briefly consider, for purposes of illustration, a few of the reforms suggested by political model proponents. Some of the suggested reforms would be beneficial, because the targeted laws inhibit entrepreneurial investment. Other proposed reforms are less helpful because they target laws that merely block institutional activism, which is unlikely to be of much interest to most diversified institutional investors in any event.

A. Reforms Promoting Entrepreneurial Investments

1. Takeover Defenses

Beginning with Henry Manne,¹⁹⁷ corporate law scholars have developed an extensive literature strongly arguing that control transactions such as hostile takeovers and leveraged buyouts create incentives for efficient management and can be used to install governance structures that create value-maximizing incentives for managers. Corporate finance scholars have also accumulated evidence that these transactions positively affect the value of common stock in public corporations.¹⁹⁸ These transactions threaten the incumbent managers of corporations, and managers have exercised great ingenuity erecting defenses, such as state anti-takeover laws¹⁹⁹ and poison pill devices,²⁰⁰ to protect themselves against the market for corporate control.

197. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 110-20 (1965). See generally Hal R. Varian, *Symposium on Takeovers*, 2 J. ECON. PERSP. 3, 3-5 (1988) (a brief overview of the purported benefits and costs of takeovers).

198. Economists have documented the negative effect of anti-takeover laws on shareholder value. See, e.g., Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 J. FIN. ECON. 291, 320-21 (1989); J. Gregory Sidak & Susan E. Woodward, *Corporate Takeovers, the Commerce Clause, and the Efficient Anonymity of Shareholders*, 84 Nw. U. L. REV. 1092, 1100-07 (1990). If repeal of these laws can be assumed to result in the opposite effect, then repeal would generate significant shareholder wealth. If other obstacles obstruct the corporate control market however, this would not necessarily be the result. See Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 857-63 (1993).

199. See R. Franklin Balotti & Michael J. Feinstein, *State Takeover Statutes*, in 2 HOSTILE BATTLES FOR CORPORATE CONTROL 119, 126-62 (PLI ed., 1990) (compiling state anti-takeover laws). State anti-takeover laws are sufficiently widespread to amount to a virtual national regime. See *De Facto Federal Anti-Bidder Stance Exists Through State Laws, IRRS Says*, 21 SEC. REG. & L. REP. (BNA) 1501 (Oct. 6, 1989).

200. See JOY MARLENE BRYAN, *CORPORATE ANTI-TAKEOVER DEFENSES: THE POISON PILL DEVICE* (1992); 1 MARTIN LIPTON & ERICA H. STEINBERGER, *TAKEOVERS & FREEZEOUTS* §6.03[4] (1992); 4 ROBERT H. WINTER ET AL., *SHARK REPELLENTS AND GOLDEN PARACHUTES: STATE TAKEOVER STATUTES AND POISON PILLS* (Supp. 1992).

Financial intermediaries, who provide guarantees to customers, must manage risk effectively in order to guard against shortfall. Systematic institutional activism would generate risks that would be difficult or impossible for institutions to manage. But diversified institutions can benefit from entrepreneurial reforms by free-riding on the innovations of entrepreneurs. As an innovation is broadly accepted by its portfolio firms, the institution will realize an overall gain without having exposed itself to firm-specific risk. This dynamic, however, is frustrated by effective anti-takeover measures, which hamper the market for corporate control. Where entrepreneurs face legal bars to reforming management, diversified investors cannot free-ride on their efforts. In light of all this, should institutional investors make systematic efforts to promote deregulation of the market for corporate control? Or should they remain passive in any controversy on these matters?

In my view, the evidence that a relatively freely functioning corporate control market benefits shareholders is, to use Professor Fischel's word, "overwhelming."²⁰¹ If I am right, then institutional investors would be exposing their portfolios to little risk by taking action in this case, sponsoring shareholder proposals to repeal poison pills and lobbying for the repeal of state anti-takeover laws. Evidence also suggests that the benefits of repeal of anti-takeover laws could be substantial.²⁰² Deregulating the corporate control market should probably be a high priority.²⁰³

The repeal of restrictions on the corporate control market appears, then, to be an example of that rare creature—a virtually "no-lose" proposition. But this does not mean that institutional activism should be elevated, as the political model suggests, into a permanent feature of the political economy of American corporate finance. It certainly does not mean that, absent legal restrictions, activism would emerge as a new paradigm. Indeed, as Professor Lowenstein has noted,²⁰⁴ many (though not Lowenstein) see institutional activism as the second-best solution to the problem of monitoring and incentivizing corporate managers, where the best solution, the corporate control market, has been frustrated by various political and legal interventions. In fact, institutional activism

201. See DANIEL FISCHEL, *PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION* 17-18, 309(1995) (surveying evidence regarding benefits of corporate restructuring).

202. This would seem to follow from the evidence for the negative effects on shareholder wealth of the enactment of anti-takeover laws. See sources cited in *supra* note 199. Repeal of those laws would probably result in some wealth gains for shareholders, although I am not aware of direct evidence of this proposition.

203. Some advocates of relational investing will certainly not share this view. See Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 250 (1983).

204. See Lowenstein, *supra* note 106, at 6.

cannot be a general substitute for the corporate control market. Financial intermediary investors might be able to help deregulate the corporate control market with little risk to themselves or their customers. But it would be a mistake to generalize from this exceptional case. Institutions cannot perform entrepreneurial functions generally and remain effective risk managers.

2. Proxy Rule Reforms

One cause of shareholder passivity, according to law and economics literature, is a problem of collective action.²⁰⁵ If a shareholder owns only a very small fraction of a firm, any change in the firm's policies, even if it proves profitable, will be of only limited benefit to the individual shareholder. The costs of voting in favor of the change, let alone persuading others to vote, may well exceed the shareholder's expected benefit. As shareholders grow in power, the collective action problem abates. The larger the percentage of stock that a shareholder owns in a public company, the more likely it becomes that she will find that the costs of voting for a reform, and soliciting others to vote, are less than her proportional share of the benefits.²⁰⁶

Political model proponents argue that if laws were changed to permit institutions to own larger shares of particular firms, collective action problems would abate, and shareholder activism would increase. I have argued, of course, that institutions will remain passive for reasons unrelated to collective action problems. Federal proxy-rule reforms that reduce the costs of communication between shareholders should not be expected to greatly increase institutional activism.

Even if it fails to encourage much institutional activism, proxy-rule reform might nevertheless promote entrepreneurial investment in firms. Indeed, it may have already done so. In an interesting article describing the effects of the new federal proxy rules, Thomas W. Briggs tells a story consistent with the distinction between entrepreneurial and institutional investors.²⁰⁷ The new proxy rules²⁰⁸ are directed at large institu-

205. See JESSE H. CHOPER ET AL., *CASES AND MATERIALS ON CORPORATIONS* 547-51 (3d ed. 1989); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453-63 (1991).

206. See, e.g., James A. Brickley et al., *Ownership Structure and Voting on Antitakeover Amendments*, 20 J. FIN. ECON. 267 (1988). Institutions are more likely to vote, and to vote against management. See *id.* at 284.

207. See Thomas W. Briggs, *Shareholder Activism and Insurgency Under the New Proxy Rules*, 50 BUS. LAW. 99 (1994).

208. See Regulation of Security Holder Communications, Exchange Act Release No. 29,315, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,811 (June 17, 1991) (original proposal release); Regulation of Communications Among Securityholders, Exchange Act Release No. 30,849, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,002 (June 24, 1992) (reproposing release); Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, [1992 Transfer Binder]

tional investors. The political model stresses that proxy regulations restrict communications between shareholders and that this increases the costs of coordinating shareholder activism. The new proxy rules take some steps to deregulate communication between shareholders. While institutional activism may have increased somewhat as a result, the change has been less than dramatic.²⁰⁹ Political model proponents predictably account for this by asserting the deregulation has not gone far enough.²¹⁰

Proxy rule deregulation and similar reforms should be taken as far as the political model proponents like, but not because it will lead to a surge in activism by large institutions. Instead, deregulation would lower, and perhaps already has lowered, the costs for entrepreneurs to use proxy contests "not [to put] a resolution on the management's proxy card asking shareholders to vote to end discriminatory employment practices or redeem a poison pill . . . [but to secure] board representation with a view to fundamentally changing a company's policies, dismissing management or taking over a company."²¹¹ The entrepreneurs using the new proxy rules in this way are not the large financial intermediaries, but rather specialized "hedge funds," "risk arbitrage funds," "value investment funds" and "vulture funds," which specialize in making risky entrepreneurial investments in corporate control.²¹²

Reforms designed to increase institutional control over portfolio firms thus may inadvertently open the door to those who actually want to go through it—aggressive entrepreneurs looking for large, tangible

Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992) (adopting release) (codified at 17 C.F.R. §§ 240.14a-1 to -103 (1996)). For a discussion of the evolution of the federal proxy rules and some of their possible impacts, see Norma M. Sharara & Anne E. Hoke-Witherspoon, *The Evolution of the 1992 Shareholder Communication Proxy Rules and Their Impact on Corporate Governance*, 49 BUS. LAW. 327 (1993).

209. See '93, '94 Proxy Seasons Said to Show Slight Increase in Shareholder Activism, CORP. COUNS. WKLY. (BNA), at 2 (June 22, 1994).

210. See, e.g., Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1 (1992) (urging greater deregulation of shareholder communication); Coffee, *supra* note 23; Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but Not Too Late*, 43 AM. U. L. REV. 379 (1994) (proposing greater steps to increase shareholder rights).

211. Briggs, *supra* note 207, at 102 (footnotes omitted).

212. As examples of entrepreneurial uses of the new proxy rules, as compared to institutional reluctance, Briggs cites the following: James P. Miller, *Alliant's Pact to Acquire Hercules Unit Is in Doubt as Fund Pulls Off Proxy Coup*, WALL ST. J., Aug. 12, 1994, at A4 (hedge fund's acquisition of control of board of directors by proxy contest to effect a program "to maximize shareholder value"); James P. Miller, *Capstay's Plans For Alliant Board Boost Firm's Stock*, WALL ST. J., June 9, 1994, at B8 (same); Stephanie Strom, *Hills Stores and Bidder End Fight*, N.Y. TIMES, Sept. 24, 1994, at 33 (vulture fund's consent fight for four of eight directorships to effect a stock repurchase program); Stephanie Strom, *Giving the Pros a Taste of Their Own Medicine*, N.Y. TIMES, Aug. 28, 1994, §3, at 4 (same); Stephanie Strom, *Investment Firm Threatens A Takeover of Hill's Stores*, N.Y. TIMES, Aug. 12, 1994, at D1 (same).

and quickly-realized gains to compensate them for the substantial firm-specific risks they must bear. Some political model proponents might view this as a bad thing, but it is probably a good thing, intended or not.

3. *The Investment Company Act*

Gilson and Kraakman have argued persuasively that regulatory barriers, especially obstacles created by the Investment Company Act of 1940 ("the 1940 Act"), prevent the formation in the United States of what they call "Managerial Strategic Investment Companies" ("MSICs"). MSICs, found in Europe and particularly Sweden, are closed-end investment companies that maintain portfolios of controlling stakes in large operating companies and also invest in smaller or start-up firms.²¹³ MSICs seem to act as entrepreneurial investors, and for that reason should not be grouped together with institutions such as pension funds and insurance companies. Gilson and Kraakman rightly stress that the existence of investment companies of this sort in Europe suggests that similar firms could exist in the United States, were they not barred by federal regulation.

The 1940 Act, as Gilson and Kraakman explain, defines "investment company" broadly to include any issuer of securities that holds more than forty percent of its assets in investment securities.²¹⁴ An investment company that sold its shares to entrepreneurially inclined investors, in order to raise capital to buy controlling or influential stakes in operating companies, would fall under this definition.

Investment companies must comply with burdensome regulations designed to protect unsophisticated investors.²¹⁵ For example, managers of investment companies may not be compensated with long-term options or equity, frustrating the most logical means of rewarding their entrepreneurial skills.²¹⁶ Neither may closed-end investment companies issue equity at a price below net asset value, limiting their ability to raise capital after an initial public offering.²¹⁷ The asset coverage requirements of the 1940 Act are very stringent; they require that any debt an investment company issues be covered 300% by assets, and any preferred stock, 200%. They also prevent an entrepreneurial investment company from designing different classes of securities to appeal to different classes of investors and limit its raising of capital to its initial offering and bank loans.²¹⁸

213. See Gilson & Kraakman, *supra* note 124, at 992 n.29.

214. See 15 U.S.C. § 80a-3(a)(3) (1994); Gilson & Kraakman, *supra* note 124, at 998.

215. See Gilson & Kraakman, *supra* note 124, at 999.

216. See 15 U.S.C. §§ 80a-18(d), 23(a); Gilson & Kraakman, *supra* note 124, at 999.

217. See 15 U.S.C. §§ 80a-18(d), 23(b); Gilson & Kraakman, *supra* note 124, at 999.

218. See 15 U.S.C. § 80a-18(a)(1)(A), (2)(A); Gilson & Kraakman, *supra* note 124, at 1000.

Furthermore, the 1940 Act bars transactions between the investment company and its promoter, underwriter, or affiliates, subject to a lengthy fairness determination by the Securities and Exchange Commission.²¹⁹ This process imposes costly delays on any investment company attempt to buy out a portfolio firm, lend it additional capital, or conduct many other legitimate transactions. Reforming the 1940 Act might help promote the emergence of entrepreneurial investment companies in the United States. For reasons I give above, however, one should not expect such reforms to encourage large institutional investors to take controlling shares in operating companies.

B. Low Priority Reforms

Political model proponents have suggested that the reforms mentioned above might open the door to institutional activism. Although institutions are unlikely to accept the invitation, the reforms may nevertheless be useful because they promote entrepreneurial investing,²²⁰ which aids institutional investors in the long run.

The reforms I will address below, on the other hand, do not have the happy, if unintended, consequence of aiding entrepreneurs. Instead, they do nothing more than offer institutions an opportunity they do not want and will not or should not accept: the chance to become more activist. These reforms may be good ideas for other reasons, but they should not have much of an effect on the dynamics of corporate governance. They should be assigned a low priority.

1. Savings and Loan Investment Restrictions

Federal law prohibits savings and loan institutions ("S&Ls") from owning any common stock.²²¹ These restrictions mean that S&Ls are not going to be intermediaries that collect large amounts of capital from numerous small investors and then invest it in controlling or influential stakes in operating companies. Whatever problems these restrictions present, preventing thrifts from becoming monitors of operating companies is not one of them. To the extent thrift institutions have any viable role in a well-functioning modern financial system, they presumably serve the financial needs of small depositors, in particular

219. See 15 U.S.C. § 80a-17(a)(1), (b)(1); 15 U.S.C. § 80a-2(a)(3); Rule 17d-1, 17 C.F.R. § 270.17d-1 (1996); Rule 17a-6, 17 C.F.R. § 270.17a-6 (1996); see also Thomas Hazen, *The Application of Section 17 of the Investment Company Act of 1940 to Portfolio Affiliates*, 120 U. PA. L. REV. 983, 985-86 (1972).

220. The argument of the political model concerning banking regulations is addressed and critiqued in Macey & Miller, *supra* note 9.

221. See Financial Institutions Reform, Recovery, and Enforcement Act of 1989, 12 U.S.C. § 1831e (1994) (amending 12 U.S.C. § 1464).

for housing loans.²²² All of the arguments I make concerning the desirability of certain institutions minimizing the risk exposure of their customers apply *a fortiori* to thrifts. If, as has been the case, government guarantees create incentives for excessively risky investments, then S&L managers might choose to invest in underdiversified, controlling stakes in operating companies, just as they chose, by many accounts, to make excessively risky investments with their federally guaranteed deposits in the 1980s. This is something to be avoided, not encouraged.²²³

As long as deposit guarantees exist, it is appropriate for the federal government to impose investment restrictions that prevent, among other inappropriate risk-taking, exactly the sort of activism the political model envisions for institutions. Forbidding all ownership of common stock might be excessively sweeping. Investing in stock index funds, for example, especially if hedged with derivatives, might be less risky than other investments S&Ls are permitted to make.²²⁴ (On the other hand, these other investments might themselves be too risky.) In any event, as long as S&Ls are attempting to appeal to their traditional clientele, and not externalize risks on taxpayers, there is no reason to view them as frustrated institutional activists.

2. Insurance Companies

Much the same may be said of insurance companies. State insurance law typically inhibits stock ownership by insurance companies, because common stock does not count toward fulfilling regulatory capital or surplus requirements.²²⁵ Roe has argued that these restrictions have political roots in progressive-era politics.²²⁶ Were these laws repealed, political model proponents seem to suggest, insurance companies might take much larger positions in fewer portfolio companies and adopt an activist role.

This is an unlikely scenario. Insurance exists so that insureds may reduce risk.²²⁷ The financial soundness of insurance companies is of primary importance to insurance customers. Insurance company soundness is closely monitored by rating companies, and even a slight

222. See FISCHER, *supra* note 201, at 190-93.

223. See *supra* Part IV.C.

224. Courts and regulators, however, lack even a basic understanding of what makes a portfolio risky. For example, in *Franklin Sav. Ass'n v. Director, Office of Thrift Supervision*, 934 F.2d 1127 (10th Cir. 1991), the OTS was apparently unable to grasp that a portfolio is risky because of its *net* exposure, not its individual components. Franklin invested heavily in mortgage-backed securities and other risky instruments, but then hedged its position with other volatile but offsetting investments. The OTS saw only the individually risky parts, but not the less risky whole. See *id.* at 1143-44.

225. See, e.g., N.Y. INS. LAW § 1402 (McKinney Supp. 1996).

226. See Roe, *1906 Pacification*, *supra* note 2.

227. See KENNETH J. ARROW, *Insurance, Risk, and Resource Allocation*, in *ESSAYS IN THE THEORY OF RISK-BEARING*, *supra* note 34, at 134, 134-35.

downgrading of an insurance company's rating can have serious consequences for its business.²²⁸ Individuals and firms that buy insurance are typically not looking to take on firm-specific entrepreneurial risk; they want to reduce the risk of contingencies such as disability, retirement, and death, not invest in reforming corporate managements.

Insurance companies that adopted the political model approach would have greater firm-specific risk than would passive rivals. This risk would lead to less predictable portfolio returns than perfectly diversified portfolios would enjoy.²²⁹ Reinsuring against this increased firm-specific risk would be costly or impossible, given moral hazard problems. Moreover, moral hazard is especially troubling in this context. Insurance companies must match their long-term obligations, such as life insurance payments, to their portfolio income. Significant firm-specific risk held over the long term of ordinary life insurance policies could impose a significant risk of insolvency on policy holders. Rival insurance providers with more conservative portfolios would win the business of insurance buyers. People buy insurance specifically to reduce risk in their own lives, not to invest in shareholder activism.

If investment restrictions on insurance companies were removed, some insurance companies might become (or be formed specifically to be) vehicles for entrepreneurial investment.²³⁰ The importance of insurance accounts for the large amounts of capital that insurance companies control, and the function of insurance companies is more than a matter of legal nomenclature. If insurance companies started to act like entrepreneurial investors, individuals with little wealth and entrepreneurial inclination would take their business elsewhere.²³¹ By the same token, removing restrictions on ownership of common stock by insurance companies might give entrepreneurs a convenient vehicle for making risky investments in corporate control transactions. But this is a far cry from the apparent hope of the political model—that insurance compa-

228. A good example of the credit-sensitivity of the insurance market is the reaction of rating services and customers to the perceived riskiness of collateralized mortgage obligations in the portfolios of insurance companies. See, e.g., Laura Jereski & Leslie Scism, *Insurers Feel Heat to Cut CMO Bonds—Mortgage Portfolios Are Called a Factor in Some Downgrades*, WALL ST. J., Nov. 27, 1995, at C1.

229. See *supra* Part II.C.

230. According to Roe, Warren Buffet invested through his Nebraska insurance holding company, Berkshire Hathaway, in various operating firms. Nebraska's laws were apparently unusual, if not unique, in allowing this type of concentrated investment. See NEB. REV. STAT. § 44-311.04 (repealed 1991), cited in Roe, *supra* note 2, at 23, n.53.

231. This is not to say, however, that there would not be substantial numbers of individuals who would want to make risky investments through entities such as Berkshire Hathaway, as that firm's recent plan to offer stock to the public suggests. See Floyd Norris, *Buffett Plans Cheap Stock but Not Quite a Penny One*, N.Y. TIMES, Feb. 14, 1996, at D1. However popular investments like this may seem, the capital they raise is a mere drop in the bucket compared to the capital committed to more conventional insurance products.

nies that function as such could intermediate between policyholders and operating companies, and increase corporate profitability through reform, while also serving customers' insurance needs.

3. Pension Funds

Private and public pension funds together constitute the largest category of institutional investors.²³² Fiduciary principles embodied in ERISA²³³ apply to private pension funds, and similar principles in the common law of trusts and state statutes apply to public pension funds.²³⁴ These fiduciary principles, in Black's view, may inhibit institutional activism by pension funds.²³⁵ According to Black, the prevailing legal interpretation of the fiduciary duty doctrine, which requires the avoidance of large losses on individual investments, is outmoded. Black suggests that a trustee's fiduciary duties should be construed in light of the modern conception of diversification, which, now, is more precisely defined as the reduction of a portfolio's firm-specific risk. The current interpretation, Black argues, leads pension fund managers to thoughtlessly imitate their peers, prompting them to engage in extreme overdiversification.²³⁶

This argument is unpersuasive on several counts. First, as I noted in Part II of this Article, financial intermediaries, including pension funds, are not overdiversified. As Posner and Langbein suggest, if a modernized fiduciary concept were applied to pension fund management, it would mandate broad diversification, not activist investment.²³⁷ Indeed, when the risks of institutional activism are properly understood, it is difficult to see how they would be consistent with any modernized conception of the fiduciary duty.

Second, the employee beneficiaries of pension funds already bear large amounts of firm-specific risk. Ultimately, the single largest asset of any private pension fund is the expectation that the sponsoring firm will to continue making contributions to the fund. Furthermore, employees almost inevitably specialize their human capital in their employer firm, exposing each employee to still more firm-specific risk. Risk-averse employees should look for ways to reduce their firm-specific risk exposure. They are unlikely to approve of investments that shift the risks of shareholder activism to them, if they understand what is

232. See BRANCATO & GAUGHAN, *supra* note 1, tbl. 10.

233. Employment Retirement Income Security Act, 29 U.S.C. §§ 1001-1461 (1994).

234. See generally Langbein & Posner, *supra* note 119, at 1-6; Langbein & Posner, *supra* note 71, at 5-6 (discussing the evolution of laws governing trustee investment powers).

235. See Black, *Shareholder Passivity*, *supra* note 2, at 553-54.

236. See *id.*

237. See Langbein & Posner, *supra* note 119, at 18-30.

going on.²³⁸ Pension fund beneficiaries may not bear all of this risk because of government guarantees, of course, but this is another example of a moral hazard problem that may ultimately result in significant costs to taxpayers.²³⁹ The fact that public pension funds are already leading shareholder activists suggests that this moral hazard may already be a significant problem.

Pension funds should not expose their beneficiaries to the risks of shareholder activism. To the extent that beneficiaries can control the management of funds and can assess their risk exposure, they would probably oppose activism. To the extent that beneficiary control cannot serve this purpose, fiduciary principles ought to require that beneficiaries be protected from this risk. If the fiduciary doctrine for pension funds is to be changed, it should make activism more difficult, not easier.²⁴⁰

CONCLUSION

The focal point of the political model is "the political and historical contingency of the American pattern of corporate governance."²⁴¹ According to this approach, the characteristically American forms of corporate finance and governance are "as much a creature of the American pattern of law and politics as the handiwork of neutral market forces."²⁴² Most objectionable to political model advocates is the passivity of large American institutional shareholders. Political model scholars suggest that if legal reforms removed obstacles to institutional activism, a new paradigm of American corporate governance could emerge.

There is no doubt that the complex tapestry of American corporate finance is partly the result of the unique political history of this country.

238. According to a presentation of Professor Deborah Weiss at the 1996 annual meeting of the American Law and Economics Association in Chicago, private pension funds are often grossly underdiversified. It is difficult to believe that workers fully appreciate the risks to which this underdiversification exposes their retirement savings.

239. See *supra* Part IV.C.

240. For an account by two CalPERS officials of fiduciary principles that apply to public pension funds, see Richard H. Koppes & Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund Through Relationship Investing*, 20 J. CORP. L. 413 (1995). Another commonplace that could have served equally well as the title of this article is "having our cake and eating it too." Koppes and Reilly seem to be arguing that large pension funds such as CalPERS should be able to manage their portfolios largely passively, and thus avoid the higher fiduciary standard that active investment strategies invoke, while at the same time remaining activist with respect to selected portfolio firms. The article lends some support to my contention that public pension fund activism is an instance of, and not a solution for, agency costs.

241. Gilson & Kraakman, *supra* note 85, at 985.

242. *Id.*

The same is doubtless the case for the financial and corporate institutions of Germany and Japan, which have histories of their own.²⁴³

Nonetheless, we do not need to view the traditional passivity of large American financial institutions as an anomaly requiring a special historical explanation. This Article argues that shareholder passivity makes sense in light of the fundamental function financial intermediary institutions perform. Institutions such as banks, pension funds, and insurance companies gather vast amounts of capital from millions of mostly far-from-wealthy people who have, in a sense, fairly simple financial needs. Robert Merton's model paints an intuitively appealing picture of the core function of financial intermediation—the provision of guarantees to risk-averse customers who cannot manage risk effectively on their own. This function creates an apparent paradox: institutions accumulate enormous amounts of capital which, perhaps frustratingly to some, must be managed with the extreme sensitivity of financial customers to the soundness of financial intermediaries foremost in mind.

It is natural to think that the vast reserves of capital in a leading insurance company or pension fund represent a reservoir of shareholder power that could, and therefore should, be used to reform corporations for the better. But this alluring promise is mostly illusory. The reason why pools of institutional capital are so big is that small risk-averse financial customers are so many. Unless they can be well insulated from the resulting risk, these customers would not do business with an institution which engaged in large scale political-model-style activism. Instead, they would take their business to more passive institutions.

From this perspective, the diversification and passivity of financial intermediary institutions does not look like the product of politics. Rather, it looks like many other products of economic evolution. It is a system whose implicit and elegant logic emerges as we realize the costs of doing things any other way.

If this account is true, passive institutions will have a distinct competitive advantage over more activist institutions. In increasingly global financial markets, competition of this kind may be inevitable. If so, as world financial markets become more open and competitive, it may be

243. See RONALD J. GILSON, CORPORATE GOVERNANCE AND ECONOMIC EFFICIENCY: WHEN DO INSTITUTIONS MATTER? (Stanford Law School, John M. Olin Program in Law and Economics Working Paper No. 121, 1995). Gilson's paper illustrates that the political model account of the historical contingency of American (and German and Japanese) financial institutions has become quite nuanced. In Gilson's terms, I contend that financial systems probably *will* converge, *cf. id.* at 12, and that something like large financial intermediary passivity will be one of this country's contributions to the resulting model. While the elusive idea of path dependency is appealing in some ways, a more plausible account ultimately, I suggest, is that German and Japanese financial systems owe relatively more to political interventions than does the American system. These are all matters that deserve further work by corporate scholars.

not American financial intermediaries that will come to look more and more like their German and Japanese counterparts, but rather the other way around. It is also possible that German and Japanese institutions, to the extent that they really are fundamentally different from American institutions, might be the product of more, not less, political intervention than are their American counterparts. Given the comparative political histories of Japan, Germany, and the United States since the 1930s, this suggestion is hardly implausible. This Article obviously does not make this case, but it does suggest the inquiry may be worth pursuing.

By arguing that institutions are inherently passive, I do not mean to endorse current American managerial practices. I merely contend that reforms of corporate managements are best left to entrepreneurs, who are willing to bear the substantial firm-specific risks implicit in managerial reform. Over time, passive institutions will benefit from successful entrepreneurial innovations and reforms as they pass market tests and become standard practice. Finally, some of the reforms political model adherents propose should probably be enacted, not because they would lure institutions into the fray of corporate governance, but because they would help entrepreneurial investors to reform corporations controlled by sub-optimal managers. Institutions and entrepreneurs perform distinct but complementary functions in American corporate finance.